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Sugar: too sweet?

Sugar prices are approaching the 30.4¢-per-pound peak set back in February. A truly amazing feat. Two consecutive years of drought-reduced crops turned self-sufficient India into a net importer of sugar in 2008-09 and 2009-10 and sparked the bull market. When it became clear that late-season yields had improved enough to increase 2009-10 output by about 4 million tonnes from early-season estimates, the market collapsed, and prices tumbled all the way down to pre-bull-market levels of 13¢ per pound. The amazing part is that the market has rallied back to these lofty price levels. Do the fundamentals warrant this strength?

Pre-season forecasts for 2010-11 Indian output began at 24.5 million tonnes, a 30% increase over the previous crop. Estimates have been creeping up. The International Sugar Organization estimates production at 25.5 million tonnes, while F.O. Licht puts output at 26.2 million tonnes.

Demand estimates for 2010-11 vary, from 22.5 million to 24.5 million tonnes, compared with 2009-10 consumption of 23.5 million tonnes. In a best-case scenario, India will have a production/consumption surplus of close to 4 million tonnes. A strong rationale for a drop in sugar usage does not exist. The population is growing, the economy is growing, and incomes are rising. We therefore believe that consumption will be at least the same as in recent years, and probably higher, which would leave a surplus closer to 2 million tonnes.

According to government statistics, India has already contracted to sell 500,000 tonnes abroad. Analysts say that exports for the 2010-11 marketing year will reach 3 million tonnes.

The carry-in from 2009-10 is estimated at 5 million tonnes, which means that 2010-11 ending stocks should be about 7 million tonnes, before exports. That is still far below the 10-million-tonne year-end inventory level that was the norm for many years.

At current price levels there is certainly a strong incentive for exporters to sell sugar rather than store it. However, if they actually export 3 million tonnes, ending stocks would be drawn down to 4 million tonnes, and in a sense, we're back where we started from. India would be under pressure to produce a bumper crop in 2011-12 or risk not meeting domestic demand.

We imagine that the struggle of the past two years, in

which the government had to ration sugar to processors, is fresh in everyone's mind. Although we haven't heard any talk regarding export tariffs, our best guess is that we will, sooner or later.

So while on the surface the return of a normal monsoon – and the excellent Indian crop that resulted – should be bearish, the market is concerned about the future. Little has been accomplished in terms of ensuring that India will return to self sufficiency in the coming years.

Until a few months ago, analysts were forecasting a return to normal conditions for the global sugar market, with estimates for a production/consumption surplus of between 3 and 5 million tonnes. Russian drought and Pakistani flooding dashed that scenario, however, and we're now looking at a balanced market.

Russia imports between 2 and 3 million tonnes per year, and with the loss of close to 1 million tonnes and inventories that are roughly equivalent to 8% of usage, it's hard to see imports not increasing. Pakistani inventory levels are reportedly higher, but losses totaled about 700,000 tonnes. Making up the shortfall from stocks would effectively wipe out their inventory, so a sharp jump in imports will be necessary. The government waived its 25% import duty back in September.

So are the supply/demand fundamentals bullish enough to justify the magnitude of the bull run?

To the extent that historical price levels are an accurate

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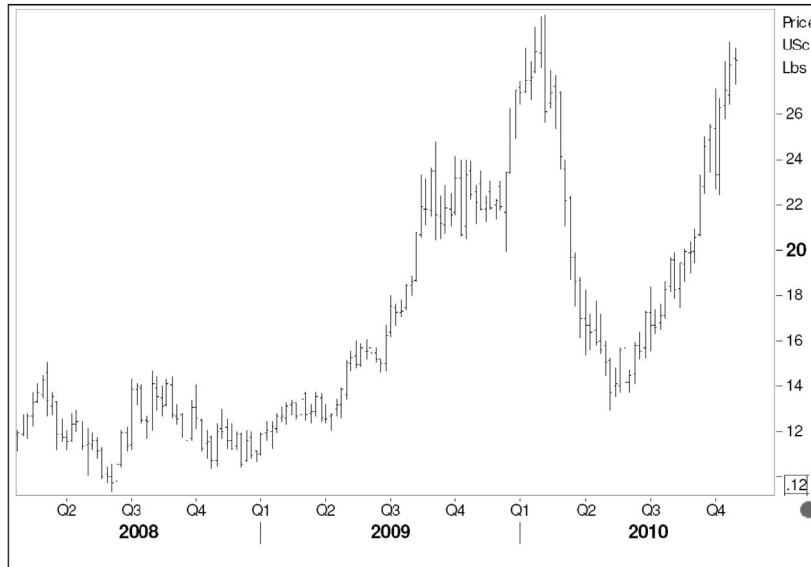
reflection of underlying fundamentals, we'd have to say that were it not for the money pouring into the commodity markets, we are severely overbought. Cost-of-production dynamics haven't changed very much. When we reached these levels in February, the street believed that the 2009-10 global deficit was close to 15 million tonnes. Now we're

