FRIEDBERG'S
FOCUS ON FUTURES

Friedberg Commodity Management Inc.

Volume 4, No. 11 December 3, 2001

Copper: Desperate measures

Copper prices have been sinking for over a year now amid a deadly combination of falling consumption and rising production. According to the International Copper Study Group's (ICSG) most recent statistics, mine production in the first 8 months of this year has grown by 5.3% over the same period last year, to 9.07 million tonnes, while usage has fallen 2.7%, to 9.9 million tonnes. The plunge accelerated over the past few months while the economic slowdown bit deeper into demand. Producers with high production costs were choking. Any hope for a quick economic recovery was quashed on September 11.

It was obvious that keeping the global supply/demand balance from moving into an ever-growing surplus and prices from falling further would not be accomplished by the demand side. The market awaited production cutbacks, and on October 23, Phelps Dodge, the world's second largest copper producer, began what would become a series of cutbacks by major producers around the globe. The company announced that it would cut output from its North American operations by 220,000 tonnes.

Naturally, the market rallied on the morning the cutback news was released, but the reaction was muted. A rally of better than 2¢ per pound faded and copper closed out the session only slightly higher. Too little, the market was saying. The market proceeded to register yet another round of fresh contract lows.

But then another round of cuts propelled the market into a serious rally (Chart 1). On November 8, BHP Billiton announced immediate cuts of 80,000 tonnes at Escondida, the world's largest copper mine, and a further cut of 90,000 tonnes at its Tintaya mine in Peru. Then Codelco, the world's largest mining company said on November 9 that it would probably cut output in 2002. On November 13, Antofagasta said it would pare back production by a more modest 40,000 per year. Finally, on November 14 a group of Chinese producers said it would cut production by 100,000 in 2002.

ICSG's latest data show a global surplus of 339,000 tonnes through August compared with a deficit in the same period last year of 416,000 tonnes. The cutbacks will certainly erase this surplus. It is a fair assumption that the handsome rally we saw the past few days was caused entirely by the production cutbacks. There has been absolutely no indication that anything has changed on the macroeconomic front.

October US retail sales soared a record 7.1%. This was much higher than analysts' expectations of a 2.7% rise. However, after stripping away the 26.4% rise in auto sales, which benefitted from a 0% financing promotion offered by car manufacturers, the increase was a far more temperate 1%. Otherwise, economic data have been downright depressing.

LME warehouse stocks have doubled since May, to 740,000 tonnes. It is interesting to note that while copper prices continued to make new lows, LME warehouse stocks actually peaked in early October (Chart 2). During this period, the contango both in New York and London narrowed slightly as well (Chart 3).

The moves in these spreads have been subtle, however, and therefore it would be premature to declare a bottom. By the same token, it is the first significant pause in all these indicators since this major downleg in prices began in May. It might be an indication that the end of the bear market is near.

While the output cutbacks are artificial, in the sense that

In this issue

Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.com).

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the mines could bring production back on line if prices firm, they definitely have a tightening effect in the interim. During this adjustment period, miners could hope that the economic environment improves and that supply and demand come back into balance.

In the meantime, open interest is still huge, and commodity funds are heavily short this market. The desperate actions by mining companies are unquestionably a bullish factor and have sent speculators running for cover. Even after a drop of 10,000 contracts, the market is still chock full of shorts, and there is probably a fair bit of upside potential just from short-covering.

In conclusion, the production cutbacks alone will not end this bear market. Demand must return. We are on the sidelines, but monitoring the situation carefully. *[November 15, 2001]*

