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Cocoa: too much rain may dash hopes for a recovery season in the Ivory Coast

Third-quarter cocoa-grind statistics for the US were a major disappointment for bulls. Analysts' expectations ranged between minus 6% and plus 2.5%, but the actual number showed that the grind fell 13.7% compared with the same period last year. It was particularly disheartening in light of the previously released European grind, which was up 8% and which appeared to indicate that demand was strong. Prices continued a downtrend that began in mid-September, but the selling lasted only a few sessions, and the market found support (Chart 1).

A very convenient rationalization that bulls can use to explain the weak grind data in the US is that grinding activity has been shifting to origin countries and that the shift is just starting to show up in the numbers. Although there is little in the way of regularly reported data to support this claim, there is evidence that consumption remains strong.

Despite the fact that newswire stories have been reporting on anecdotal evidence of well supplied processors who have not been active buyers, what hard data there have been point in a different direction. Asian butter ratios, which have lagged European ratios over the past couple of years, have picked up recently and have been quoted just below 2.7 times the London spot price of beans, up from 2.5 where the ratio spent most of this year. European ratios have jumped above 3 for the first time in several years.

It is the supply side, however, that is driving the market. The just completed 2006-07 crop year was a disappointment for West African producers, but the upcoming season was expected to yield larger crops. Precipitation levels were excellent in the early stages of development, enough for the main-crop harvest – which normally moves into full swing in October – to begin about 4 weeks early.

In fact, in the Ivory Coast, the new crop began early enough to create some confusion in understanding the output statistics. Early arrivals of the new crop that show up to port before the end of the outgoing old-crop marketing year, which ends on September 30, are counted as part of the old

crop. Normally this represents only a trickle, but this year, by our calculations, the final figure for the 2006-07 season of 1.292 million tonnes includes about 120,000 tonnes of new-crop beans.

Of course, knowledge of which season those beans are attributed to is in itself neither bullish or bearish, we point it out only to highlight the fact that actual output from the 2006-07 *crop* year was as poor as anticipated, even if published statistics of the *marketing* year are larger. Although we are definitely running ahead of last season's arrival pace in the new marketing year, it does not necessarily mean that the 2007-08 main crop will run longer than last year.

The solid start to the new crop was viewed as an indicator that 2007-08 would be a recovery season, but things are not unfolding that way. The rains, which were welcome when the crops were developing, have been excessive and have hampered the drying process, leaving beans susceptible to mould. Although volumes have continued strong, size and quality have been poor. Drier weather is definitely a must for the strong output pace to continue. Over the past few days, the rains have let up, but that trend would have to continue. A resumption of wet conditions could see

Inside

Wheat: Aging bull?	2
Soybeans: Brazil crop no price lid	4
Sugar: Brink of transition	5

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

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the amount of beans of export standard taper off sharply. The spreads between the nearby delivery months have been careening in and out of backwardation, but have not been in the kind of contango we're accustomed to in this market for some time (Chart 2) – quite the anomaly for the New York cocoa market and perhaps an indication that the

fabled burdensome global inventories are not as large as once believed.

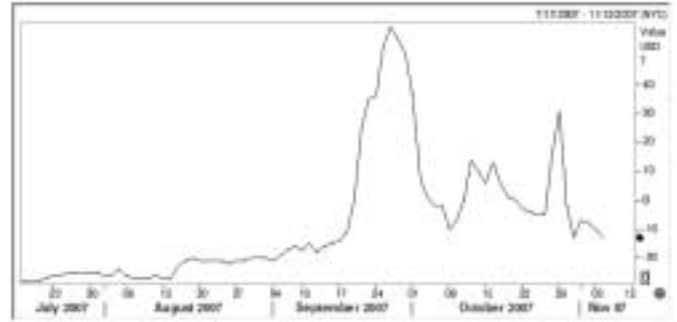
It's been a boring market relative to many other commodities, but we're convinced that the long-term fundamentals remain bullish, and we advise maintaining long positions. *[November 7, 2007]*

Chart 1 – December cocoa



Source: Reuters

Chart 2 – December/March spread



Source: Reuters

WHEAT

An aging bull?

It's been just over a month since spot wheat prices rose to what in the not-too-distant past would have been an unbelievably high price of \$9.60 per bushel. Prices have now fallen by more than \$1.50 per bushel from their early-October record highs (Chart 3).

Although inventories still remain at historic lows, they have stopped falling. The estimates for 2007-08 global ending stocks have been shrinking since June, when stocks as a percentage of consumption stood at 18.8% – compared with the average of the previous 5 years of 23.7%, to a low of 17.36% in October. The November USDA supply/demand situation report actually showed an uptick in stocks, to 17.78% of consumption.

