

# FRIEDBERG'S

## FOCUS ON FUTURES

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## A smaller US soybean crop will not dent burdensome global supplies

When we last wrote about the soybean market in late August, the 2013-14 US crop – now in harvest – was stressed, and output estimates were tumbling. In its September crop report, the USDA lowered the yield estimate to 41.2 bushels per acre, down from the 42.6-bpa August estimate. That shaved over 100 billion bushels from the production estimate, to 3.15 billion bushels (85.7 million tonnes).

The USDA revision to the yield estimate came as no great shock – the figure was right in line with the average of analysts' guesstimates of 41.172 bpa. The market rallied 40¢ per bushel regardless and maintained the rally through the following session. That proved to be the high of the range, though, as timely rains arrived to alleviate pressure on the crop. Prices have since fallen by more than \$1 per bushel.

The most recent weekly crop progress report showed that the good-to-excellent portion of the crop jumped by three percentage points from the previous reading. During the US government shutdown, this and other data will not be collected, so we'll be driving in the dark for a while. Private forecasters have been revising their crop estimates cautiously higher. The November crop report should show an increase from the September estimate, but the crop will still be significantly smaller than early-season forecasts indicated.

After the September crop report, the next important report was the September 30 quarterly stocks update. Analysts were off the mark with this one. This report reflects the final quarter of the marketing year, so the guesstimates were based largely on the September crop report's 2012-13 ending-stock estimate, which was 125 million tonnes. The average guesstimate was 124 million tonnes, but the figure came in at 140 million tonnes. The market greeted the report with a 40¢-per-bushel selloff.

It was definitely a bearish development. To put things in perspective, however, at 4% of consumption, it will still be the lowest US ending-stock figure in history. So it is imperative that the improved weather in mid-September will be effective in raising yields substantially. Moreover, a

successful harvest is also crucial. Because of the very late planting season this past spring, the crop will be in the fields longer than in other years, exposing the plants to a greater risk of frost. Only 11% of the crop has been harvested so far. That compares with 39% last year at this time and the 5-year average of 19%.

Even with the US crop smaller than early-season expectations, global ending stocks should remain stubbornly high. While the September crop report slashed US output by 3 million tonnes, the estimate for Brazilian production was increased by the same amount, to a record-by-far 88 million tonnes. Planting is just underway in Brazil, so we're a long way off. With anything even close to normal weather conditions, however, the impact of the somewhat disappointing US crop is dwarfed.

At 53.5 million tonnes, the Argentinean crop will not be a record – 2010-11 output reached 54.50 million tonnes – but will be significantly higher than last year's output of 49.40 million tonnes.

The demand side is bullish. The USDA is forecasting a 4% increase in US exports, but export commitments to date

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show that sales are ahead by 15.8%. The entire anticipated increase comes from China. The estimate for Chinese imports is 69 million tonnes, up 9.5 million tonnes, or 16% from last year.

Even if it all gets shipped, supplies will be ample to meet known demand and beyond. Global ending stocks for

2013-14 are estimated at 71.54 million tonnes, or 26.6% of consumption. That's the second-highest inventory level in history.

Sell short January soybeans. Place initial stops at \$1,350 per bushel, close only.

[By Sholom Sanik, October 4, 2013]

Chart 1 – January soybeans



Courtesy Bloomberg LP

## COCOA

# Deficits for the foreseeable future

Our July 30 recommendation to establish a long position in cocoa would have been a dandy – had we not suggested to patiently wait “...for setbacks.” Unfortunately, there were no setbacks. The market took off within days and has since rallied by more than \$400 per tonne, or 18% (Chart 2).

There have not been any earth-shattering changes in the fundamentals, but the developments on both the supply and demand sides continue to be bullish.

About 65% of global supply of cocoa beans is grown in the Ivory Coast and Ghana, and production levels have not increased over the past few years. While some minor producing nations have increased output, others have seen declines. Brazil, for example, had a bit of a renaissance in 2012-13 after years of falling off the cocoa map, but for 2013-14, arrivals are down 40%, year-over-year. Overall, global production is stagnant.

Aside from intermittent weather problems, crops in both the Ivory Coast and Ghana have suffered from insufficient application of fertilizer and from neglect of other crop enhancement activity.

