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Is copper demand showing signs of strain?

Copper prices have a strong historical correlation to stock prices. Significant divergences in the relationship between the two markets should therefore be noted. Since the beginning of 2011, the Dow Jones Industrial Average is up 7.8%, while copper prices have *fallen* by 9.4% (Chart 1). Even during the recent drubbing taken by commodities, stocks outperformed copper by a wide margin. The free ride on the commodity-bull-market train may have ended. Markets without bullish fundamentals could drift back to price levels more reflective of their supply and demand realities. Is copper headed in that direction?

Perception of Chinese demand continues to be the primary market mover. Data released on May 2 showed that China's purchasing manager's index for April missed expectations and fell below the March level, further pressuring an already weak copper market, sending prices to a seven-week low. Traders fear that tightening measures – among other government efforts – to slow the economy have been effective and will soon result in falling prices for commodities, which were driven up mainly by huge Chinese purchases.

The outlook for other regions, notably the US, has not been helpful. Most US data have been pointing to a softening of the economic recovery. Manufacturing activity has been disappointing, and labor statistics have been particularly weak. The disappointing outlook has helped push copper prices down further to test the $4-per-pound level.

Inventories at LME, COMEX, and Shanghai warehouses rose sharply from the beginning of the year through the end of March, which provided a backdrop for falling prices (Chart 2). Studying exchange warehouse stocks for clues to disappearance may have become a relic of the past. The story of off-exchange stocks being held in bonded warehouses in China continues to spook bulls. Imports that allegedly were never intended for industrial consumption are accumulating. When we first made mention of these inventories in February, the stockpile was reportedly 500,000 tonnes. According to the strictly anecdotal evidence, that number has grown to 700,000 tonnes.

Chinese importing behavior has flashed signals in both directions. Data for February – reported at the end of March – showed a steep 35.6% drop in refined copper imports from January, to a 27-month low (Chart 3) of 158,000 tonnes. That news certainly gave some credence to the over-burdened bonded-warehouse story. One month later, however, March imports snapped back, with a 21% increase over February, to 192,000 tonnes.

According to the International Copper Study Group's (ICSG) comprehensive global summaries, however, a scenario of collapsing demand has not materialized. For 2010, the global balance sheet ended with a deficit of 305,000 tonnes. The early forecast for 2011 calls for a deficit of 377,000 tonnes. Although the 2011 deficit estimate was lowered by 20,000 tonnes from the previous ICSG forecast, the size of the deficit is still staggering – assuming it remains that way. ICSG has not reported much data for 2011. The most recent month in its study is January, which started off the year with a 20,000-tonne deficit.

ICSG estimates that global refined production will grow by 3.48% in 2011, down from a 4.43% increase in 2010. Thus far, that forecast seems to be accurate, with production in the world's largest copper-producing nation off to a slow start in 2011. Chilean output for the first quarter is down slightly from the same period in 2010. The ICSG is also calling for slower consumption growth of 4.08%, compared with very strong demand in 2010, which expanded by 6.76%.

The demand component, of course, is the key. Much of that demand comes from Chinese imports, and if the flood-

Inside

Cocoa: Will peace tame the bull? 3
Corn: Crop report story 4
Sugar: Revised output: bullish or bearish? 5

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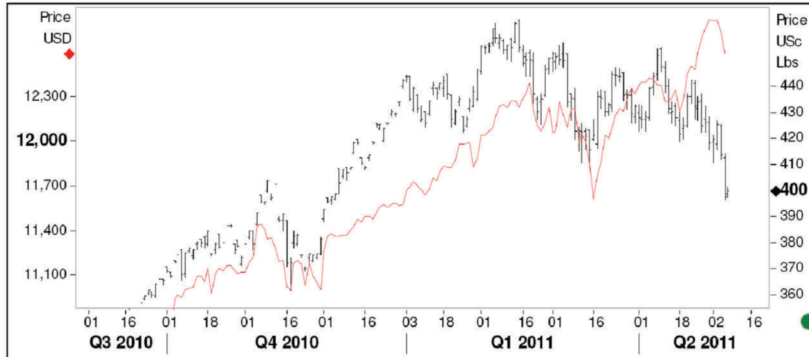
gates of the bonded-warehouses ever open, we would expect overseas purchases to shrivel. The ICSG deficit estimates are highly scrutinized in some circles because of the potential overhang of unreported Chinese inventories. The outlook for the demand-side fundamentals remains extremely murky.

