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Wheat: A bull market in waiting

Another contract low in December wheat – blasé! The bear market in grains has not drawn many headlines in some time. Five years of sliding prices has allowed participants to become complacent. The tape tells us that the supply/demand fundamentals are bearish, and you can't fight the tape, they say. We've tried a number of times and were overwhelmed by the market's interpretation of the fundamentals.

Our primary case all along has been – and still is – that global wheat production has actually declined the past few years, while consumption has increased, a process that has depleted stocks (Table 1).

Table 1

Millions of tonnes	Output	Usage	Ending Stocks	Stocks as a % of usage
1998-99	588	590	137	23%
1999-00	585	595	127	21%
2000-01	583	596	114	19%

Source USDA

The argument is so simplistic it's almost embarrassing to keep repeating it. Nonetheless, we believe that the longer prices remain depressed, the more farmers will continue to shift to more profitable crops, which will ultimately stretch the production/consumption deficit far enough to cause tightness in supplies.

A number of fresh developments have surfaced, which have piqued our interest again. First, the early weeks of planting of the winter wheat crop in the US have not seen ideal weather conditions. The US Great Plains, where a significant percentage of the winter wheat is planted, has been experiencing dry weather, which has left the soil deprived of moisture that is vital for seed germination. Many areas are so dry that farmers have not been able to start planting.

To illustrate, consider that in Monday's crop progress report, the USDA said that only 21% of the crop had been planted compared with the 5-year average of 30% for this time of year. It is still quite early. Timely and ample rainfall can still salvage the situation. But until the planting season is through, there should be a premium attached to the price to account for a potentially smaller crop. At this time, the forecast for the next week or so calls for no significant precipitation.

The uncertainty about the fortunes of the winter wheat crop *vis à vis* spring wheat is illustrated vividly in the spread between December Kansas City wheat (winter only) and Chicago Board of Trade (winter and spring). This spread has widened rather dramatically over the past year. The recent problems have tacked on an additional 10¢ to the spread (Chart 1).

There are other supply-side issues as well. Other key exporters, such as Canada and Australia, were slated to produce the kind of crops that, on the surface, were consistent with depressed prices. It seems to us that although both of these countries have seen estimates for their crops downgraded in recent weeks, the market hasn't adjusted for these changes.

Canadian wheat-growing regions struggled with dry weather this summer. Despite the fact that Statistics Canada

In this issue

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

– Canada's equivalent of the USDA – lowered its estimate of the Canadian crop to 25.4 million tonnes on August 25, the USDA persisted with its more optimistic outlook by lowering its estimates by only 500,000 tonnes, to 26 million tonnes.

The Australian government's ABARE lowered its forecast for its crop by 800,000 tonnes to 22.2 million tonnes, but the USDA still lists its output at 23 million tonnes.

It's not that the USDA is ignoring the surveys of these two reliable Western government agencies. Rather, the USDA takes a more conservative approach and combines the results of surveys with trendline data until there is a more accurate picture when the harvest begins.

If it turns out that the locals have a better idea of what's going on in their own backyard, the difference is not an insignificant amount of wheat. Together, these two output cuts would lop 1.4 million tonnes off production, which would lower ending stocks to 112.2 million tonnes, or just below 19% of consumption. Carryover stocks at the end of last year stood at 126 million tonnes, or 21% of consumption (Table 1).

On the demand side, exports have been steady but unspectacular recently. Average new sales for the past 4 weeks were 472,000 tonnes compared with 698,000 tonnes for the average of the previous 4-four week period. Egypt went on a buying binge of US wheat in the past 48 hours. Reports have it that it purchased 340,000 tonnes of winter wheat.

China's agreement with the US to smooth the way for Chinese membership in the World Trade Organization will probably pave the way for reciprocal gestures, which will include the resumption of US wheat purchases.

In conclusion, there isn't any one single issue stark enough to make prices go up. When you put everything together – a small 2001-02 winter wheat crop and a bubbling export market – there is a fair bit of vulnerability. And with prices crawling along these multi year-lows for so long now (Chart 2), we're ready to place our bets on the long side.

