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Indian sugar imports set to increase, but the Brazilian cupboard will soon be bare

Sugar prices were sliding hard earlier this month when reports began to surface that analysts were revising their forecasts for 2009-10 Indian imports to 7 to 9 million tonnes, up from previous estimates. An October 8 US attaché report put imports at 6 million tonnes. The news seemed to grip the market, bringing a halt to falling prices with a 3¢-per-pound rally in just a few sessions.

It was no surprise to us. The weakest monsoon in 37 years quashed hopes for a bounce in Indian sugar production. Up until several months ago, a 20-million-tonne crop seemed achievable. The estimates have been dropping consistently, though, and we are now looking at a crop that some forecasters are saying could be as low as 14 million tonnes. With domestic consumption of over 23 million tonnes, and negligible carryover stocks from 2008-09, it's been obvious for some time now that India would continue easing import restrictions to facilitate greater import needs.

To complicate the matter, the supplier of last resort, Brazil, has seen output estimates nosedive. Pre-harvest production estimates reached as high as 36 million tonnes. The latest estimate provided by local Brazilian analysts are as low as 28.6 million tonnes for the Center South region, which accounts for 90% of the cane harvest. This would put total output between 31 and 32 million tonnes. A commensurate drop in exportable surplus follows, and regardless of which country India buys sugar from, global inventories are being depleted.

The poor performance for Brazilian output is a great disappointment. At one point early in the 2009-10 season, cane area was about 15% above the previous season, but actual sugar output will be equal to or perhaps even less than last year. Ethanol production is not to blame, because the portion of the crop crushed for ethanol actually shrank to about 57% from 62% in 2008-09.

With sugar prices surging, processing sugar has become far more profitable than ethanol production. Although this has shifted momentum in favor of sugar output – as illustrated – the weather problems that have reduced yields have just about wiped out any potential benefit from lower ethanol output.

The Brazilian government, which controls the minimum amount of ethanol required to be used in the nation's cars and

trucks, is considering paring back the current 25% minimum ethanol blend to 20%, to protect consumers from fast-rising ethanol prices. This measure would certainly make more sugar available, but it will have no effect on the current crushing season, which is almost over.

While the bullish fundamentals are solid, the volatility and the wild swings demand cautious trading strategies. Chart 2 shows that in January 2008, when sugar barely reached 15¢ per pound, open interest skyrocketed to 1.1 million contracts. An argument can be made that at the current level of 750,000 contracts, we're down sharply from the 2008 peak, but on the other hand, we're still very high by historical standards. In addition, Chart 3 shows that the net-long fund position may be down from 2008, but as a percentage of total open interest, it is actually much higher.

The classic bull market process that provides incentive for producers to increase output has been compromised, both in India and Brazil. Farmers increased acreage, but to no avail with weather that would not cooperate. Prices must now continue to rise to ration demand. There will be no significant increase in new supplies for many months, and the rationing process we anticipate can drive sugar prices to previously unimaginable heights.

Remain long.

[October 20, 2009]

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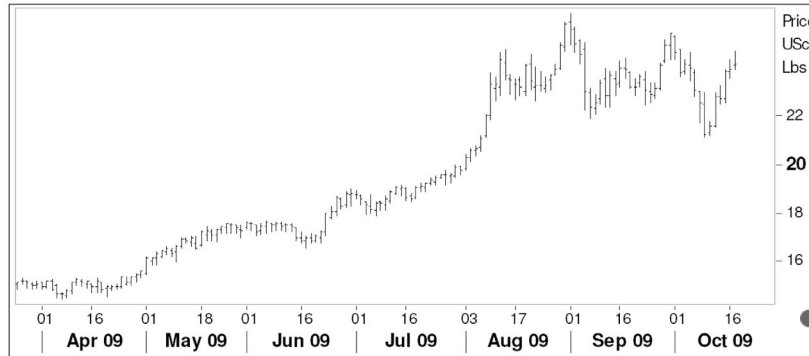
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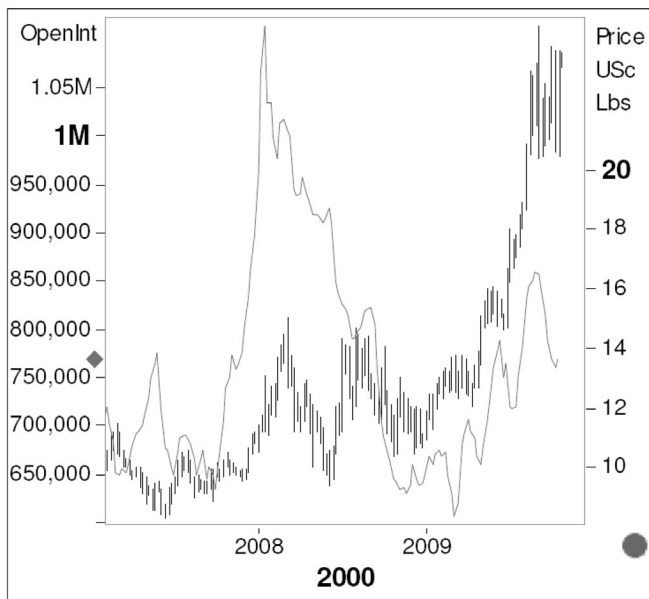
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Chart 1 – March Sugar