The Ghanaian government successfully engineered a doubling of the country’s crop size over the past 10 years, by subsidizing 50% of fertilizer costs. Last month, however, the government announced that it will be phasing out the subsidies in the coming years. Fertilizer purchases have reportedly plunged. So it is highly unlikely to see any further output growth.

With the jump in world prices, the Ivorian cocoa ministry recently raised the minimum prices farmers will receive for their beans. But poor pesticide and fertilizer usage is widespread, and the increase in farmers’ income will not readily find its way to improved crop management.

Global demand, at the same time, has been quite strong. Third-quarter European grind figures, released on October 10, show a 4.7% increase over last year. When compared with anemic production, it is not difficult to see why the market has tightened.

Butter stocks have dwindled, which has shown up in skyrocketing butter prices. The butter-to-beans ratio has spiked to 2.9 times the price of spot London beans. As seen

in Chart 3, the ratio had fallen to 1 in mid-2012. Powder prices have fallen, keeping the combined butter/powder ratio at bay (Chart 3), but butter drives the market.

On October 7 the International Cocoa Organization (ICCO) revised its balance sheet for the recently concluded 2012-13 marketing year to reflect these developments. The estimate for the global production/consumption deficit jumped to 86,000 tonnes, a larger shortfall than its previous estimate for a deficit of 52,000 tonnes. It cited sluggish output and the fresh demand coming out of a growing Asian middle class.

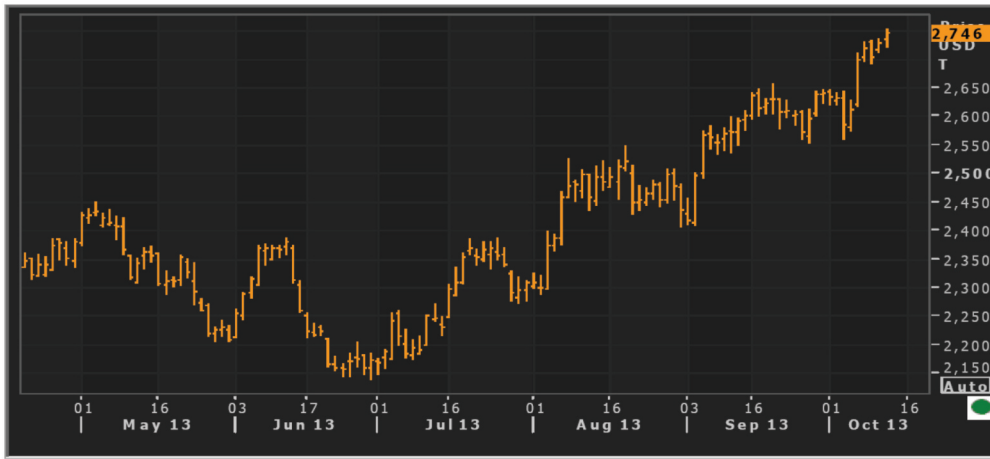
The ICCO also forecast that the global balance sheet

would remain in deficit over the next four years. This outlook may be a bit hasty, but based on current trends, ongoing deficits will persist.

If you did not follow our (exact) recommendation and were astute and aggressive enough to establish a long position, remain long and place sell stops at \$2,500 per tonne, basis the nearest contract, close only. If you are sidelined, we continue to recommend discipline and close monitoring for the inevitable setback – shallow as it may be – to get long this market. We believe the market is poised for a return to the 2011 highs that reached beyond \$3,700 per tonne.

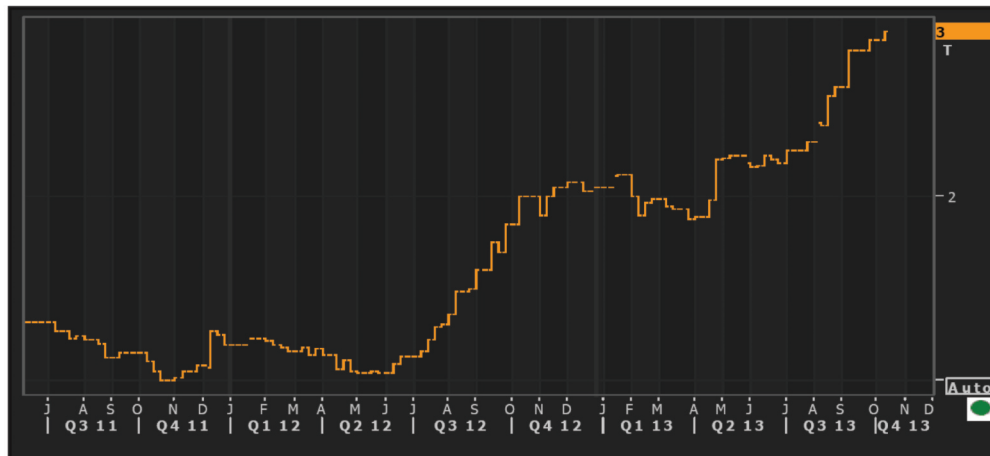
[By Sholom Sanik, October 14, 2013]