facing, at worst, a small deficit. Overbought conditions, though, can last for a long time.

Our most recent recommendation dates back to August 20, and that was to remain long with an 18¢-per-pound stop. That stop should be ramped up to 26.5¢, basis March.

[October 27, 2010]

Chart 1 – Sugar weekly nearest contract



Courtesy Reuters

SOYBEANS

China just can't get enough

We have been bearish on soybeans over the past year. The basic premise was this: Like other commodities, demand for soybeans was recovering from the worst moments of the worldwide economic slowdown. Unlike some other commodities, output recovered alongside demand, which resulted in rebuilding of inventories in the major exporting nations, the US, Brazil, and Argentina. The global balance sheet shows this very clearly. In the three-year period preceding the 2008 bull market, stocks as a percentage of consumption averaged about 25%. In 2008-09, global ending stocks plunged to just below 20% of usage, but by the end of the recently completed 2009-10 marketing year, stocks had snapped back to 25.4% of usage.

Mercifully, our August 27 short-sale recommendation was accompanied by a tight stop. Since taking out light resistance at \$10.50 per bushel, January soybeans have rallied by over \$2 per bushel since early September. US dollar weakness and a broad commodity bull market are convenient explanations for this powerful bull run, but in fact, there have been several soybean-specific bullish developments.

In September, analysts were expecting a downward revision for the bushel-per-acre (bpa) yield estimate, but the

USDA surprised the street by raising the estimate by over 1 bpa from the August estimate, to 44.7 bpa – a substantial revision. The bearish case looked intact. The market settled back into the range – but only for a few days.

In October, it was the reverse. The average analyst guesstimate was for a further increase to 44.9 bpa, but the actual number came in at 44.4 bpa. In addition, the USDA slashed the estimate for harvested area by 1.2 million acres. As a result of these revisions, the estimate for US production was cut 75 million bushels (about 2 million tonnes), to 3.408 billion bushels.

In itself, lower US output should not have had too large of an impact on the market, because the estimate for Brazilian output was raised by 2 million tonnes.

The real driver for this market has been the demand side. The US exported a record 40.77 million tonnes of soybeans in 2009-10. That was about 15% to 20% above the average of the previous several years. Early estimates for 2010-11 called for exports to fall slightly, but estimates have been inching up every month. With the October USDA crop report, foreign sales are now projected at yet another record of 41.37 million tonnes.

The Chinese have been on a buying spree. The weekly export report shows that total commitments for the marketing year, which began only two months ago, stand at 27.35 million tonnes. That is 4.4 million tonnes, or 19%, above last year at this time. This leaves the USDA's forecast for only a small increase in annual exports, to 41.367 million tonnes, severely understated. Barring unforeseen circumstances, the USDA will have to raise the US export estimate further, perhaps by several million tonnes. In October alone, weekly Chinese purchases averaged 1.064 million tonnes, compared with 478,000 tonnes in the same period last year.

The combination of lower acreage, reduced yields, and the USDA's modest increase in the estimate for US exports all contributed to a sharp downward revision for US 2010-11 ending stocks. Inventories were revised to 8% of usage, down from last month's estimate of 10.6%.

At the global level, ending stocks were revised to 24.3% of usage, down from last month's 25.2%, and as

mentioned earlier, down from much higher levels this past summer, which peaked at 27.4% in July and formed the basis of our bearishness.