[September 28, 2000]

CURRENT STRATEGY: *Liquidated long December CBOT wheat as per Flash Update of October 23.*

Chart 1
Spread Between Kansas City and Chicago Wheat

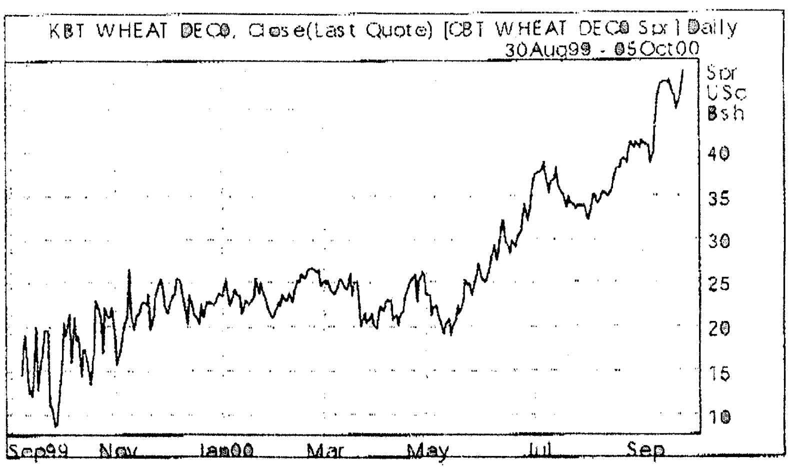
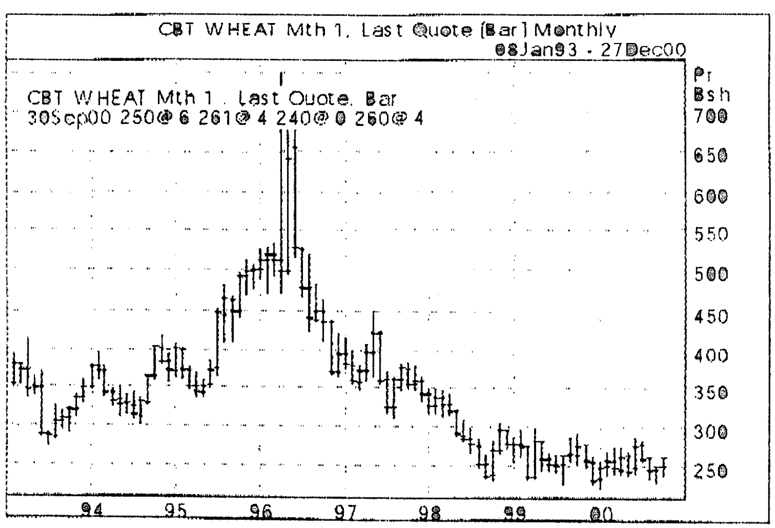


Chart 2
Monthly Spot Wheat



Charts courtesy of *Reuters*

COPPER

A corrective dip, but trend is still up

The sharp rally in December copper stopped just shy of 95¢ per pound in mid-September amidst ideas that the market had stepped ahead of the pertinent fundamentals and had become overbought (Chart 3). Indeed, when prices peaked, open interest had swelled by some 25,000 contracts, or 40%, since early summer, indicating that speculators had a hand in pushing prices to multi-year highs. The bulging open interest warned of an overextended market. It follows, then, that a healthy correction in price accompanied by a large drop in open interest should provide a signal that the countertrend move has ended. The 6¢-per-pound slide in copper has helped to shed 10,000 contracts.

The explanations for the pullback in prices seemed rational, but were weak. Scrap copper is typically drawn to the market when prices are strong, and it was assumed that this would be the case in this environment as well. However, we've seen reports that indicate scrap copper conditions are actually quite tight. (More on tightness later.)