Chart 2 – December cocoa



Courtesy Bloomberg LP

Chart 3 – Butter ratio



Courtesy Bloomberg LP

**INDIA****A global laggard**

In the midst of a broad-based global bull market in equities, attractive short positions are in short supply. This, despite widespread doubts about the stability of financial markets and the strength of the global economic recovery. With the prospect of a violent pullback in equities that could arise at any time, spurred perhaps by a heightening of tensions in Europe's indebted nations, a violent confrontation in the Middle East, a cooling of the Chinese growth engine, a tightening of credit in the US, or any other unknown catalyst, we feel that a somewhat market-neutral stance is warranted.

To this end, identifying weak markets is important to achieve this balanced approach. One of our favored candidates is the Indian equity market. The Indian economy is in a perilous state. Plagued by persistent inflation, a weakening currency, and an ever-widening current account deficit, Indian equities will have a lot to overcome in order to rally higher.

Over the next several months, leading up to national elections due by May 2014, it will be exceedingly difficult for the ruling Congress party to enact any pro-growth policy changes. In fact, the government has already been bogged down by a bureaucracy that makes the US House of Representatives look efficient by comparison. This is likely to create a drag that will carry into next year, and add to uncertainty.

Markets would prefer to see the BJP form a government led by Narendra Modi, whose pro-industry record and history of strong governance contrasts with the more leftist Congress party, so shifting expectations for the results of the election could move markets in either direction.

More immediately, the new Chief of the Reserve Bank of India, Raghuram Rajan, has clearly signaled that price stability is a necessary condition for economic growth, and spooked markets with a surprise increase in the main policy repo rate in September (Chart 4). Given the persistent and rising inflation, it now seems likely that the tightening will continue.

In Washington this past week, Rajan encouraged the Fed to consider the impact of its policy on emerging markets. India was hit hard by taper talk in the spring of 2013, sparking a multi-month selloff in the rupee that saw the currency lose a quarter of its value (Chart 5), sending equity markets into a tailspin.

Rajan seems intent on getting ahead of the Fed in raising rates, saying last month in Mumbai, "Let us remember that postponement of tapering is only that – postponement," adding, "This is the course we have to take in order to stabilize the economy, and we need that stabilization whatever the Fed does... Let's not lose the chance, the warning that we have been given, because this is going to come back and what

we need to do is put our house in order before."

Under Rajan's leadership, the RBI should become more credible and decisive, which is needed as the data points paint an ugly picture that looks awfully close to stagflation.

Trying to balance the need to promote growth in a sluggish economy (GDP consistently falling lower – see Chart 6) with the need to promote price stability (inflation consistently creeping higher – see Chart 7) is no easy task. Rate increases are necessary to keep prices in check, and as per the discussion above, seem the likeliest course of action.

The RBI's surprise rate hike in September was met with disdain from the business community. Rajiv Kumar, the former secretary-general of the Federation of Indian Chambers of Commerce and Industry said, "This is an unwise move, and I don't know why he [Rajan] has sided with the hawks and given growth no chance at all." He added, "Given where we are, this ensures that the recovery doesn't begin for a while... It is a major misstep, and it means that any talk of a recovery in the real economy in the second half is now not going to happen."

The campaign against inflation will be hard fought, with rising prices being exacerbated by the falling currency, which although it has recovered somewhat from the lows, remains 12% below where it was before the Fed introduced the word "taper" to the investment world's lexicon.

The persistently widening current account deficit (Chart 8) does nothing to help the situation, and gives further credence to Rajan's hawkish stance in order to stem capital outflows on the heels of rising US yields.

Despite all of the negative factors, the Nifty 50 index, the most accessible avenue for trading the Indian stock market, is pushing up against its highs (Chart 9). Over the past four years this level has proven to have significant resistance, with sellers stepping in time and again to push the market lower.