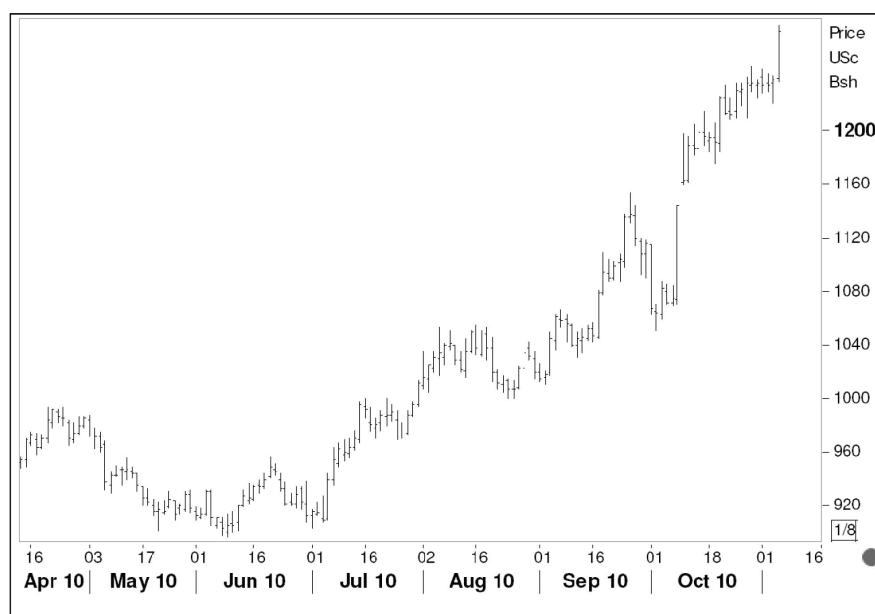
Chinese buying cannot possibly continue at its current clip. But even with a toned down pace, the USDA will be revising US exports upwards in future monthly crop reports. Even a conservative increase implies global ending stocks closer to 23% of consumption.

We are not looking at shortages. We have, however, shifted into a mode where good crops are an imperative, with no wiggle room for crop failures. According to the USDA October crop report, the global production/consumption balance shows a small surplus, but after adjusting for the spurt in demand, we will actually post a small deficit.

This has turned into a bull market, but we're not about to chase it. Stand aside for now. Look for sharp setbacks of about 50¢ per bushel to establish long positions.

[November 4, 2010]

Chart 2 – January soybeans



Courtesy Reuters

COTTON

Moonshot

Cotton prices blasted through the April 1995 high of \$1.17 per pound in mid-October and have been setting record levels almost daily (Chart 3).

The US is by far the world's largest exporter of cotton. After US exports rose to record levels at mid-decade, foreign sales plunged during the global economic slowdown. US farmers astutely slashed output in anticipation of a reduction

in demand. They also correctly anticipated the post-recession recovery and expanded acreage for the 2010-11 marketing year. Cotton area rose by close to 2 million acres over 2009-10. Yields improved from 777 pounds per acre to 841 pounds per acre this season. The harvest-to-planted ratio jumped from 82% to 97.5%. As a result, output increased from 12.19 million bales to 18.87 million bales.

The 55% leap in US output, as it turns out, may be insufficient to meet the world's needs and to keep prices tamed. China has been on a buying rampage. The USDA forecast strong overseas buying, but not of the magnitude that we've seen. Early season estimates of 13.5 million bales for US exports have been growing steadily. The October estimate, unchanged from September, was 15.5 million bales. As of the most recent weekly export report, commitments since the marketing year began on August 1 stand at an astounding 11.4 million bales, up from only 4.1 million bales last year at this time and 6.8 million bales a year earlier.

US exporters have been selling about 500,000 bales per week since mid-September, well above average levels and probably not a sustainable pace. But even if sales fall back into a normal pattern of, say, 200,000 bales per week, the USDA estimate of 15.5 million bales is still on the conservative side.

Weather has not been friendly to the Chinese crop this past summer, and production estimates are being trimmed. In August output was as high as 33 million bales. In the October crop report the USDA lowered its estimate by 500,000 bales, to 31.5 million bales. A recent estimate from a Chinese trade group puts the harvest at only 30.4 million bales.

India is expected to harvest a record crop of 26 million bales, but the government has restricted exports to keep a lid on domestic prices that are spiraling out of control. A decision regarding export licenses is expected to be announced in December. Despite the bumper crop, exports are estimated to fall to 4.8 million bales, down from last year's 6.5 million bales.