STRATEGY: *Stay tuned*

Chart 1 – December Copper & Production Cutbacks

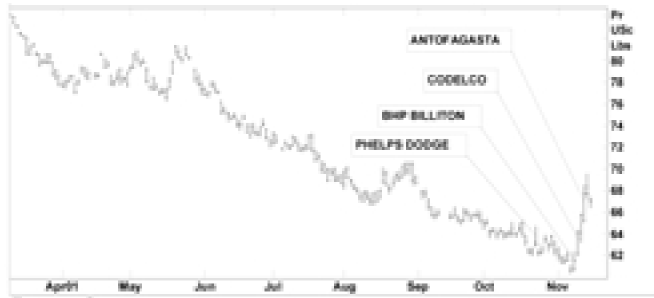


Chart courtesy Reuters

Chart 2 – LME Copper Warehouse Stocks

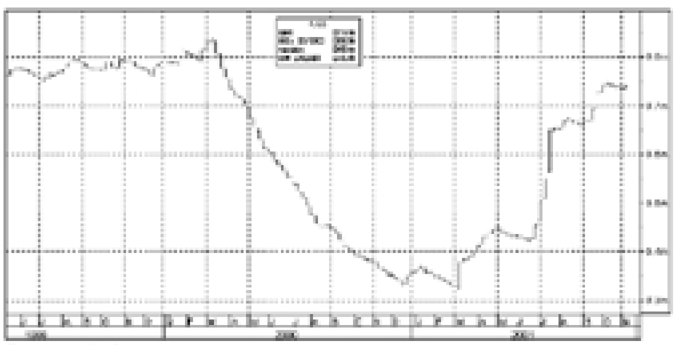


Chart courtesy Bloomberg

Chart 3 – Comex December/March Spread

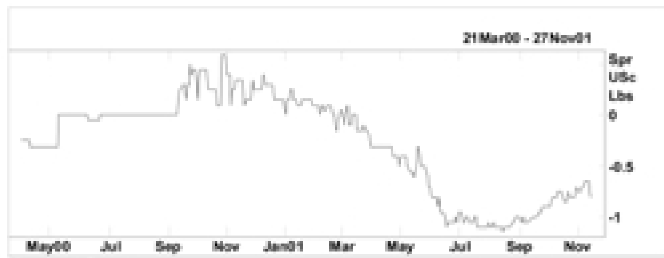


Chart courtesy Reuters

COCOA

The bull comes raging back

How could we have missed it? On November 7 cocoa prices exploded into a $300 per tonne, or 28%, rally. March cocoa was trading at just over $1,000 per tonne when we published our September 26 comment on the cocoa market.We showed a bullish bias by casting some doubt on E.D.&F. Man's assertions that the poor showing of the 2000-01 Ivorian crop was an anomaly and that the 2001-02 would recover to 1.3 million tonnes.

It now appears that those doubts were not unfounded. At this juncture of the marketing year, accurate data on arrivals are scarce. It is clear, however, that arrivals are lagging last year by a fair margin. The season did get off to a slow start because of the tax dispute, but that has been resolved, and cocoa beans should be flowing to the ports. They're not. Typically, Ivorian arrivals at the end of December reach 600,000 tonnes, but talk has it that to date, only 200,000 tonnes have arrived.

One theory suggests that farmers are holding back because they too can see prices rallying and are waiting for better prices. While some of this is probably happening, it is not likely that arrivals would be so far behind the norm. The slow pace of arrivals reinforces theories that we have entered a new era in which the size of Ivorian cocoa crop is in decline and the bulk required to reach 600,000 tonnes by year-end simply does not exist.

E.D.&F. Man has been liberal with its 2001-02 estimates for the other significant producing countries as well. It forecasts a 450,000 tonne crop for Ghana, up significantly from the 395,000 tonnes produced in the 2000-01 season. For Indonesia, it estimates only a slightly better crop of 400,000 tonnes, compared with 390,000 tonnes last year. Again, there is no abundance of information available, but the press reports do not seem to support Man's optimism.

For Ghana, talk has it that because of various problems, the crop is actually much closer to 400,000 tonnes than it is to Man's 450,000 tonnes. While the weather has been favorable, with excellent precipitation, there have been reports that the increased moisture has made the beans more susceptible to disease. Although the government engaged a spraying program that was intended to limit the incidence of disease, it was not successful this season because of technical difficulties.

The Indonesian mid-crop harvest is wrapping up about now and is expected to be more than 10,000 tonnes smaller than last year's. Its results were not known to Man at the time of its September report.