The perilous state of the Australian crop was the focus of the upcoming Southern Hemisphere harvest. And indeed, the estimate was lowered once again, by 500,000 tonnes, to 13 million tonnes. Aside from the fact that a drop in the Australian estimate was a given, it was well above the official local estimate of 12.1 million tonnes.

Estimates for some of the other major producers were actually increased, including Argentina – a significant Southern Hemisphere exporter – which saw its crop jump by 1 million tonnes, to 15.50 million tonnes. The additional 1 million tonnes is all exportable surplus and was actually slightly higher than recent Argentinean government estimates.

The potential for any 2007-08 supply surprises is minimal at this juncture.

The issue now becomes a question of whether anxious analysts have overestimated demand. The USDA forecast for US exports stands at 31.30 million tonnes, a 26.5% increase over 2006-07 exports. Current export commitment data certainly substantiate this estimate. The most recent figure shows US wheat contracted for export at 26.6 million tonnes, 48% above last year at this time. Shipments lag a bit, but at 43% above last year, are still very strong.

The only problem is that evidence has begun to emerge that these numbers were rung up in a very panicky period, and the pace could slide back substantially. The US is the world's largest exporter of wheat, and the fluctuations in export activity are considered a reliable barometer for global demand. Consider that the average weekly commitment tally in September was 1.45 million tonnes, followed by a 1.16-million-tonne weekly average in October. The first two weeks in November saw net sales of a paltry 180,200 tonnes the first week and then an almost non-existent 14,600 tonnes in the most recent period.

Looking ahead to next year's output picture, current price levels are very enticing for farmers. To the extent that high corn prices shifted acreage away from wheat, profitability during the period leading up to the planting of the Northern Hemisphere winter wheat crop favored

wheat over corn (Chart 4).

The first USDA winter-wheat acreage estimate is not released until early January. Early private estimates are looking for total US wheat acreage – over 70% of which is winter wheat – to increase by about 8%. Global acreage growth is expected to be between 3% to 4%. Even with a trendline increase in global consumption, we should see the first production/consumption surplus in the global wheat balance sheet since the 2004-05 season – with cooperation from the weather, that is.

Even after the huge correction in old-crop prices, new-crop July wheat is trading at a hefty discount to spot in historical terms (Chart 5), which reflects the possibility that the market will stabilize in the 2008-09 season. But new-crop prices are still very high in historical terms,

because of the uncertainty of a recovery in production. In fact, were it not for the bad weather that reduced all major Northern Hemisphere crops, 2007-08 planted area would have been adequate to bring the market back into balance. Of course, there is no guarantee that the weather will cooperate for the 2008-09 crop that will be harvested in the spring.

We do not have any clear trading recommendations at this time. We tend to favor the idea of the historical pattern of bear markets following bull markets at a point when prices have become rich enough for producers to over-produce and turn a deficit into a glut. There is no clear indication that we have arrived there yet.

Remain sidelined but stay tuned.

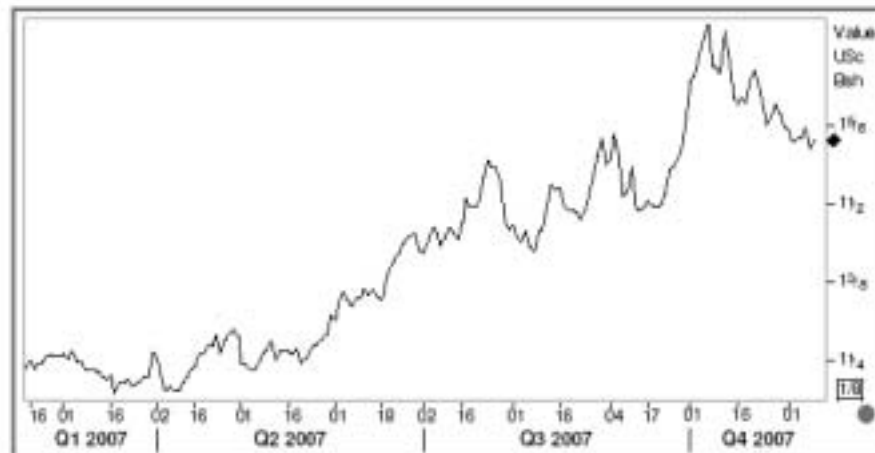
[November 12, 2007]