As such, from a technical perspective we are at a very attractive level to initiating new shorts. The Nifty 50 contract that trades in Singapore is highly liquid, and priced in US dollars (eliminating the currency risk inherent in most overseas investments). It must be rolled monthly, which at first glance would seem costly to hold. However due to a sharp contango, shorts earn around 7% or 8% per annum in positive carry.

A more conservative approach could also be a market-neutral position, long US equities via S&P futures or another broad index, while short India via the Nifty 50 futures. Over the past 12 months, the S&P has outperformed the Nifty 50 by 10.45% (before the positive carry), and over the past two years, the outperformance swells to 25.69%.

*[By Jaime Macrae, October 18, 2013]*

Chart 4 – Reserve Bank of India Repurchase Rate



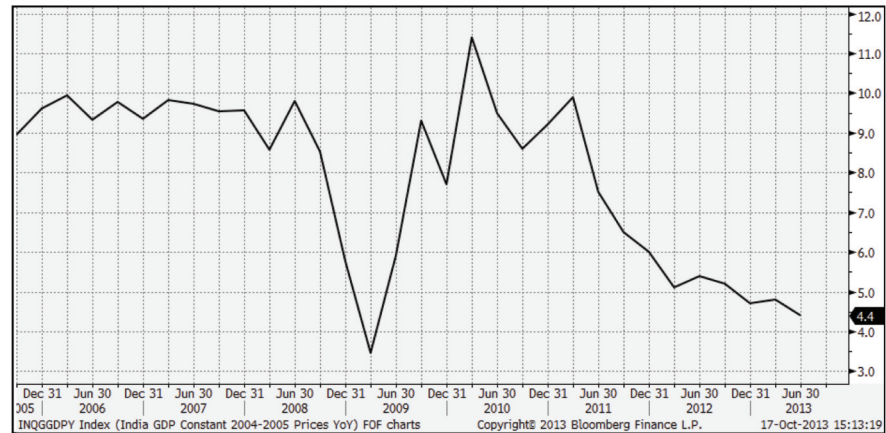
Courtesy Bloomberg LP

Chart 5 – Indian rupee vs US dollar



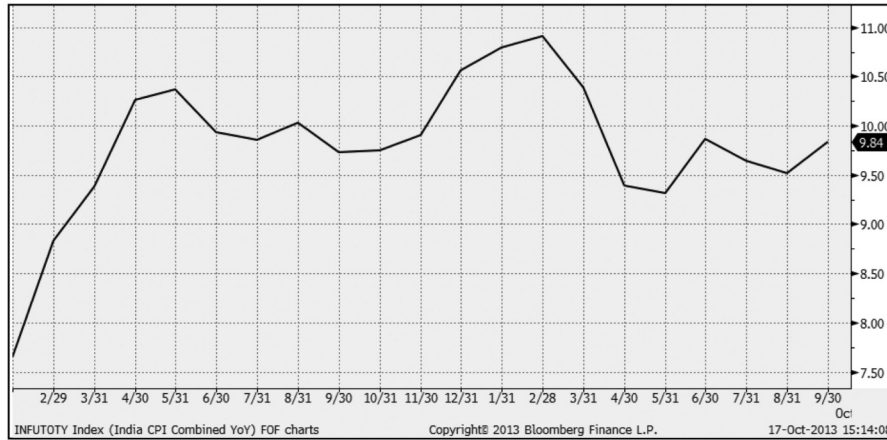
Courtesy Bloomberg LP

Chart 6 – Indian GDP



Courtesy Bloomberg LP

Chart 7 – Indian CPI



Courtesy Bloomberg LP

Chart 8 – Indian current account balance (% of GDP)



Courtesy Bloomberg LP

Chart 9 – Nifty 50 futures (rolling front month)



Courtesy Bloomberg LP

**CORN**

## Ethanol still a force, but corn stocks in recovery mode

In early October, rumors began to circulate that the Environmental Protection Agency (EPA) was set to reduce the minimum ethanol blend that it mandates the US fuel industry blend into gasoline. Over the past decade we've seen explosive growth for the US corn-based ethanol industry. In the early 2000s, only about 10% of the US corn crop was turned into ethanol. Back then, the USDA did not even include ethanol statistics in the monthly crop report that is available to the public. The ethanol market then experienced explosive growth. Currently, about 35% of the corn crop is used for ethanol.