We were stopped out of our long position at $4.25 per pound, as per our February 25 recommendation. Remain sidelined. *[May 6, 2011]*

Chart 1 – July copper (bar), Dow Jones Industrial Average (line)



Courtesy Reuters

Chart 2 – Global copper exchange warehouse stocks

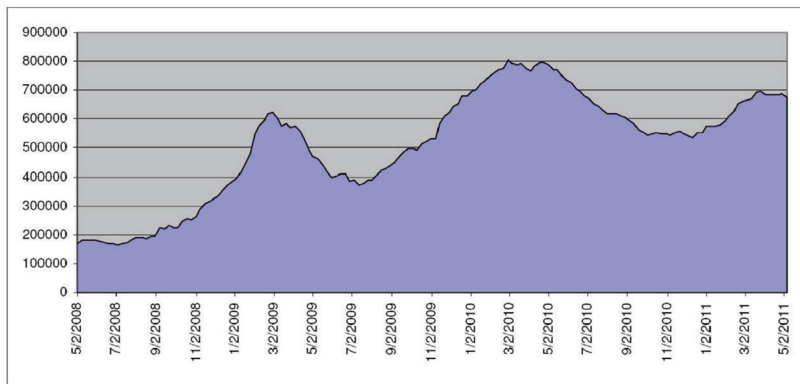
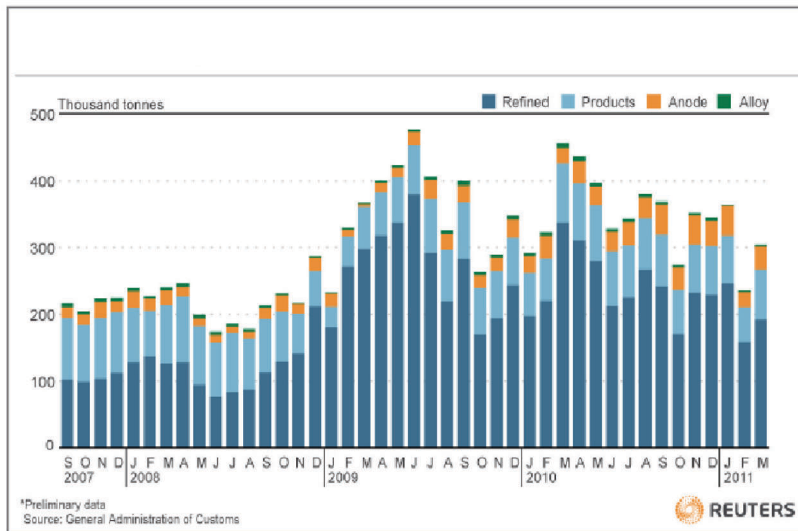


Chart 3 – Monthly Chinese copper imports



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COCOA

Is peace in the Ivory Coast enough to tame the cocoa bull?

The war in the Ivory Coast is over. Mr. Ouattara has moved into the Presidential offices. EU sanctions have been lifted, and the internal feud regarding exports taxes seems to have been defused. The 500,000-tonne mountain of cocoa beans that has been awaiting export is slowly being loaded onto ships destined for European chocolate manufacturers. West African neighbor Ghana has seemingly compensated for temporarily unavailable Ivorian beans. By all rights, cocoa prices should be coming down, yet they seem to be holding support levels (Chart 4).