Chart 3 – December wheat



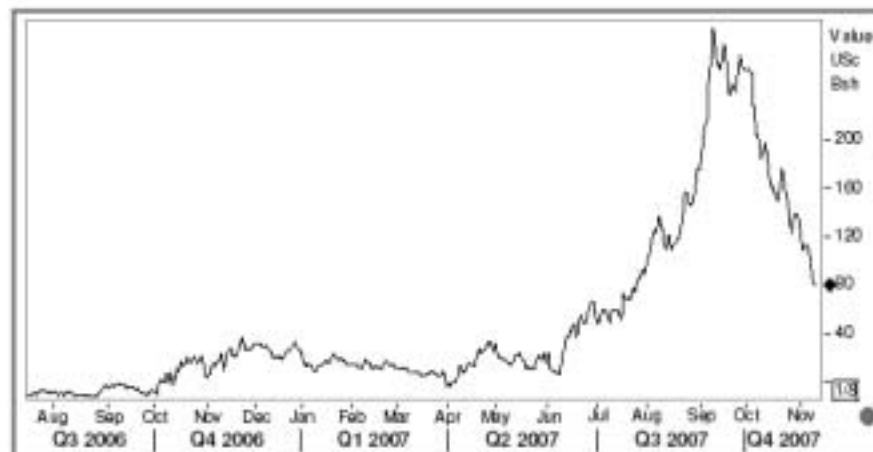
Source: Reuters

Chart 4 – July wheat/September corn (ratio)



Source: Reuters

Chart 5 – December wheat-July wheat (spread)



Source: Reuters

SOYBEANS

Prospects of a massive Brazilian crop can't keep a lid on prices

With well over 90% of the 2007-08 US soybean crop harvested, the monthly crop estimates are more meaningful, and we can fully appreciate the gargantuan shift of soybean to corn acres that took place this past spring. As it turns out, with the market making new highs on the day of the release of the November supply/demand situation report, the harvest pressure during late-September and early-October was a mere blip on the screen (Chart 6).

Actually, the report did not contain any monumental changes for the US balance sheet. The crop estimate came in at 70.61 million tonnes, slightly smaller than last month's estimate of 70.71 million tonnes but, more significantly, below analysts' guesstimates for 70.99 million tonnes. That we're light years away from last year's 86.77 million tonnes is, of course, not news.

Although crop conditions were mostly stable in the final growing stages – the good-to-excellent portion of the crop rose from 56% in early-September to 58% in the final survey – the size of the crop has ticked down gradually each month, dispelling any notion of a late surge in yields.

While the US picture did not change very much, the USDA did make a substantial adjustment to the global balance sheet. To reflect an increase in crushing activity in Brazil and Argentina in 2006-07, carryover stocks were revised downwards for the two countries by a combined

820,000 tonnes. In addition, the Brazilian 2007-08 crush was revised upwards by 400,000 tonnes.

The net effect of all revisions was a formidable drop in 2007-08 global ending stocks, to 49.35 million tonnes, or 21.13% of consumption, down from 21.75% last month, and 27.6% in 2006-07. So there was ample reason for the market to greet the November report with a rally to new contract highs.

The estimate for the 2007-08 Brazilian crop to be harvested this coming spring was maintained at a record 62 million tonnes. The forecast for Argentina also remains steady at 47 million tonnes. Any disappointment on that front should turn lukewarm bulls – and even bears – into full-fledged bulls. Over the next couple of months, the weather in Brazil and Argentina will be the single most important factor that will set the direction of soybean prices.

It may seem somewhat premature to be discussing corn and soy acreage that will be seeded in the spring for the 2008-09 crop, but the prices of the new-crop forward contracts go a long way to determining acreage allocations. Private forecasters are already weighing in.

On October 19, Informa Economics forecast a dramatic swing from 2007-08 planting patterns. Corn acreage will nosedive from 93.6 million acres in 2007-08 to 85.8 million acres, while soy acres will jump from 63.7 million acres to 71.7 million acres. This is still well shy of the 75.6 million

acres planted in 2006-07, but just less than the average of the previous 10 years.

Chart 7 illustrates that while soybean prices have not returned to their peak historical profitability level *vis-à-vis* corn, they have certainly come back into the range and explains why surveys by private forecasters indicate that 2008-09 crop should bounce back to normal levels.

Just a final note on a long-term bullish factor: Methyl ester, or biodiesel as it is more commonly known, has been taking an ever-increasing share of the soybean oil market

away from the food side of the balance sheet. The USDA has been raising its estimate of soyoil-based biodiesel production all season long. It now stands at 4.2 billion pounds, which represents 19.4% of total US usage. This is up from 2.8 billion pounds in 2006-07, or 13.5% of usage, and 1.56 billion pounds in 2005-06, or 8% of usage – definitely cutting into the food side.