The possibility of a shrinking US ethanol market added a bearish slant to a market that had already fallen substantially over the past several months. Without government pressure to maintain the ethanol blend at current levels, it was reasoned, US corn stocks could become burdensome.

The news made for some catchy headlines, but was largely misunderstood. Even if the EPA adopts these proposals, it is not really much of a bearish factor for corn. When the original ethanol mandate was formed, the government projected that by 2014, US gasoline demand would reach 154 billion gallons per annum. That forecast for gasoline usage was off by a wide margin, partly because of the recession and partly because of the advent of more fuel-efficient cars. The estimate for 2014 gasoline consumption has fallen to only 133 billion gallons.

The new legislation would cut the ethanol mandate to 13 billion gallons, down from the current 14.4 billion gallons. The 10% minimum ethanol-blend mandate will not change, it is just that the industry will not have to scramble to fit the existing required amount of biofuel into a gasoline market that is not growing as quickly as the legislation was designed for. As it is, estimated ethanol production for 2013 is about 13.5 billion gallons, which is right about at the target 10% of gasoline usage. The government is not abandoning the program, only attempting to tailor it to economic realities. So it is hardly a bearish factor, and certainly not as far reaching as the initial headlines may have intimated.

The federal government shutdown has ended, and data will start flowing soon. In the meantime, market participants have traded in the dark. The key October USDA crop report will be omitted entirely, and we won't see another estimate for comprehensive national supply/demand statistics until the November 8 installment.

Despite late planting and periods of poor weather, US farmers are expected to harvest a record 2013-14 corn crop of 13.5 billion bushels, according to the now-dated September crop report. In the absence of government data, private forecasters have weighed in with their own estimates. Generally, the outlook is for much higher yields than the USDA's estimate for 155.3 bushels per acre in the September crop report. Some estimates put the yield over 160 bpa, which would mean the output estimate would swell to over 14 billion bushels.

The Monday-afternoon weekly crop report was the first bit of post-shutdown information regarding the crop to be released, and it confirmed the revisions of private forecasters. It showed that the good-to-excellent portion of the crop jumped to 60%, up 5 percentage points from the last pre-shutdown report. That's a fairly large change and bodes well for a sharp uptick in the yield estimate.

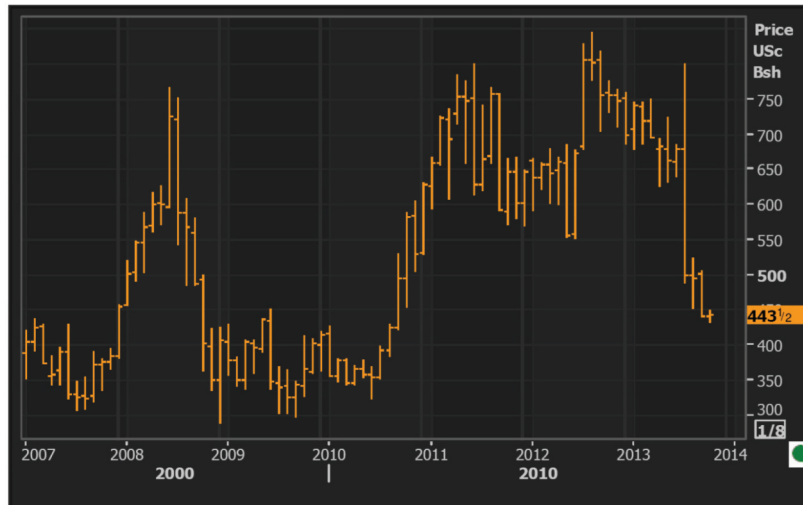
Global production is expected to reach a record 956 million tonnes, up 11% from 2013-14, and that figure could increase meaningfully if the US crop estimate is increased to reflect the improvement in crop conditions.

Consumption is forecast to grow as well, but by only 6.5%. The September estimate for ending stocks was 16.3% of consumption, up from an average of 14.7% over the previous three year. If the US crop is revised upwards, ending stocks would grow to over 17% of usage.

We're still shy of 2008-09 and 2009-10 levels, when ending stocks averaged 18% of consumption, but global corn inventories are being replenished. We believe the market should be traded from the short side, but with prices at three-year lows (Chart 10), we recommended looking for rallies to establish short positions.

