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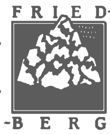

Volume 3, No. 11 December 4, 2000

Is the recent weakness in copper prices just a correction?

After chalking up recovery highs not seen since the autumn of 1997, copper prices reversed in mid-September and have since fallen almost 15% (Chart 1). Has this budding bull market come to an abrupt halt, or are we merely facing a correction?

There are arguments to support either approach. The bearish case is based primarily on the belief that demand will contract as the economy begins a slowdown. There is some evidence of such worries. In its November report, the International Copper Study Group (ICSG) said that demand from January through August was 10.1 million tonnes compared with 9.4 million tonnes during the same period last year, an increase of 7.6%. Mine production in the same period grew at a much slower 1.3%. The combination of increased consumption and tepid output growth leaves us with a global deficit of 400,000 tonnes for the year thus far.

On the surface it would seem that this configuration would augur well for continued strength in prices. However, a closer look reveals that the pace of consumption has slowed. There was a surplus of 55,000 tonnes for August compared with a deficit in July. Last month ICSG reported that demand was running 9.3% ahead of the comparable period in 1999 with mine output at about the same level as this month. With anecdotal evidence of Chinese imports drying up in the second half of the year, these figures seem to depict an accurate picture of the copper market and explain why the multi-year highs couldn't hold.

Indeed, it would be difficult to refute ideas that the prices of copper and other industrial commodities are not affected by a clear change in direction of economic activity. Still, we believe that there is a bullish case as well.

While enduring bull markets are almost always fueled by demand, we cannot ignore the supply side of the equation. The era of rampant growth in world production is over. Mines with cash costs that are high enough to challenge profitability have been closing over the past two years. There has been no significant news of any mining companies restarting production because of higher world prices. Energy costs form a significant portion of mining costs. Soaring crude oil and natural gas costs have probably delayed any recovery in high-cost mining indefinitely.

More interesting, though, is that we have seen a similar pattern in areas where profitability has not been an issue. Chile's Codelco, the world's largest copper mining company, whose cash costs are about 42¢ per pound, reported on November 8 that it produced 1.09 million tonnes of copper in the period between January and September, roughly the same as the same period in 1999. This compares with output growth of double-digit percentage rates in the past few years.

Although demand has clearly tapered off recently, consumption in the first half of the year was strong enough to draw copper stocks down sharply. Consider: At the end of the period in the ICSG's report, inventories stood at 1.1 million tonnes, or 10.8% of consumption, compared with 1.5 million tonnes at

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the end of the period in 1999, or 16% of consumption.

We also believe that an extraordinary event has put a lot of pressure on copper prices recently and that it had little to do with the supply/demand fundamentals. Aur Resources, a Canadian mining company, completed a formidable copper hedging program that was required to secure financing for the purchase of a Chilean mining company. According to a press release on November 10, the company sold forward the equivalent of 14,000 contracts of copper. It is not inconceivable that such a large order would not only keep prices from rallying in a situation where they otherwise might have, but would actually force prices down.

In summary, we acknowledge the slowdown in demand. At the same time, we believe that with a deficit of 400,000 tonnes, consumption would have to fall dramatically through the end of the year to bring the market anywhere close to balance. We therefore believe that the recent slide in prices was a bull market correction. *[November 19, 2000]*

CURRENT STRATEGY: *Remain long March copper as per Flash Update of November 15. Raise stops at 82.90, close only.*

Chart 1
December Copper

Chart courtesy of *Reuters*

WHEAT

A wakeup call for wheat bulls: sluggish exports but an equally sluggish winter wheat crop

Wheat prices continue struggling. Perhaps they shouldn't be. The supply side has certainly provided ample ammunition for a rally. The fate of the US winter wheat crop is the most bullish development we've seen. Seeding was delayed because of dry weather that left fields bone-dry and unplantable. After farmers finally received enough rain to get the crop in the ground, the precipitation overstayed its welcome and is hindering the emerging stage.

The optimum period for planting has passed. The latest USDA crop progress report shows that as of November 19, 91% of the winter wheat crop had been planted compared with the 5-year average of 97%. To illustrate the significance of having the crop planted on time, consider that at this point in the 1999-00 season, 96% of the crop had been planted and output was 1.7 billion bushels. This past season, 88% of the crop had been planted at this juncture and yielded 1.56 billion bushels. This, despite the fact that acreage was virtually identical both seasons.