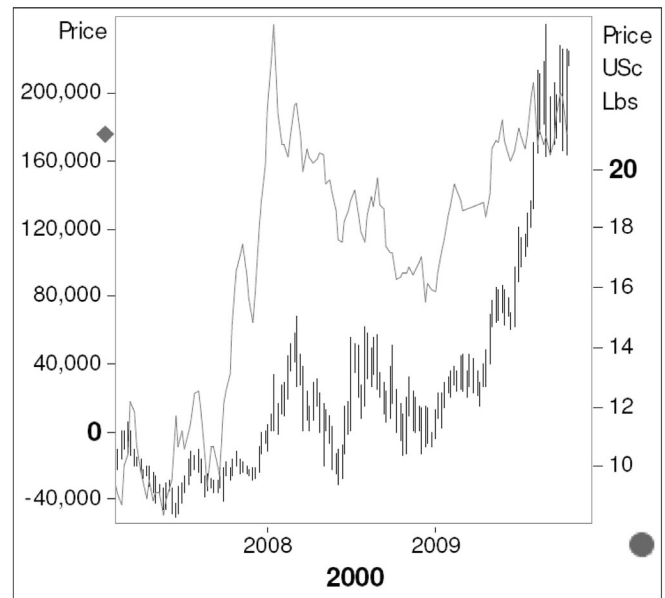
Courtesy Reuters

Chart 2 – Weekly sugar (bar), Open interest (line)



Courtesy Reuters

Chart 3 – Weekly sugar (bar), Fund net-longs (line)



Courtesy Reuters

COTTON

Prices climbing a wall of flat demand

Cotton market participants have been struggling with the conflicting signals coming from the supply and demand sides. At present, the bullish supply side is prevailing.

This past spring, anticipating continued slow demand and attracted to fatter profit margins available from switching to other crops, US farmers planted the smallest cotton area since 1983. And they certainly got their projections for the demand part right. Domestic mill usage in the US fell 22% in 2008-09, to 3.59 million bales. As the new marketing year progressed, we believed that demand would show some improvement as world economies began to stabilize, but the situation is not unfolding quite that way.

In the October supply/demand situation report, the USDA revised 2009-10 mill consumption downwards by 100,000 bales from the September estimate, to 3.40 million bales. Considering average monthly mill consumption over the past six months, the USDA estimate is too high and will be revised down further if business doesn't pick up.

The export market is in dismal shape. The October estimate for 2009-10 exports was unchanged from September's 10.5 million bales, which is 21% below 2008-09 exports. We're already three months into the marketing year, and according to weekly commitment data, US export sales are 40% below last year at this time.

Well, if nobody is buying, why are prices at one-year highs? The weak US dollar is definitely a factor in keeping the price of cotton, as well as other commodities, well bid. The real issue, however, is that producing countries planned smaller crops for 2009-10 because of falling demand, but did not expect the exceptionally bad weather that's been with this crop from planting right through to development and harvest.

The most recent crop progress report shows that because of late planting, only 19% of the crop has been harvested, compared with 38% last year at this time, and a five-year average of 43%. The good-to-excellent portion of the crop has fallen to 44%, from 49% at the beginning of October.

In its October report, the USDA lowered the average yield per acre by 28 pounds, to 807 pounds per acre, which would reduce the crop to 13 million bales, down 440,000 bales from the September estimate. Weather in Texas, the largest cotton state by far, has not been too unfriendly. But extremely wet weather in the Mississippi Delta and throughout the Southeastern states may very well spur another cut to the yield estimate and presents the strong possibility of some abandonment.