*[By Sholom Sanik, October 22, 2013]*

Chart 10 – Nearest contract corn



Courtesy Bloomberg LP

## SUGAR

### The bull has returned

On the morning of October 18, sugar prices were consolidating a 3¢ per pound rally that began in mid-July. The market was meeting some resistance at seven-month highs (Chart 11). Then news broke that a massive fire broke out at Santos Port terminal, the largest in Brazil. March sugar spiked up by over 1¢ per pound. By the end of the session, the market had pared the gains and settled at prices not seen since December 2012.

In addition to extensive damage to the facility, the fire destroyed 180,000 tonnes of sugar, which had been stored in five warehouses. Miraculously, there were no fatalities and only some light injuries.

The burned sugar itself is insignificant in the grand scheme – it represents less than 0.05% of total 2012-13 Brazilian output. The market can handle that. The much larger problem is the effect on the shipping infrastructure. The gutted terminal has capacity to ship 9 million tonnes per year, about a third of all sugar sold abroad by Brazil. Competing ports will take up some of the overflow, but it is estimated that 20% of total Brazilian sugar shipping will be disabled until repairs are complete. Brazilian sugar traders already invoked *force majeure* on sugar that was scheduled to be shipped from the port.

A week has passed since the devastating fire, and sugar prices have slipped back to pre-fire levels. It would seem – judging by the market’s reaction – that the impact on the global supply chain will be limited. There is no sign

of tightness, even for the near-term. The March-May spread, which had been trading near flat, spiked briefly on the day of the fire to 50 points premium to spot March, but has since narrowed to only 16 points (Chart 12).

The global balance sheet for the outgoing 2012-13 marketing year will show a surplus of close to 10 million tonnes. The surplus is expected to narrow, but will still be several million tonnes for the upcoming 2013-14 season. So it is understandable that there is a feeling of complacency. A one-off event, like the blaze at the Brazilian port, has historically created short-lived excitement for bulls and typically leaves nothing but a false breakout on charts. Once the implications for long-term supply/demand fundamentals are assessed, the market retreats.

We should remember, however, that the market rallied to 19¢ per pound before the unfortunate fire. While analysts and press reports keep talking about a surplus of about 4 million tonnes for the new marketing year, those estimates are probably stale and have not taken into account recent developments. Output for 2013-14 in Thailand and India is expected to increase by about 1 million tonnes each, all of which will be available for export – but that has been known for many months.

Brazilian production for 2013-14 was a major disappointment. Earlier in the season output was expected to be much higher, based on the size of the cane crop. Wet

weather, however, has lowered sucrose content and hampered crushing operations. Lower sucrose content has a double effect. Aside from lower yields, it provides an incentive for processors to divert a greater percentage of the cane to ethanol.

Although the center-south crop, which represents 90% of Brazilian output, was more than 10% larger than in 2012-13, sugar output will be about the same or lower than in 2012-13, at about 34 million tonnes. One analyst lowered the estimate to 32 million tonnes. The weather remains wet, and production continues to fall behind seasonal norms. The estimates vary, but it's a good bet that the production loss in Brazil since the last global surplus forecast is at least equal to Indian and Thai increases.

The long-term bullish case is intact with or without the port fire or wet weather in Brazil. Prices are too low, and processors are not profitable. A recent report by

commodity analyst Czarnikow says that even after the rally, sugar prices remain below the cost of production, affecting mills in Brazil, India, and China.

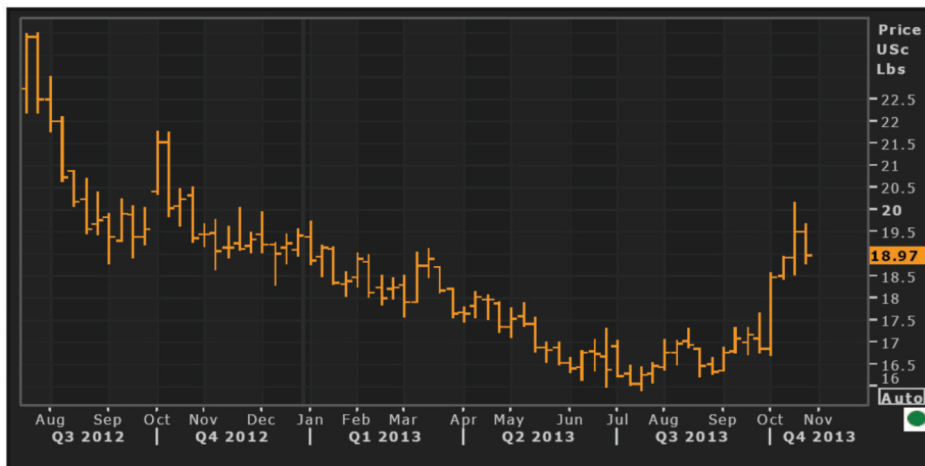
In Brazil, mills are running at capacity, and there obviously is not much investment in new infrastructure, because with world sugar prices at these levels, it is not a very profitable enterprise. In turn, the cane crops are not expected to expand, because of inadequate mill capacity.