In Nigeria disease has affected about half the country's trees, and local analysts are looking for a crop no bigger than 185,000 tonnes, compared with Man's forecast of an improved crop of 200,000 tonnes.

Years of low prices have discouraged all these producers from investing in the maintenance necessary to check the spread of disease. The neglect is beginning to show. While a second year of better prices may cause an increase in the use of pesticides in the future, it is not going to help this year's crops.

On the demand side, grinding results for the third quarter were mixed. The Pan-European grind was down 4.6% from the same period last year. It is widely believed that this is not a true reflection of demand because a significant amount of grinding activity has shifted to origin countries. Unfortunately, the industry has not yet incorporated an organized format for reporting grindings in origin countries. The US grind was 2.4% higher than the third quarter of 2000.

We believe, however, that current prices are telling us more about demand than these incomplete statistics. When the rally began, the wire services talked about the strength being related to option expiry. That has come and gone. The commodity funds were net short earlier in the fall, but have been relatively flat since the first week in October. So we can't blame the runup on fund short covering either, a particular favorite of the financial press when it can't explain a strong move in this or any security. Rather, we think that chocolate manufacturers are scrambling for beans and therefore view the events of the past month in this market in the context of a long-term bull market that began in January 2001.

Man estimated the deficit for 2001-02 at 100,000 tonnes. We have no problem doubling up on that, at the very least. The overshoot we illustrated above for Ghana, Indonesia, and Nigeria alone amounts to 75,000 tonnes. As far as the Ivory Coast is concerned, it is difficult for us to imagine that the crop is any bigger than last year's. This would lop an additional 100,000 tonnes off global output, leaving a deficit of 225,000 tonnes and stocks at a very bullish 27% of consumption.

So, how did we miss it? Good question, no good answer. Watch carefully for a consolidation and a buy recommendation. *[November 20, 2001]*

STRATEGY: *Stay tuned.*

Chart 4 – March Cocoa

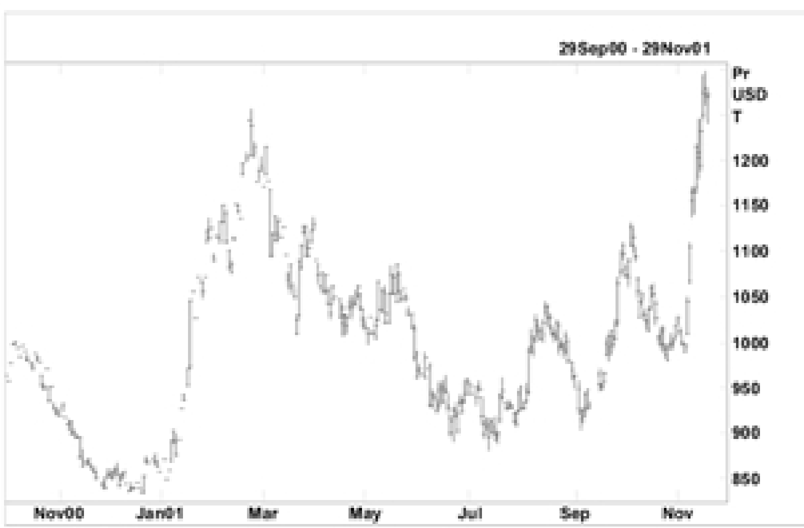


Chart courtesy Reuters

SUGAR

Looking good with production surprises and solid demand

Our foray into the long side of the sugar market was motivated primarily by the presence of the formidable net short position held by commodity funds. We reasoned that although the fundamentals were not terribly bullish because of a smart recovery in the 2001-02 Brazilian crop (see *Focus on Futures*, September 30) and falling demand as a result of a weak economic environment, prices had fallen too far. March sugar had dropped below 6¢ per pound in mid-October while the fund net short position had ballooned to 36,826 contracts. The weakness, we felt, was exacerbated by speculative selling. After all, even with improved crops we were still looking at a small production/consumption deficit for 2001-02.

The market has rallied about 1¢ per pound from our entry level, and the funds have covered about 16,000 contracts, but they are still net short over 20,000 contracts. So from that angle, the concept that put us in this trade may have some juice left but it may also be getting close to maturity.