For a number of years, Ghana set a target for 1.2-million-tonne annual production. While output hovered between 600,000 and 700,000 tonnes, we were skeptical all along that the lofty targets could ever be reached. While the Ivory Coast has grabbed all the headlines over the past several months, Ghanaian arrival rates were skyrocketing to record levels. As of the most recent report, Ghanaian arrivals are up 54% over the same period in 2009-10. The current government estimate for the total crop, which includes the mid-crop, is 920,000 tonnes, compared with 632,000 tonnes in 2009-10.

There has always been some confusion regarding both Ivorian and Ghanaian production data, because there was substantial smuggling from Ghana to the Ivory Coast, where farmers received higher prices. It's impossible to know the actual amounts, but 100,000 tonnes annually is the figure usually cited. The turmoil in the Ivory Coast, however, has turned the tables. This season Ivorian farmers were content with being able to sell their beans – period. So the beans flowed the other way, into Ghana. Ghanaian government officials speak proudly about innovative farming techniques, but analysts continue to doubt Ghana's ability to ramp up production by 50% from one season to the next.

Ghana has been trying to expand production and improve yields, so it's reasonable to assume that the reported large crop did account for part of the inflated arrival pace. But analysts say that as much as two thirds of the increased "output" figure includes smuggled Ivorian beans. If this assessment is accurate, it would mean that Ghana had a good year, but achieved nothing more than meeting the top end of its historical production range. Ghana may have finally taken the spotlight in the headlines, but the bearish impact should be limited once market participants absorb the dynamics.

Ivorian exports have resumed, but it seems that the existing infrastructure cannot accommodate shipping 500,000 tonnes of cocoa in a short period of time. Typically, monthly exports at the peak of the main crop season would total about 100,000 tonnes. Analysts estimate that 50,000 tonnes of beans will be loaded by the end of May. So in the short term, the market will remain somewhat squeezed, even as the beans start to reach their European destinations.

Ivorian officials maintain their original 2010-11 output forecast of 1.3 million tonnes. Doubtful. As illustrated, a good chunk has made its way to ports in Ghana and is being counted as that country's output. The Ivorian mid-crop, which was expected to reach 300,000 tonnes, is now estimated to reach only 200,000 tonnes because of labor problems, mostly involving difficulty in getting workers to stay on plantations where they feel their lives are in danger.

There have been no indications that the 500,000-tonne stockpile has deteriorated in quality. We question, however, whether storage facilities, which were likely never designed to hold 500,000 tonnes of cocoa beans all at once, will prove to be adequate in terms of the proper ventilation required in a tropical climate.

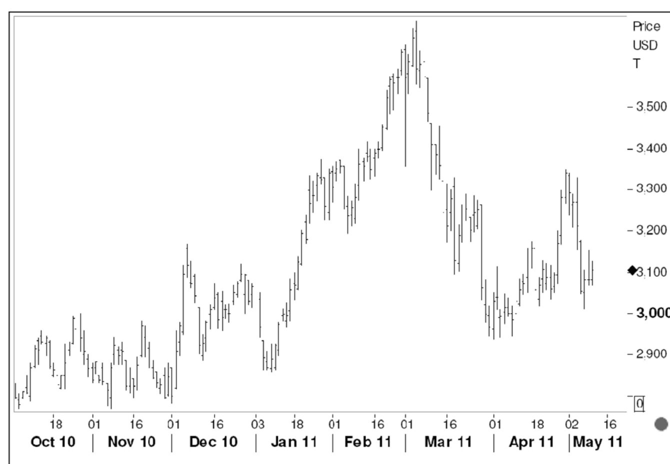
On the demand side, first-quarter grind results reported in April were mixed. The European grind grew by 3.5% over the same period in 2010, at the high end of expectations. The North American grind was up only 2.1%, at the low end of analysts' guesstimates. Butter ratios remain weak.

This bull market was never about demand, though. Analysts continue to forecast a global surplus, with some estimates running as high as 185,000 tonnes, compared with a 2009-10 deficit of 66,000 tonnes. Perhaps, if the wall of Ivorian cocoa beans makes its way to market in a timely fashion and the quality has not been compromised.