The damage from the fire will be fixed in time, but the accident highlights the vulnerability of 50% of world exports originating in Brazil.

As we mentioned earlier, market participants are complacent with the (dwindling) surpluses, which leaves long-term call options inexpensive. We remain very bullish. Use the setback to add to long positions.

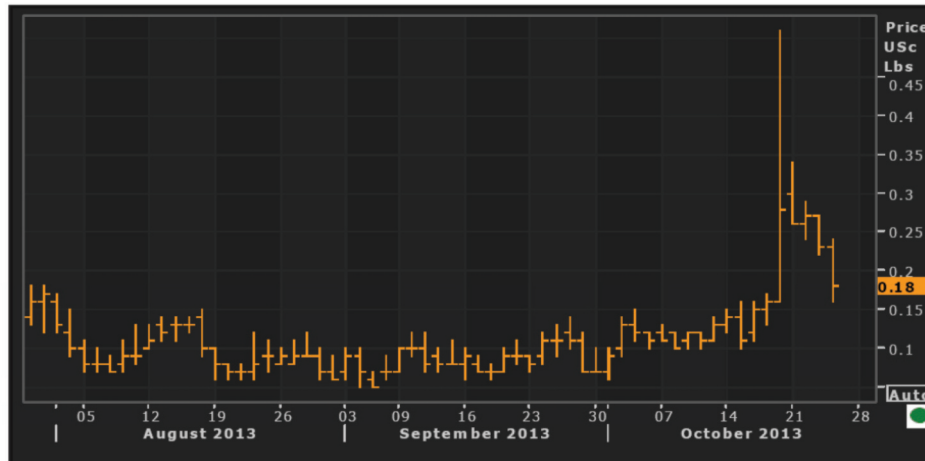
*[By Sholom Sanik, October 25, 2013]*

Chart 11 – Nearest contract sugar



Courtesy Bloomberg LP

Chart 12 – March/May ICE sugar spread



Courtesy Bloomberg LP

**EURO BANKS**

## Climbing the wall of worry

Investor sentiment continues to strengthen, and nowhere is that more evident than in Europe – the new darling of mutual and hedge fund managers. The past 15 weeks have seen more than \$22 billion pour into European equity markets, in the longest stretch of uninterrupted inflows since 2002.

The primary motivation would appear to be a shift towards favoring value over quality, as the broad Euro Stoxx 50 Index is 32% cheaper than the MSCI World Index of developed-market equities, based on the assets held by the companies. Also, while economic growth is hardly anything to celebrate (Spain posted its first quarterly GDP growth in two years, but it was a paltry 0.1%, and unemployment is still rampant), the trend is up, and some measures are pointing to a recovery. For example, the Markit Eurozone Manufacturing PMI rose to 50.3 in July, the first reading over 50 since 2011, indicating growth.

In the hunt for value, European banks offer the greatest discount to historical valuations. The Euro Stoxx Bank Index is still 70% below its pre-crisis level compared with the 20% lost in the broader index (Chart 13). In the US, financials are down around 44%, while the general market is now up over 11% since the crisis began.

While there is much work to be done to return Europe's banks to health, a more proactive central bank and upcoming regulatory harmonization should help weed out the weaker banks and create a more robust banking sector.

Mario Draghi, the head of the European Central Bank, last week unveiled the bank's plans for the third round of

“stress-testing.” The Asset Quality Review (AQR) is to begin in November this year, and will conclude in 12 months. This means that there is a one-year window in which European banks may be insulated from severe headline-driven volatility, as the market awaits the AQR's verdict on the health of banks.