Interestingly, though, our long position could be transforming itself into a position with backing from the fundamental camp. Just as we were a whisker away from our stop-loss price, Hurricane Michelle swept through the Caribbean, causing some serious damage to Cuba's sugar crop. Cuban officials say that the storm affected as much 35% of the crop, with actual loss of output of about 10%, or 400,000 tonnes. Most analysts balk at this figure and estimate that the losses were more in the neighborhood of 150,000 tonnes. Still, this is not a totally insignificant amount and must be replaced by another sugar exporter. Cuba, which exports almost its entire crop, has regular customers for its sugar, such as Russia and China, and has no stocks from which to draw on.

A storm that struck the Philippines at about the same time also caused enough damage to hurt the crop. The Philippines is a sugar importer and it will need to increase its purchases to compensate for the estimated 100,000 tonnes lost in the storm.

At first it seemed that these storms would serve only to provide us an opportunity to exit gracefully from a position that was stagnating. But then sugar analysts – incorporating these and other global developments – began revising their estimates for the 2001-02 production/consumption balances to show greater deficits.

On November 14, Czarnikow increased its global deficit forecast by 430,000 tonnes, to 2.92 million tonnes. About half the increase came from downwards revisions to production, while the other half came from increasing consumption, which – if accurate – is encouraging, considering general expectations of slow demand in most commodities. Czarnikow expects consumption to grow by just under 3 million tonnes. On November 19, the International Sugar Organization raised its estimate of the 2001-02 deficit by 170,000 tonnes.

The reduced output from Cuba and the Philippines is important, but these are not the only production problems. Analysts have been slashing their forecasts for EU output. This week, the EU Commission lowered its forecast for the 2001-02 beet crop again by 400,000 tonnes from its September estimate, to14.51 million tonnes. This compares with 2000-01 output of 16.71 million tonnes. Polish sugar production could drop by as much as 700,000 tonnes from last year, to 1.4 million tonnes.

Both the EU and Poland are exporters of the higher-quality whites, and traders report that there is a noticeable tightness developing. Charts 5 and 6 show the formation of a rather steep backwardation for both the New York and London March/May spread.

Estimates of the size of the 2001-02 Chinese crop vary, but it definitely had a better year. Still, even under optimum conditions production is roughly in line with consumption. If official reports are credible, the Chinese have little in the way of inventories and will continue to turn to the export market to make up any shortfall.

The deficit that sparked the rally last year began under similar conditions, with analysts gradually raising their forecasts of the size of the production/consumption gap. Despite burdensome carryover stocks in India and elsewhere, there was a limit to how much sugar could be mobilized on short notice. With some regular export/import channels clogged because of production shortfalls and harvest delays we could be looking at a repeat of last year's squeeze.

A reminder that global ending stocks are still high could serve to moderate excessive bullishness. According F.O. Licht, even after a couple of years of production/consumption deficits, we are still saddled with a 45.69% stocks-to-consumption ratio, a drop of only 2 percentage points from the peak in 1999-00.

We maintain our long position, but remain alert to bearish developments. *[November 26, 2001]*

STRATEGY: *Remain long March sugar as per Flash Update of October 18. Raise stops to 6.95 close only.*