We remain bullish and advise hanging on to long positions. Use a $2,900 stop close, basis nearest month.

[May 11, 2011]

Chart 4 – July cocoa



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CORN

Don't judge the crop report by its cover

The May USDA crop report presented the first comprehensive look at corn for the new marketing year, which begins on September 1. Together with some revisions to the current marketing year, the report painted a bearish picture for the US corn market. With a limit-down selloff in old-crop months and a sharp drop in new-crop months in the session that followed the release of the data, traders certainly viewed it that way (Charts 5 and 6).

The March 31 quarterly stocks report showed significantly lower US inventories than expected. Analysts therefore expected any crop-report revisions to slant to the bullish side. The average guesstimate for US 2010-11 ending stocks was for a moderate drop to 661 million bushels, down from the 675-million-bushel April estimate, but the estimate was revised upwards to 731 million bushels. The results should not have been much of a surprise. Domestic consumption was not changed, only the export estimate was lowered by 50 million bushels, which merely reflected the recent sluggish pace of old-crop sales.

Analysts were off with their forecasts for the new crop as well. The USDA estimate for US ending stocks for 2011-12 was 900 million bushels, up from the average guesstimate of 808 million bushels. Based on March 31 acreage estimates and a significant increase in the estimate for yields, to 158.7 bushels per acre, the new crop is expected to jump to a record 13.505 billion bushels, 8.5% larger than 2010-11 output.

The demand side was bearish as well. Only ethanol usage is expected to grow, by 50 million bushels, to 5.05 billion bushels. Domestic feed is forecast to slip back by 50 million bushels from 2010-11, and exports are expected to fall by 100 million bushels.

While the market's reaction was commensurate with the headlines, a closer look reveals that the US farmer has accomplished little in the way of addressing the expanding global demand. First, even when looking at the data in the context of the US alone, this early forecast puts US 2011-12 ending stocks at 6.7% of usage, up from the dangerously low inventories of the current marketing year of 5.4%. Average ending stocks from 2000-01 through 2010-11 were 13.7% of consumption, a level which bred the current bull market to begin with. So at 6.7% of usage, it is hardly a stretch to say that stocks are still in the "dangerously low" zone.

Then, on the global front, output is forecast to grow in all major producing nations. The USDA estimates that global production will jump by 6.4%, while consumption will increase by only 2.6% from 2010-11. After two consecutive years of production/consumption deficits, inventories will expand, but by a negligible amount. Ending stocks for 2011-12 will inch up to 15% of consumption, only marginally higher than 14.6% estimated for 2010-11 and still near record modern-day lows.

As mentioned earlier, the US corn-production estimate is based on a 4-million-acre increase in corn area. Heavier-than-normal precipitation has slowed planting in most corn-growing regions. Devastating flooding is some areas will result in acres being lost to corn altogether, because those regions will not dry up before the planting window for corn has closed. Soybeans, which can be planted later, will see greater-than-expected output. As of the most recent planting progress report, only 40% of the corn crop had been planted, compared with 80% last year, and the 5-year average of 59%.

The expected increase in US output represents over 50% of the increase in global output. If that mammoth jump in production seemed in jeopardy, ending stock estimates would drop quickly.

Although not an imminent concern, bears point to the fact that the growth of US ethanol demand is based solely on generous government subsidies, which survived the last round of legislative challenges, but may not do so indefinitely. In less than 10 years, ethanol usage in the US has gone from being a footnote in the industrial section of the USDA balance sheet to all but equaling feed usage. The May crop report estimates 2011-12 feed consumption at 5.1 billion bushels and ethanol usage at 5.05 billion bushels. Which on the one hand illustrates clearly why farmers have had such a struggle keeping up, but on the other should make bulls worry what would happen to prices if there was a successful legislative drive to eliminate subsidies.

We view the recent setback as a correction in a long-term bull market. The output increases still leave global inventories at very vulnerable levels.