How big will the crop being planted this autumn be? Sparks Commodities released an estimate on November 17 that puts total US winter wheat acreage at 41.6 million acres, or 4% smaller than last season's. This would represent the smallest number of acres planted in 20 years. Yield per acre for last year's winter wheat crop – at 44.6 bushels per acre – was the lowest in several years. Even if we assume that yields will recover somewhat to, say, the 3-year average of 46.4 bushels per acre and farmers harvest 82.5% of planted acres (also the 3-year average), the crop would come in at 1.59 billion bushels. This would be the best-case scenario. A more likely and less optimistic outcome – given the poor planting conditions – would be yield performance similar to last year and a winter wheat crop of 1.53 million bushels, the smallest since the 1996-97 season.

Most of the US winter wheat crop is hard red wheat, which is used for making bread. The hard red wheat winter (HRW) portion of the 1999-00 crop was 10% smaller than the 1998-99 crop. The 2000-01 HRW crop was 20% smaller than the 1999-00 crop. While estimates of ending stocks of hard wheat (winter and spring combined) at 40% of consumption (43% last year) are still consistent with stock levels of the past few, bear-market, years, we believe that the market price reflects complacency (Chart 2).

To maintain the cushion of a comfortable level of ending stocks, we would have to hope that we could eventually bounce back with decent crops, which as illustrated above does not seem likely for the 20001-02 marketing year. We

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must also assume that consumers of wheat will continue with just-in-time buying patterns that have become commonplace these past few years.

The export market has been dull. The November 16 weekly USDA export figure stirred some optimism that buyers were finding their way back. The USDA reported new commitments of 741,000 tonnes, 45% above the 4-week average, and the highest tally in as long as we can remember. Those hopes were dashed, however, with this past week's exports figures of 375,000 tonnes, which came in at the low end of analysts' estimates.

The soft export market has been blamed by some on the strength of the US dollar, which remains as strong as ever. The USDA's estimate for global imports, however, is up a tad from last year. It is not as if consumption has actually fallen; rather, it has shifted. Argentina has seen an increase in export activity. Exporters have sold 11.2 million tonnes of old crop wheat so far this year compared with 7.3 million tonnes at this time last year. New crop exports are running at 3.3 million tonnes compared with 1.8 million tonnes at the same time as the previous year. Global demand is not quite as dead as it would appear from observing the US market in isolation.

Another recent development that the market has largely ignored has been the unwelcome rains in Australia, which will lower the already battered crop by another 1 million tonnes (to 20 million tonnes compared with the November USDA estimate of 21 million tonnes and last year's 24 million tonnes). Even more devastating is market talk that 4 to 5 million tonnes will be downgraded from milling quality to feed grade.

The ratio of availability of hard wheat to soft wheat is shrinking. This can be seen in the ratio of the price of Kansas City Board of Trade wheat (HRW) to Chicago Board of Trade wheat (soft or hard wheat). See Chart 3.

Open interest has ballooned to record highs and is laden with net speculative long positions, which makes us a bit uncomfortable. Still, the supply-side fundamentals are doing their job for the bulls. As long as exports remain sluggish, the market will muddle along. If, however, there is pent-up demand waiting on the sidelines, perhaps anticipating a weaker US dollar, we could see much higher prices in the months to come. *[November 27, 2000]*

STRATEGY: *Keep a close eye on weekly export reports and stay tuned.*

Chart 2 – Wheat Monthly

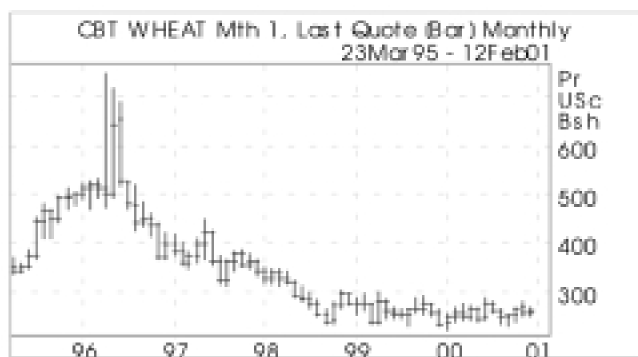

Chart 3 – "Ratio Kansas City/Chicago Wheat

Charts courtesy of *Reuters*

GOLD

Precious once again?