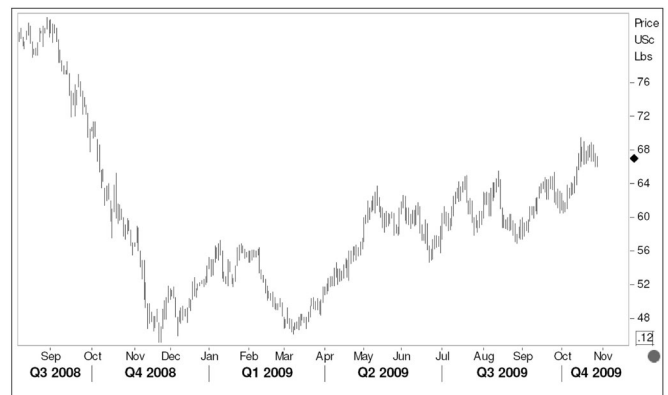
In China, the weather has been favorable for the harvest. Acreage was down sharply from last year, though, and growing conditions, were not ideal, prompting the USDA to lower its October estimate for the crop by 1 million bales, to 32.5 million bales, down sharply from 2008-09 output of 36.7 million bales. On October 15, the Chinese Cotton Association released an estimate for the Chinese crop at 30.7 million bales.

If the Chinese crop really has fallen by 6 million bales from last year, it is hard to understand why its importing activities have all but ground to a halt. US export data show that Chinese commitments are a fraction of last year at this time. And it is not as if they're buying elsewhere. Chinese customs data indicate that imports fell 40% from January through August.

Bulls should be nervous about the plunge in demand, but then again, when all the harvests are in, we could find the anomaly of tightness in a market in which demand is trending lower. If demand picks up, which we believe is inevitable, and the condition of crops in the US and China does not improve, prices are poised to explode.

Remain long. [October 29, 2009]

Chart 4 – December cotton



Courtesy Reuters

COPPER

Mixed signals from a recovery in production and a surprise surge in Chinese imports

On October 1 we suggested liquidating long copper positions. The bullish fundamentals that have driven prices up by \$1.80 per pound since the beginning of the year, or more than 100%, had turned the corner. Although economic conditions in the US and Europe were improving, all of the major copper-specific indicators had headed into bearish territory – and, for the most part, continue to do so. Regardless, the timing of the recommendation was unfortunate. Prices have since sprinted to new highs for the move and sit 25¢ per pound above the October 1 closing price (Chart 5).

Aside from the tumbling US dollar, which benefitted prices in most commodity markets, the primary bullish factor was the combination of a sharp drop in production and booming Chinese imports. While producers accurately predicted the drop in demand for most consuming regions, they miscalculated the endurance of the Chinese market.

During the bull run, Chile, the world's largest copper miner, saw mine output plunge. From January through July, average monthly production fell 3.67% from the same period in 2008. Since April, however, the output losses were moderate, and in August and September, the most recent months for which data are available, output jumped by an average of 8.15%.

Two consecutive sharp declines in Chinese imports, in July and August, kept copper prices at bay even while stocks were soaring and the dollar was plunging. With all major copper producing regions starting to crank up output, any increase in usage in industrialized countries would pale in comparison to a significant drop in Chinese demand. Expectations leading up to the release of the Chinese September import numbers were for a continuation of the downward trend that began in July. The average guesstimate

was for a 21% decline. The guesstimates were way off the mark, as it turned out, with imports recording a 23% increase. After the October 13 release of the Chinese import data, prices burst into new high territory.

The most recent International Copper Study Group (ICSG) global balance sheet shows that the market began to turn back towards surplus in the summer. Although the supply/demand deficit for the first seven months of 2009 was 186,000 tonnes, it was down sharply from one month earlier, when the deficit was 292,000 tonnes. The drop in the deficit went a long way to make sense of ICSG's October 9 forecast for a 370,000 tonne surplus for 2009.

Global warehouse stocks continue to rise. Just over the past couple of months, combined inventories at LME, COMEX, and Shanghai exchange warehouses have risen by about 100,000 tonnes, to 532,000 tonnes, within reach of the same stock level back when prices took off from \$1.25-per-pound (Chart 6).