Remain long old- and new-crop contract months.

[May 16, 2011]

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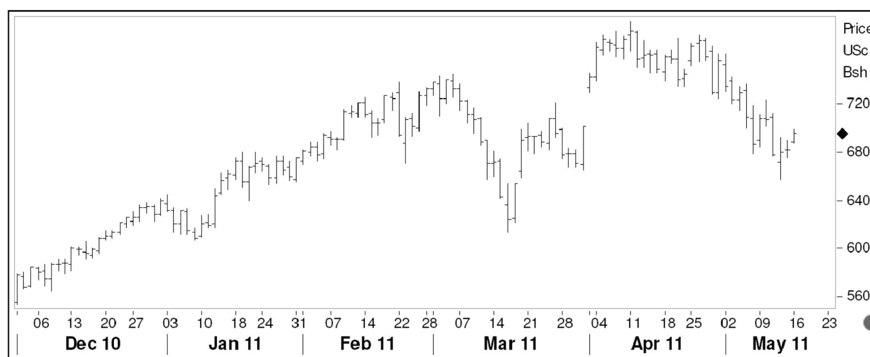
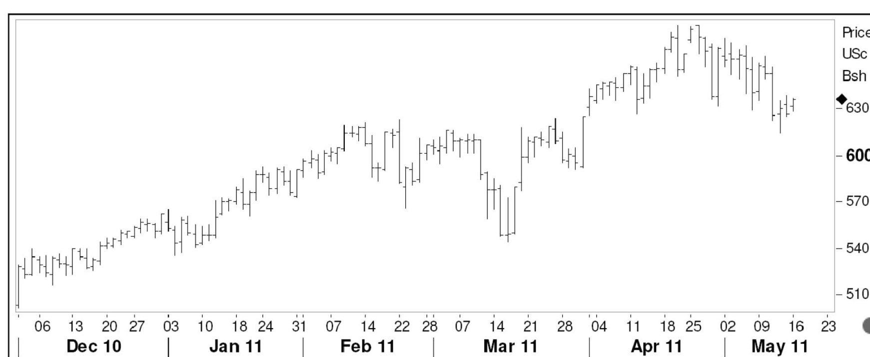
Chart 5 – July corn



Courtesy Reuters

Chart 6 – December corn



Courtesy Reuters

SUGAR

Unexpected output revisions: bullish or bearish?

Sugar prices spiked to 36¢ per pound in February. It was short-lived, though, because while prices were at multi-decade highs for a good part of the past several years, farmers in sugar producing nations were expanding acreage to take advantage of the high prices (Chart 7). As a result, the global balance sheet moved from deficit in 2009-10 to a small surplus in 2010-11. As the season progressed and individual country estimates became more accurate, prices had nowhere to go but down.

Among key producing countries, India has returned to normal levels after two consecutive drought-afflicted seasons. With current estimates at just below 25 million tonnes, the size of Indian output has not varied very much since early acreage-based estimates were released.

A major factor that facilitated the drop in sugar prices over the past few months is Thai production. Annual production has averaged about 7 million tonnes in recent years. Early season estimates put 2010-11 output at 6.8 million tonnes, but as the harvest season wore on, it became clear that yields were going to be extraordinary. Based on recovery rates thus far in the crushing season, analysts expect total output to reach 9 million tonnes. This leaves 3 million tonnes of previously unexpected sugar available for export to the Asian market.

Pakistan also surprised with output of about 300,000 tonnes more than anticipated.

The record cane crop forecast for Brazil certainly contributed to the drubbing the market has taken. However, just over the past week, statistics regarding the progress of the Brazilian crush have emerged, which may very well have halted the slide in prices.

A very wet April made harvesting extremely slow. By May 1, sugar and ethanol processors had crushed only about 30% of the volume that they had last year at this time. Yield has suffered because of the weather as well. At present, sugar content is estimated to be down 11% from last year. It will dry up eventually, and the harvest will accelerate. However, it would seem that some irreparable

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damage to total output has occurred.