Talk to a gold bug about "precious" metals and you'll likely find a frustrated investor bristling at your choice of adjective. After all, what's so precious about a market that has been tumbling for about 20 years (Chart 4)? Those who took the equity route by owning mining stocks fared no better. Gold stocks, as measured by the Philadelphia XAU Index of primary gold producers, have shed some 25% of their value in the past 5 years (Chart 5), bypassing the meat of the stock market's glory days.

Three major factors have kept gold prices weak – producer hedge sales, central bank sales, and a strong US dollar. In its September report, Gold Fields Mineral Services (GFMS) said that producers sold a net total of 497 tonnes of gold forward in 1999. It estimates that net producer hedging for 2000 has dried up completely. For now, the bearish impact of producer hedges is gone. If anything, the years of active hedging could be a bullish factor when and if the hedgers decide to cover. The other two factors are still present.

While these bearish influences have not only maintained a presence, but have actually grown in stature (i.e., the dollar has been making new highs this year – see Chart 6) and central bank sales have increased, gold has not made a new low since August 1999 (Chart 4).

Presumably, if one had a strong opinion about continued dollar strength, it would be difficult to make a case for

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a recovery in gold prices, given that gold has, by and large, tracked the dollar over the years and will probably continue to do so. The discussion would end right here. We, however, have somewhat of a bias towards a weaker dollar. While this is not nearly enough of a reason to be long gold, it certainly provides us with a backdrop against which to build a case that would be friendly towards gold prices.

As far as central bank sales are concerned, GFMS estimates that central banks will sell 596 tonnes in 2000 compared with 420 tonnes in 1999. We've argued in previous articles that more systematic and transparent central bank selling would ease downward pressure on prices, regardless of the amount of gold sold. This is exactly what has occurred since the European Central Bank announced in 1999 that member countries had agreed to limit sales to 2,000 tonnes over a five-year period.

There have been many financial and geopolitical crises over the past decade. Aside from the occasional hiccup, gold prices barely stirred. Actually, gold traders were correct in assuming that financial markets would weather each storm. Stocks (technology and otherwise), bonds, and derivatives were a better bet. Many risky investments – mistakenly of course – were confused with gold's traditional role, that of a store of value.

But the world has changed, the stock market has taken a nasty fall. The Nasdaq, the nouveau store of value, has dropped 45% since this past spring. Many widely held technology stocks have fallen by anywhere from 50% to, well, 100%. Other stocks have not dropped as much – yet. The asset bubble is bursting.

Investors are going to demand value for their investment dollar – a sure sign that the falling stock market is more than just another ho-hum correction can be found in credit spreads. Chart 7 shows that the spread between yields on 10-year AAA corporate bonds and 10-year Treasuries has widened to record levels, indicating clearly that investors are concerned and are demanding to be paid for taking risk.

Aside from the reasons described above, gold has been in a bear market because investors have been conditioned not to worry. Ever since the market survived the crash of October 1987, it seemed that the market would always survive. This conventional wisdom is now under attack and, assuming that gold's structural problems (dollar, and hedger and central bank sales) don't get in the way, the stage is set for a return to golds's traditional role as a safe haven.

While it is premature to declare the end of the bear market, we do believe that a cautious probe of the long side is warranted. *[November 29, 2000]*

STRATEGY: *Remain long February gold as per Flash Update of November 17. Raise stops to 266, close only.*