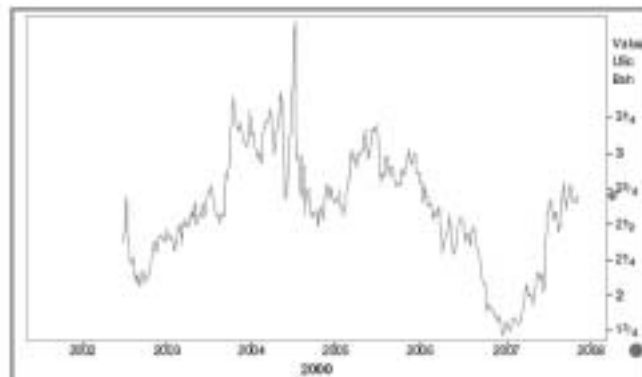
We keep thinking that prices are overextended, but they keep making new highs. We cannot recommend doing battle with the tape, so we remain sidelined. [November 12, 2007]

Chart 6 – January soybeans



Source: Reuters

Chart 7 – Soybean/corn ratio



Source: Reuters

SUGAR

On the brink of transition

There have been several developments in the sugar market – short-term bearish and long-term bullish – which for the most part involve India.

Sugar bottomed back in June and sits smack in the middle of the range set since then (Chart 8). We're hearing a lot of talk about the formation of a base on the chart, and indeed, the market has stopped falling.

It is hard to muster any bullishness, though, when considering that estimates for the 2007-08 global production/consumption surplus continue to grow. Some estimates put the surplus at 12 million tonnes, up from the International Sugar Organization's recent 10.8-million-tonne estimate.

India is the largest contributor to the global glut. Some analysts argued that the Indian surplus – close to 14 million tonnes! – would not be as big a drag on prices that the stag-

gering numbers would seem to indicate, partly because of official government policy of maintaining inventories of staples to stabilize markets when food prices are rising and partly because of the bureaucratic nightmare of working through the archaic export tariff system. Sugar would sit benignly in warehouses. But the government has been working on relaxing legislation that would facilitate an increase in exports because of the burdensome stocks, and apparently its efforts have been successful.

Over the past couple of weeks, there have been a number of large Indian sales to purchasers never before serviced by Indian exporters. They include Indonesia, Dubai, China, Singapore, and – what seemed to create quite a stir in the market – Russia, always a loyal customer of Brazil. Estimates call for 2007-08 sales of up to 5 million tonnes, compared

with only 1.5 million tonnes last year. This makes the global surplus more meaningful, because rather than just sitting around, it is actively depressing prices. In fact, traders say that Indian exporters are so eager to move their sugar that much of the sugar is sold at a very small profit margin or even at breakeven prices.

The ethanol angle was thought to be a very bullish factor, particularly with crude oil prices shooting to over \$90 per barrel. But despite strong demand for ethanol, prices have languished, because there is ample supply in the pipeline.

Shades of the inevitable, however, have begun to emerge. There are forecasts that have 2008-09 sugar acreage in India down by 20%. The huge crops that India grew over the past two seasons were planned while sugar prices were somewhere between 15¢ and 20¢ per pound. Commodity bull markets always look like they're going to last forever, but they do not.

In addition, a ripple effect is expected to extend into Australia, where farmers are also frustrated by low prices and by the sudden competition posed by India. Analysts believe that some Australian sugar area will find its way to more profitable crops in the coming season. It would be quite the bullish combination if two of the three significant exporting

countries in the region (the third is Thailand) have a sudden drop in output.

The obvious bullish implications of ethanol consumption have been dormant, as we mentioned above, but that is unlikely to last for long. India has neither the production nor consumption infrastructure for widespread commercial use of ethanol. But the government has legislated a minimum 10% ethanol blend for gasoline that will go into effect by October 2008. While the time frame may not seem realistic, we can assume that the government will establish subsidies to assist industry in expediting commercial viability.

More imminent, though, is that Brazilian ethanol production is expected to rise by 18% for the 2008-09 cane crush, even though the crop is not expected to be much larger than this past season.

We continue to believe that prices are going to work their way lower in the short term because of the huge overhang. But since the very causes of the bull market are starting to wane, we will adopt a more cautious approach by lowering the stop on our short position from 11¢ per pound, to 10.5¢ per pound close only, just above the recent high.

[November 13, 2007]

Chart 8 – March sugar



Source: Reuters

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Subscription Enquiries for
Friedberg's Focus on Futures
Suite 250
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 Ltd.
Suite 250
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

For U.S. Persons
Friedberg Mercantile Group, Inc.
Suite 250
181 Bay Street
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1-800-461-2700

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