The estimate for 2010-11 global ending stocks has been falling all season and is now at a season low of 37%. That compares with 39.65% at the end of last season and 55% the previous year. That is back to mid-1990s bull market levels. While 37% of usage may still seem ample and sufficient to avoid shortages, we should bear in mind that while these inventories may actually exist, they are not necessarily mobile and available to meet demand from world trade.

For example, Indian ending stocks are forecast to rise by 1 million tonnes, to 7.7 million bales. But the government's intention is obviously to keep the domestic market supplied at affordable prices. Any policies regarding cotton will favor keeping those inventories in India.

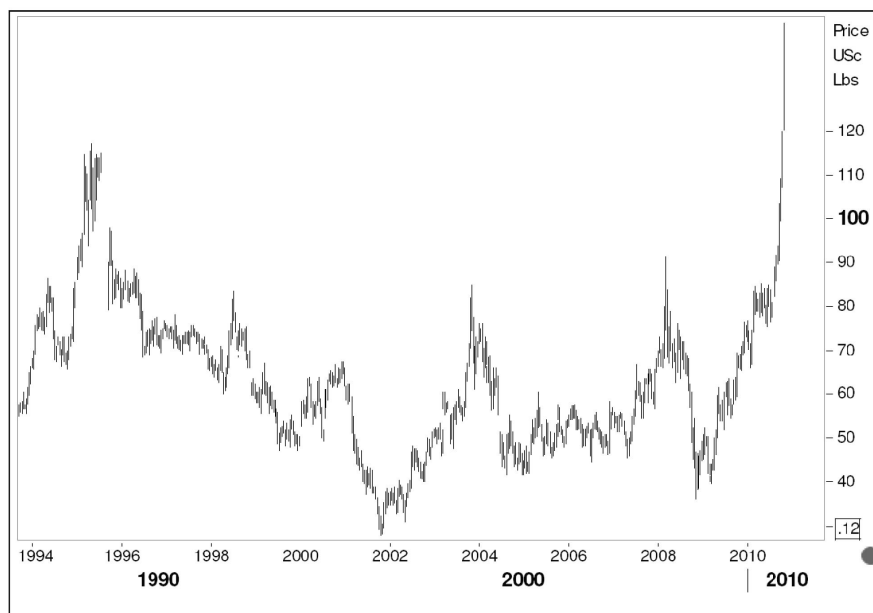
China's ending stock are estimated at 14.7 million bales. Even if this figure is anywhere near accurate, which is doubtful, government policy has obviously steered users to buy abroad rather than release warehouse stocks. If the US ships all its commitments, its stocks will be run down to negligible levels. The pool of ending stocks that can be shipped is smaller than implied by balance sheet data.

Bears remind us that with spot cotton trading at record highs of \$1.44 per pound, demand could prove to be elastic with the advent of garments made from synthetic materials. On the other hand, we counter, that with the price of crude oil approaching \$90 per barrel, petrochemicals are not cheap either.

Should you have been so fortunate not to have been tempted to take profits, continue to avoid temptation. Remain long.

[November 5, 2010]

Chart 3 – Cotton weekly nearest contract



Courtesy Reuters

COCOA

The laggard, but not for long

The cocoa and natural gas markets are vying for the title of worst-performing commodity on the board. Just about every other market is soaring to multi-decade highs or even new highs. At the very least, they've moved into their 2008 bull-market ranges. Natural gas fundamentals are generally bearish. What's with cocoa? Fund managers have been buying indiscriminately whether balance sheets show any sign of tightness or not. Actually, Chart 4 shows that funds remain net-short cocoa. Are supplies overwhelmingly abundant?

The final tally for 2009-10 Ivorian port arrivals, which is used as a proxy for output, was 1.213 million tonnes, down less than 1% from 2008-09. That would consist of 900,000 tonnes for the main crop and a better-than-average 300,000 tonnes for the mid crop. The data used to arrive at the weekly port statistics are erratic. At different points in the season, arrivals data show the crop to be much higher and then much lower than the previous season, but the final number usually stands.