Chart 4 – Spot Gold

Chart 5 – Philadelphia Gold Index

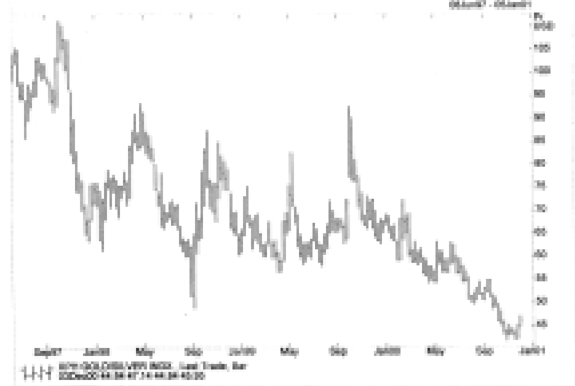

Chart 6 – US Dollar Index

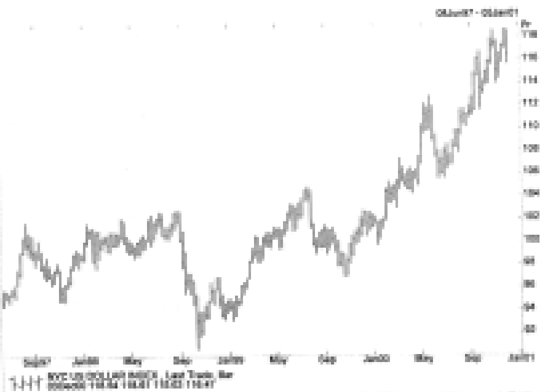

Chart 7 – Yield Spread Between 10-Year AAA Corporates and US Treasuries

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SOY COMPLEX

Mad Cow sparks the bull

In our October 26 issue we attributed sagging soybean prices to a weak US dollar, but argued that importers had needs that would surface eventually. The market moved out of the gate when the Mad Cow Disease-scare surfaced. We were long the market at the time and were somewhat concerned that as soon as the panic died down, the market would retreat. Being the prudent and disciplined traders that we are, we snuggled our stop up and were promptly taken out on the first minor price correction. We are now watching helplessly from the sidelines. Beans have risen by 8% from our exit point; meal has rallied by 15%.

What about Mad Cow Disease? First, a brief history of the facts pertinent to soy-complex prices. Until the recent outbreak of the disease, Britain was the only EU country that had completely banned the use of bone and meat meal as an animal feed. Back in October, beef from a contaminated herd found its way to a French supermarket chain. By mid-November, the ensuing panic forced the French government to ban the use of T-bone steaks and meat-based animal feed. The ban quickly spread to other EU countries, such as Spain, Italy, Austria, and the Netherlands, which adopted strict measures to prevent the spread of the disease.

The ban manifests itself on the consumption of other protein meals in two ways. First and most obvious, EU farmers have to replace the banned bone and meat meal with alternate sources of protein. Second, we could safely assume that the consumption of meat will remain constant. The scare is likely to shift a significant amount of consumption away from beef and onto pork and poultry products. Here's the catch: Cattle consume almost no protein in their diet, while 12% of a hog's and 20% of a chicken's diet consists of protein meals.

While it might be difficult to quantify the exact impact the ban would have on the demand for soybean meal, it is not difficult to get a pretty good idea. The EU produces 3 million tonnes of bone and meat meal a year. The EU executive is holding an emergency meeting on December 4 to determine the merits of issuing an EU-wide ban on feeding bone and meat meal to animals. Were they to consider such a ban, farmers would have to replace the 3 million tonnes.

Not all the business would necessarily go to soybean meal. But considering that global soybean meal production represents 65% of all protein meal production, we could assume that much of the burden of replacing 3 million tonnes of bone and meat meal would fall on the soy market.

In its November supply/demand situation report, the USDA estimated that total EU consumption of soybean meal this year will be 26.64 million tonnes, down slightly from last year's 26.82 million tonnes. We can be certain that this figure will require revision. Already, the German oilseed publication, *Oil World*, said just the other day that EU consumption of soybean meal will rise by 6% in the 2000-01 season.

The USDA also lowered it estimate for US soybean exports to 25.86 million tonnes from its October estimate of 26.26 million tonnes (26.49 million last year). It lowered soybean meal exports to 6.44 million tonnes from 6.58 million tonnes (6.59 million last year). In the first full week since France issued the ban, the US did some robust soybean export business. Net new sale of 716,000 tonnes were near the high end of expectations and 16% above the 4-week average. Sales of soybean meal came in at 207,000 tonnes, 88% above the 4-week average, a marketing-year high and considerably above expectations.

With soybean commitments for the year so far slightly above the level they were at the same time last year, it is a given that the USDA will raise exports to at least last year's level of 26.49 million tonnes. Such a revision would draw US ending stocks down to 9.2 million tonnes, or a very bull-marketish 12% of consumption. Meal exports are still lagging last year's pace, but again, odds favor that the gap will be closed.