Chart 5 – New York March/May Spread

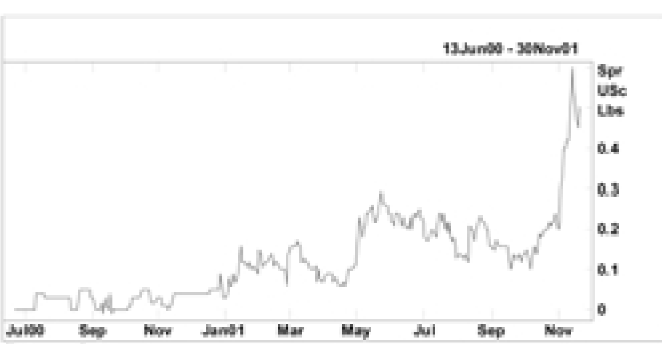


Chart courtesy Reuters

Chart 6 – London March/May Spread

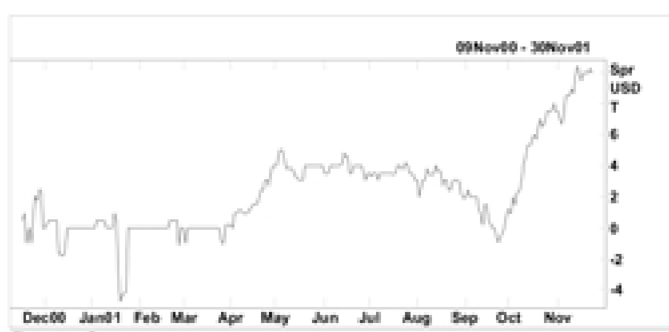


Chart courtesy Reuters

SOYBEANS

Soybeans: Why aren't strong US exports inspiring higher prices?

A glance at recent US export sales data would give a casual viewer the strong impression that the soybean market was on very solid ground. Despite a strong US dollar and a weak economic environment, importers seem to be on a rampage. This past week net new sales totalled 1.416 million tonnes, almost double the high end of trader's expectations and considerably higher than the recent weekly average of over 1 million tonnes.

The crop harvested this fall is now available, and this should be the busiest time of year for US exporters, particularly because Brazil is out of the market now, having already shipped 90% of its exports for the year. While this may be true, a comparison with last season's activity at this time of year indicates that the size of this season's sales is rather extraordinary. Average sales for the past 4 weeks were 1.141 million tonnes, compared with 617,000 tonnes in the same 4-week period last year. The average for the previous 4-week period was 1.109 million tonnes, compared with 762,000 tonnes last year.

Total commitments so far this year stand at 15.65 million tonnes, compared with 12.27 million tonnes at this juncture last year. The USDA has projected that total exports for the year at 26.67 million tonnes, which means that US exporters have already sold 59% of anticipated exports. At this point last year, commitments represented only 45% of annual exports of 27.17 million tonnes. Soybean meal and oil sales are also running way ahead of last year's pace.

So why are beans trading 25¢ per bushel off multi-year lows? Global consumption has been growing steadily each year. The USDA estimates record consumption of 180.84 million tonnes for 2001-02, up 5% over the 2000-01 season, which was 7.35% higher than the 1999-00 season. But the world's three largest producer/exporters – the US, Brazil, and Argentina – have not sat idly by. They have met the demand by growing record crops this year.

The US crop is forecast to reach a record 79.55 million tonnes in 2001-02. In the past, we've talked about South American producers challenging the US position as the world's biggest producer. This is no longer just a prediction. Brazilian and Argentinean output have grown at a phenomenal rate in the past two years. In the 1999-00 season, the two countries produced 55.4 million tonnes. According to recent estimates, they will produce 70.3 million tonnes in 2001-02, a jump of 27% in only 2 years.

As a result of explosive output and in spite of equally explosive demand, the global production/consumption balance has remained steady as measured by the level of carryover stocks. To illustrate, consider that based on the USDA November supply/demand situation report, the stocks-to-consumption ratio for 2001-02 is forecast at 16.5%, compared with 16.4% for 2000-01 and 16.7% at the end of the 1999-00 season. So, yes, the export flow is exciting, but it does not seem to be depleting supplies.

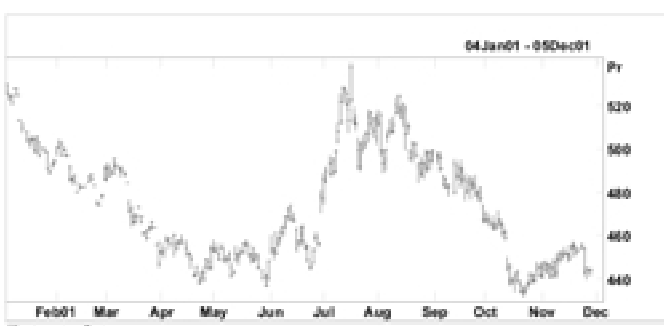
A closer look at US exports reveals that actual shipments are lagging last year's pace. So, while foreign importers are contracting to buy lots and lots of beans, taking delivery is another matter. Last year 7.063 million tonnes had been shipped by this time in the season, compared with 6.744 million tonnes this year. The difference is not huge – about a third of one week's worth of sales – but at the same time, the lag is inconsistent with the aggressive purchasing patterns displayed by the export commitment data. While the buyers may take delivery of most of what they contracted for, we need to worry that they are overbuying. This will eventually lead to some cancellations and a much slower pace of weekly sales. The USDA certainly feels this is the case. It maintained its forecast for US exports at 26.67 million tonnes in its November report, unchanged from October, but 500,000 tonnes below last year.