Arrivals for the 2010-11 marketing year, which began on October 1, are reportedly 108,000 tonnes, down from 183,000 tonnes last year at this time. That's a huge gap in percentage terms, but means next to nothing, particularly this year, because many operations in the infrastructure have been temporarily suspended owing to the presidential elections. One report says that after counting beans that have been harvested but are still on farms, the current level is closer to 150,000 tonnes. Estimates for the main crop vary widely, from 800,000 tonnes to 1 million tonnes.

Even with an optimum-size main crop of 1 million tonnes and a repeat of the excellent mid crop, Ivorian production growth is stagnant. Due to disease, Ivorian yields are the lowest among the major producing nations, with 500 kilograms of beans harvested per hectare. This compares with 1 tonne per hectare in Ghana and 2 tonnes in Indonesia. To combat this problem, confectionary giant

Nestlé is expected to distribute about 750,000 disease resilient trees to farmers this season. Sounds like a huge amount, but it actually takes about 3 billion trees to produce the 1.2-million to 1.3-million-tonne crop. So it's just a drop in the bucket. Besides, it takes years for a new tree to produce fruit.

While production growth remains sluggish in the Ivory Coast and other countries, there hasn't been much growth – if any, for that matter – on the demand side either. Third-quarter grind statistics released in October were anemic. Europe was down 4% while North America was up 1.7%. In our September 13 issue we said that, as bulls, we would not be disappointed with poor third-quarter grind results, because butter prices have been low for so long. It would take some incentive, we reasoned, to get processors to increase grinding activity, which would in turn create more demand for beans.

Butter prices have stabilized, but have not improved much since they bottomed several months ago. Butter supplies are reportedly adequate, but powder is said to be tight, with prices up about 25% from early-year lows.

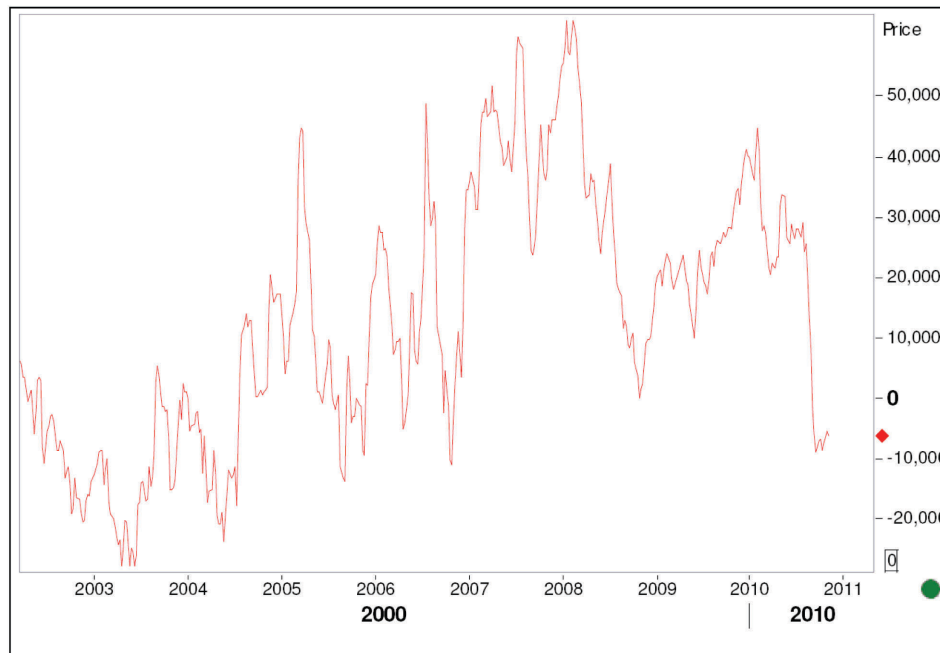
There is no compelling evidence to indicate that demand is about to improve. While global demand for commodities has increased, chocolate demand is not as entrenched in many of the markets of the developing world that have seen extraordinary growth in other commodities and raw materials.

The bullish case is the same we've been presenting and comes largely from the supply side. The fourth-quarter grind results are reported in January, and a positive number would be a bonus for bulls. But cocoa is unique in that global output has almost no chance for growth. Anything but perfect growing conditions in West Africa and Indonesia would leave the market vulnerable to large deficits.

This is still a cheap commodity. Remain long.

[November 9, 2010]

Chart 4 – Net fund position



Courtesy Reuters

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