We're faced with what seems to be a recovery in mine output, which is definitely a strong bearish factor. Mining companies displayed restraint by curtailing production to avoid flooding the market, as illustrated. But that strategy

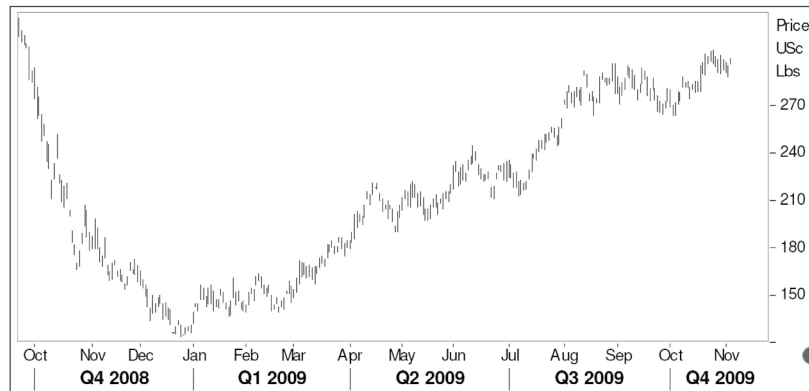
was in place when prices were dramatically lower. As we've pointed out in the past, mining companies can overproduce copper without too much concern, because average cash costs are well below \$1 per pound after gold and other mineral credits are accounted for. Mining companies are far less likely to be cautious about controlling production levels when copper is trading at \$3 per pound than they were when prices approached \$1 per pound a year ago.

The only vestige of bullishness left is therefore the potential for a new wave of Chinese buying. Many believed that the Chinese import bubble was over, but the September data showed that this is not necessarily the case. The spike in new production may very well be able to accommodate Chinese imports, but we're not about to recommend a short position with the broad-based commodity euphoria driving everything up.

Bear spreads are a possible conservative bearish strategy. If we are amply supplied, we should see the market slip back to a wider contango. Stay away from being short the nearby – specifically, sell May 2010 and buy December 2010, currently trading at about minus 45 basis points.

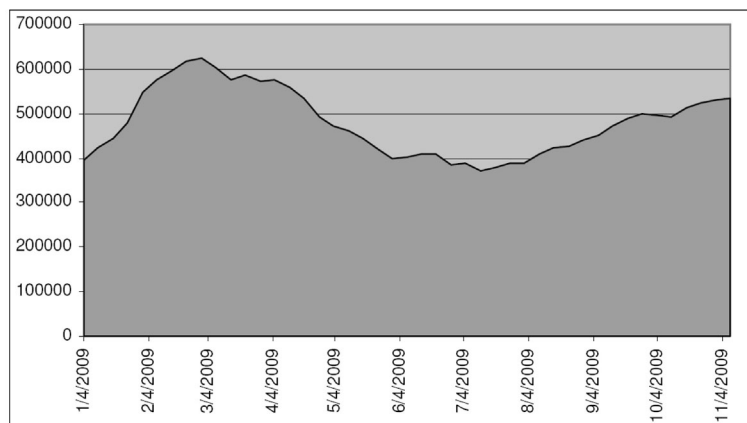
[November 5, 2009]

Chart 5 – Nearest contract copper



Courtesy Reuters

Chart 6 – Spread – January/November



Courtesy Reuters

CORN

Market awaits crucial November crop estimate

“We caution against trying to be short this market. On the contrary, we view current price levels as the new price floor. Maintain long positions.” That was the conclusion of the September 3 issue of *Focus on Futures* regarding corn. December corn closed at \$3.15 per bushel that day and is now trading at \$3.80 per bushel (Chart 7).

The rally was driven by uncertainty surrounding the 2009-10 US crop, which is currently being harvested. Of course, the weak US dollar played a large role, but speculation that the USDA estimate for a near-record, 13.018-billion-bushel crop is too high was the main factor. Weather for the actual growing season was fine, but conditions for the start and finish were anything but.

The crop went in very late because of above average precipitation, and the harvest has been delayed for the same reason. The harvest extended far enough into the autumn to suffer some frost damage, but the biggest concern is the yield loss that can result from the crop sitting out too long in soggy fields. The most recent crop-progress report shows that only 25% of the crop has been harvested. That compares with 53% last year at this time and the 5-year average of 71% – the latest harvest since the USDA began recording crop progress data in 1985.

The rally notwithstanding, the popular analysts are bearish and haven't allowed themselves to be intimidated by the rather ominous weather forecasts. With the November 10 USDA estimate just a few days away, forecasters are weighing in with their estimates. The average guesstimate is for a 78-million-bushel downward revision, to 12.94 million bushels. The well-known analysts have lowered their estimates, but are well within the zone of the October USDA estimate.