As per the above comments, we have a negative bias. However, the beans have already dropped $1 per bushel since the summer, so the bearish factors have been largely discounted. The US is the supplier of last resort until the South American harvest begins in the spring. Export commitments should be monitored in conjunction with shipments. If sales continue at this pace, then US ending stocks would be drawn down enough to make current prices look ridiculously cheap. If the torrid sales pace turns out to be an anomaly in an otherwise well supplied market, the market will drift lower.

[November 28, 2001]

STRATEGY: *Stay tuned.*

Chart 6
March Soybeans



HOTLINE UPDATE

***Flash Update* – Tuesday, November 6, 2001:**
Good morning for Tuesday, November 6, 9:15 am. This is a Flash Update. We have purchased December gold at 279.20, placing our initial stop at 273, close only.

***Flash Update* – Tuesday, November 6, 2001:**
Good afternoon for Tuesday, November 6, 4:15 pm. This is a Flash Update. We have covered our short December mini S&P position at 1,120.25. We repeat our Flash Update of this morning, where we purchased December gold at 279.20, placing our initial stop at 273, close only.

Friday, November 9, 2001:
Good afternoon for Friday, November 9, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December wheat, with our stop at 280.5; long March sugar, with our stop at 6.50; and long December gold, with our initial stop at 273. All stops are close only.

***Flash Update* – Tuesday, November 13, 2001:**
Good morning for Tuesday, November 13, 10:45 am. This is a Flash Update. We have liquidated our long December wheat positions at 280.

***Flash Update* – Friday, November 16, 2001:**
Good afternoon for Friday, November 16, 1:30 pm. This is a Flash Update. We have liquidated our long December gold positions at 274.80.

Friday, November 16, 2001:
Good afternoon for Friday, November 16, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March sugar, with our stop at 6.50. All stops are close only.

***Flash Update* – Wednesday, November 21, 2001:**
Good morning for Wednesday November 21, 9:15 am. This is a Flash Update. We have sold short December mini S&P at 1143.75, placing our initial stop at 1,170, close only.

Friday, November 23, 2001:
Good afternoon for Friday, November 23, 2:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March sugar, with our stop at 6.50, and short December mini S&P, with our initial stop at 1,170. All stops are close only.

***Flash Update* – Monday, November 26, 2001:**
Good morning for Monday, November 26, 9:00 am. This is a Flash Update. We have covered our short December mini S&P position at 1,151.

***Flash Update* – Wednesday, November 28, 2001:**
Good morning for Wednesday, November 28, 9:15 am. This is a Flash Update. We have purchased February gold at 275.30, placing our initial stop at 260, close only.

Thursday, November 29, 2001:
Good morning for Thursday, November 29, 9:40 am. This is a Flash Update. We have sold short December mini S&P at 1129.25, placing our initial stop at 1165, close only.

Friday, November 30, 2001:
Good afternoon for Friday, November 30, 4:00 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long March sugar, with our stop at 6.50; long February gold, with our initial stop at 260; and short December mini S&P with our initial stop at 1,165. All stops are close only.

Subscription Enquiries for
Friedberg's Focus on Futures
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
(416) 364-1171

All enquiries concerning trading accounts should be directed to:

In Canada
Friedberg Mercantile Group
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 350-2903
Attn: Sholom Sanik

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1910
New York, N.Y. 10005
(212) 943-5300