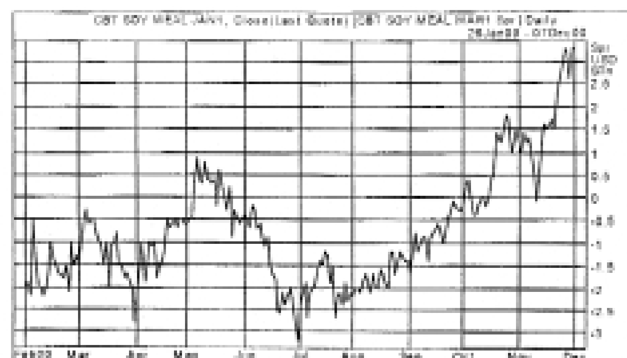
The Mad Cow affair has neutralized another bearish factor that plays on the minds of all wanna-be soy bulls: the probability of record Southern Hemisphere crops next spring. With EU farmers scrambling for supplies with which to feed their animals, prices could be forced higher before the first Brazilian bean is harvested. Ample proof of tightness is available. A very serious backwardation has developed in soybean meal prices (Chart 8).

As illustrated in our October 26 article, this market had bullish underpinnings without Mad Cow Disease. The crisis in the EU served only to highlight the crux of our point that the market was tight enough to be vulnerable to an "accident." The downside is that EU might not exercise its mandate to impose a full ban, in which case we would certainly see the market pull back. Being on the sideline, we will have the luxury of analyzing such a correction objectively.

We're very bullish, a bit frustrated, and waiting for an opportunity. *[December 1, 2000]*

STRATEGY: *Watch for dips and stay tuned*

Chart 8 – Spread Between January and March Soymeal



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HOTLINE UPDATE

***Flash Update* – Tuesday, October 31, 2000:**
Good morning for Tuesday, October 31, 9:10 am. This is a Flash Update. We have sold short December 10-Year Notes at 100-30, placing our initial stop at 102, close only.

***Flash Update* – Thursday, November 2, 2000:**
Good afternoon for Thursday, November 2, 2:30 pm. This is a Flash Update. We have purchased December silver at 480, placing our initial stop at 469, close only

***Flash Update* – Friday, November 3, 2000:**
Good morning for Thursday, November 3, 10:30 am. This is a Flash Update. We have liquidated our long December silver position at 475.

Friday, November 3, 2000:
Good afternoon for Friday, November 3, 4:20 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long January soybeans, with our stop revised to 471; long December cotton, with our initial stop at 59.95; and short December 10-Year Treasury Notes, with our initial stop at 102. All stops are close only.

***Flash Update* – Thursday, November 9,2000:**
Good afternoon for Thursday, November 9, 2:00 pm. This is a Flash Update. We have covered our short December 10-Year Treasury Note at 100-27.

***Flash Update* – Friday, November 10, 2000:**
Good afternoon for Friday, November 10, 2:05 pm. This is a Flash Update. We have liquidated our long January soybean position at 471.

Friday, November 10, 2000:
Good afternoon for Friday, November 10, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December cotton, with our initial stop at 59.95. All stops are close only.

***Flash Update* – Wednesday, November 15, 2000:**
Good morning for Wednesday, November 15, 9:15 am. This is a Flash Update. We have purchased March copper at 83.65, placing our initial stop at 79.75, close only.

***Flash Update* – Wednesday, November 15, 2000:**
Good afternoon for Wednesday, November 15, 11:45 am. This is a Flash Update. We have liquidated our long December cotton position at 64.50.

***Flash Update* – Friday, November 17, 2000:**
Good morning for Friday, November 17, 9:30 am. This is a Flash Update. We have purchased February gold at 269.80, placing our initial stop at 262.

Friday, November 17, 2000:
Good afternoon for Friday, November 17, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March copper, with our initial stop at 79.75, and long February gold, with our initial stop at 262. All stops are close only.

Friday, November 24, 2000:
Good afternoon for Friday, November 24, 2:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March copper, with our stop revised to 81.90, and long February gold, with our stop at 262. All stops are close only.

***Flash Update* – Monday, November 27, 2000:**
Good morning for Monday, November 27, 10:45 am. This is a Flash Update. We have purchased March sugar at 10.14, placing our initial stop at 9.25, close only.

***Flash Update* – Friday, December 1, 2000:**
Good afternoon for Friday, December 1, 12:00 pm. This is a Flash Update. We have liquidated our long March sugar position at 9.65.

Friday, December 1, 2000:
Good afternoon for Friday, December 1, 4:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March copper, with our stop revised to 82.90, and long February gold, with our stop revised to 266. All stops are close only.

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