Further alleviating pressure is the ECB's intention to follow the AQR with corrective measures should they be needed, including new equity issuance, reorientation of funding sources, asset separation and sales – which, while they may dilute the value for some existing shareholders, will in the end recapitalize banks and place them on surer footing.

From a macro perspective, funding pressures in Europe are easing, as evidenced by the narrowing of the spreads between peripheral debt and German bunds (Chart 14). Should this trend continue, it could lead to the re-rating of peripheral equities as the cost of capital comes down.

Despite the recent strength and the argument for a continued recovery, European banks are a very risky asset. The overhang of sovereign debt problems has not gone away. High unemployment still plagues the peripheral southern states, and tepid economic growth still seems the best-case scenario for these nations. But as the European equity markets climb a wall of worry, the laggards (i.e., the banks) stand to benefit the most.

The Euro Stoxx Bank index is tradeable as a futures contract on the Eurex.

*[By Jaime Macrae, October 29, 2013]*

Chart 13 – Euro Stoxx 50 and Euro Stoxx Banks (dark line)



*Courtesy Bloomberg LP*

Chart 14 – 10-year yields: Spain, Italy, and Germany



Courtesy Bloomberg LP

## EURO CURRENCY

### A turning point

The euro currency looks like it has reached a tipping point this week, with the bullish picture shifting dramatically due to a couple of economic releases. Coming into this week, sentiment was overwhelmingly bullish, reflecting Fed dovishness contrasted against a more conservative ECB, an uptick in European economic data, and strong capital inflows, as discussed in our earlier note entitled “European Banks: climbing a wall of worry” (*Focus on Futures*, Oct. 29, 2013). This argument seems now to have been turned on its head.

The first pin fell on October 30, when minutes from the latest FOMC meeting threw cold water on expectations that tapering asset purchases would come later rather than sooner. Language about signs of “underlying strength” in the economy have now reversed those expectations, with many participants now anticipating the first reduction will come in January instead of March 2014.

The second pin fell on October 31, when European economic data took a turn for the worse. Of primary importance was a surprise cooling of euro-area inflation, to the lowest level in four years (Chart 15). This marked

the ninth straight month that inflation has lagged the ECB’s stated target of 2%, and inflation now sits at a level last seen when Europe was mired in a deep recession.

The second data point was unemployment, which hit an all-time high of 12.2% for the euro area (Chart 16). Both releases contradict the prevailing positive sentiment that the region was growing stronger, and expectations have since emerged that the ECB will loosen its benchmark refinancing rate to 25bps from 50bps at its meeting in December.

Of developed-nation currencies, the euro has been the star performer so far in 2013 (Chart 17). The strong currency poses a risk to export-oriented Germany, by far the strongest pillar of support for the eurozone, and has also contributed to lagging inflation as imports get cheaper.

Barring a significant weakening of US economic data, or strengthening of European data, the winds have now shifted in favor of euro currency weakness. Establish new short positions here, risking the recent highs with a stop at 1.3850 (basis December futures).

[By Jaime Macrae, November 1, 2013]

Chart 15 – Eurozone all items y/y CPI



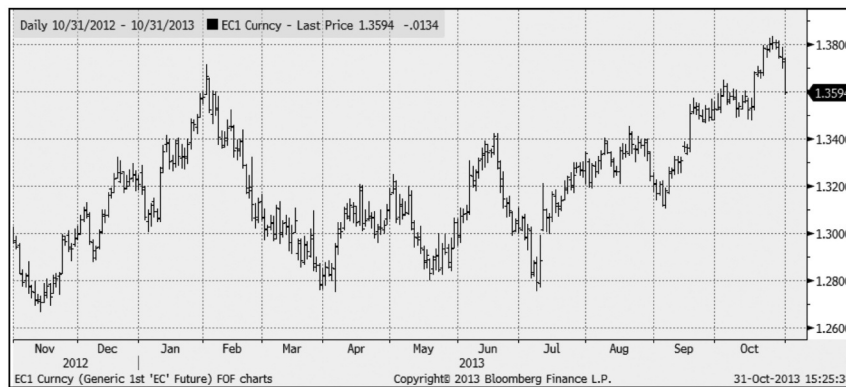
Courtesy Bloomberg LP

Chart 16 – Eurozone unemployment



Courtesy Bloomberg LP

Chart 17 – Front month euro currency futures



Courtesy Bloomberg LP

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