Moreover, in the early part of the crushing season, the ethanol/sugar ratio tends to be higher, because the cane's sugar content is not as rich as it is later in the season, which makes ethanol production more profitable. The forecast for the ratio for the 2010-11 marketing year is 54.7/45.3 in favor of ethanol, which is lower than the average ratio of recent years. Industry analysts are reporting that the ratio is currently running at 64.6/35.4.

Over the past few months, ethanol prices rose sharply, and although prices of sugar were at multi-decade highs as well, ethanol production had an edge. An extremely high rate of ethanol output was the obvious result.

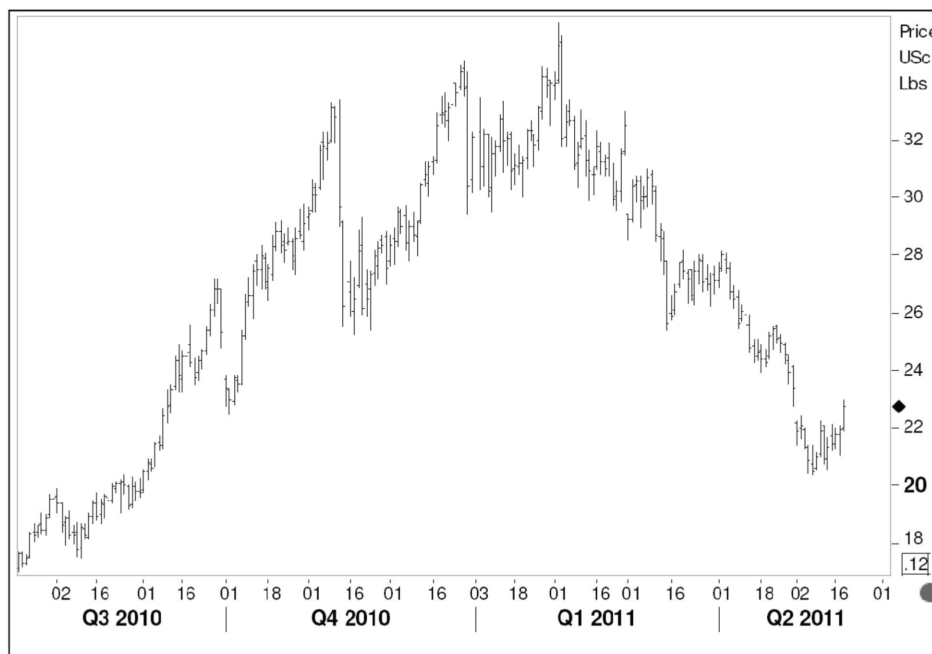
As ethanol from the new crop became available, however, ethanol prices fell as sharply as they had risen. But sugar prices fell too, so it will be very interesting to watch carefully for ratio estimates as the crushing season progresses. Either way, sugar output has taken a hit, and we believe it is very unlikely that the 35-million-tonne estimate for the center-south region, which grows 90% of Brazilian cane, will stand.

The two big surprises – bearish from Thailand and bullish from Brazil – may cancel each other out.The two big surprises – bearish from Thailand and bullish from Brazil – may cancel each other out.

Early forecasts for 2011-12 are looking for a comfortable surplus. The range of estimates is wide, from 3 million tonnes to 10 million tonnes. The optimistic surplus forecasts for both 2010-11 and 2011-12 seem to have included the Thai revisions, but probably have not accounted for the full potential impact of the bullish Brazilian estimates.

We believe the market has fallen too hard and too fast. Despite the best efforts of farmers around the globe, it seems that the 2010-11 balance sheet will remain in a deficit position after all. Current price levels present an excellent low-risk opportunity to enter the long side. Buy October sugar at the market. Place initial sell stops at 20.50¢ per pound, close only. *[May 18, 2011]*

Chart 7 – Nearest contract ICE sugar



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