We do not have the resources to formulate a proper estimate. We are, however, skeptical about the argument that in years in which the yield estimate grows throughout the season, it tends to increase until the final estimate. As mentioned above, there is no prior history with the crop being quite this late. Logic dictates that this year may be an exception. In addition, the good-to-excellent portion of the crop was revised down by 2 percentage points, to 67%, in the latest progress report.

The demand side is mixed. The USDA expects exports

to bounce back, but commitment flow has been abysmal. In response, in October the USDA already lowered its estimate for US exports by 1.27 million tonnes from the September estimate. The forecast for 2009-10 sales is still 15% higher than the previous season, but commitments are running only 4% ahead of last year at this time. Over the past four weeks, commitments averaged 462,000 tonnes, but we would need to see weekly sales average about 800,000 to meet the USDA target.

The outlook for ethanol consumption, on the other hand, is quite positive. Ethanol is now a much larger component of the market than exports. As recently as in the 2007-08 marketing year, exports comprised 19% of US consumption, compared with 24% for ethanol. In 2009-10, projections are for exports to form 16.5% of total consumption with 32% for ethanol. Last year was a poor one for ethanol producers, because profit margins were slim to non-existent. This year, with the recovery in energy prices, ethanol prices are allowing producers to show healthy profits.

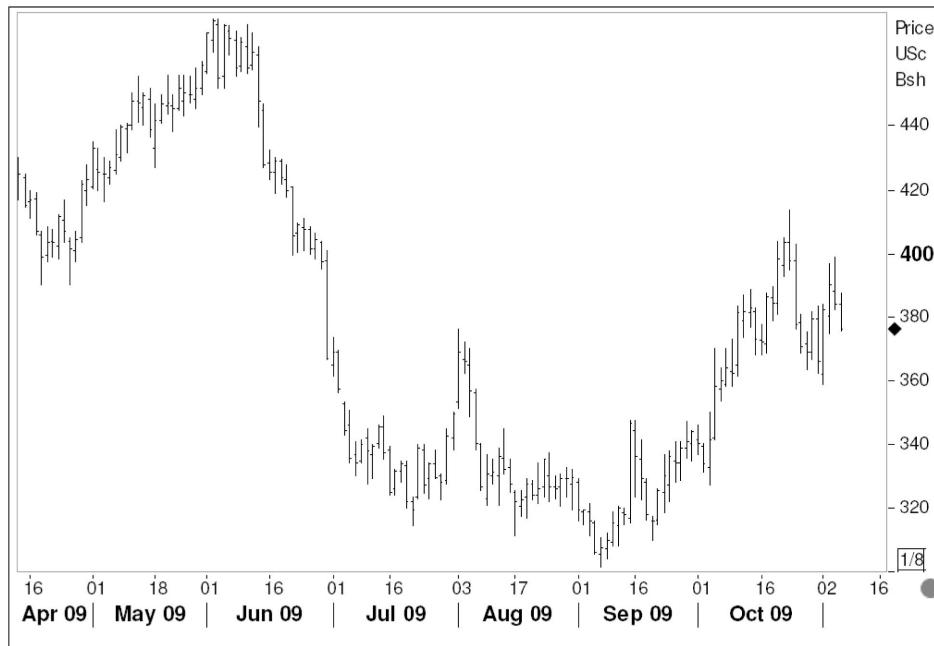
The gasoline/ethanol blend ratio set by the US federal government stands at 10.5 billion gallons. The 14% increase in usage estimate for corn to be distilled into ethanol for 2009-10 is roughly equal to the jump in the blend ratio for next year to 12 billion gallons. So that's in the market. However, if the ethanol business remains profitable, output will grow and surpluses will be available to meet a growing market for export.

The October USDA report lowered Chinese production by 5 million tonnes. China is unlikely to become an importer of US corn, though, because it has ample reserves. We do believe that demand for US corn from traditional customers will resurface as the cloud of the worldwide recession begins to lift.

With all the bearishness that we read, one would think that inventories will be rebuilt to comfortable levels with the record US crop. Not so. According to the October estimate, global ending stocks are estimated at 16.9%, down from last year's 18.9% and back to 2007-08 levels – from where the bull market began. A bullish surprise in the November crop report will see December corn trade back above \$4 per bushel. Remain long.

[November 6, 2009]

Chart 7 – December corn



Courtesy Reuters

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