A favorite endeavor of the financial press is correlating the prices of economic data to those industrial commodities sensitive to economic activity. A frequent misuse of this tool is tying short-term movements in the price of copper to short-term movements in equity prices. With the NASDAQ down over 20% since September 1, analysts could easily justify the 5% slide in copper prices. While reactions by participants may indeed create the illusion that this relationship exists, a look at longer-term patterns makes it clear that it does not. During the bear market in copper, which began in mid-1995 and bottomed last summer, the value of the NASDAQ doubled.

The relationship is far more clear if we isolate protracted economic slowdowns. Prices took a steep dive when the Asian crisis hit, falling to 60¢ per pound from $1.05 per pound over a period of two years, from mid-1997 to mid-1999. Similarly, the market fell to 75¢ per pound from $1.35 during the recession of the early 1990s. But to argue that a downturn in the stock market is a precursor to an economic slowdown, which should be a precursor to a fall in commodity prices, is a stretch and should be beyond the scope of discussion of short- to intermediate-term movements of copper prices.

Surging oil prices have been the subject of bullish and bearish arguments for the copper market. On the one hand, there are fears that $34-per-barrel crude prices – in conjunction with a series of central bank tightenings – are going to stifle economic growth around the globe and as a consequence, demand for industrial commodities. On the other hand, production of base metals is an extremely energy-intensive process, which is expected to cause producers to cut back production.

A glance at related markets shows that there is support for the weak-economy argument. The other important base metals – zinc, lead, aluminum, nickel, and tin are all experiencing sharp pullbacks.

On October 6 the International Copper Study Group (ICSG) released its most recent report, which makes sense of all of the above tidbits. Global consumption has indeed slipped back a bit but not enough to change the outlook significantly. The production/consumption deficit for July was only 3,000 tonnes, compared with a deficit of 85,000 tonnes in June.

The big picture, however, remains intact. The deficit for the year thus far rose to 392,000 tonnes, compared with a surplus of 146,000 tonnes in the same period last year. Interestingly, despite the smaller deficit in July, the year-to-date deficit grew from 349,000 tonnes in June because of revisions to earlier periods this year. The smaller monthly deficit was neutralized by the revision, confusing traders, leaving prices where they were and in search of direction. We were not confused, because we view the drop in consumption as an anomaly until there is a trend to confirm it. One month does not make a trend.

LME stocks continue to fall each and every day. They now stand at 388,000 tonnes, down from over 800,000 tonnes this past February. Looking for the daily change in these inventories when we turn on our computers each morning has lost all element of suspense. There is, however, something rather new and exciting for bulls: The contango is vanishing. Only a few weeks ago, the cash-to-3-month spread for LME copper was $25 per tonne. It has been tightening steadily and is now only $8 per tonne. The same pattern appears in New York where the market is already inverted (Chart 4). This leads us to believe that the bull in this market is alive and the major trend is still pointing clearly upward.

[October 11, 2000]

CURRENT STRATEGY: *Liquidated long December copper as per Flash Update of October 17.*

Chart 3 - December Copper

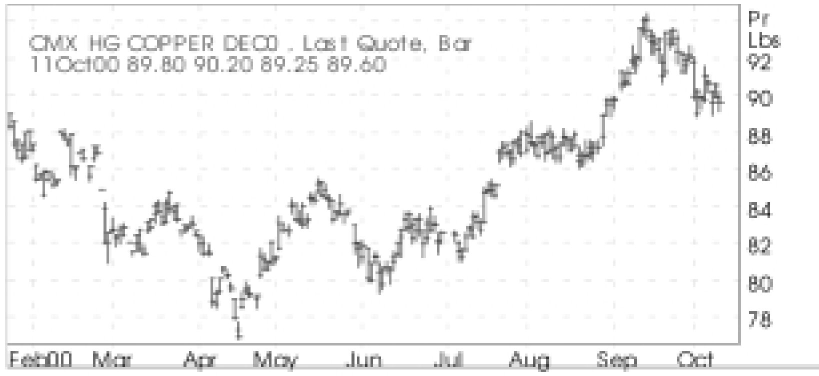
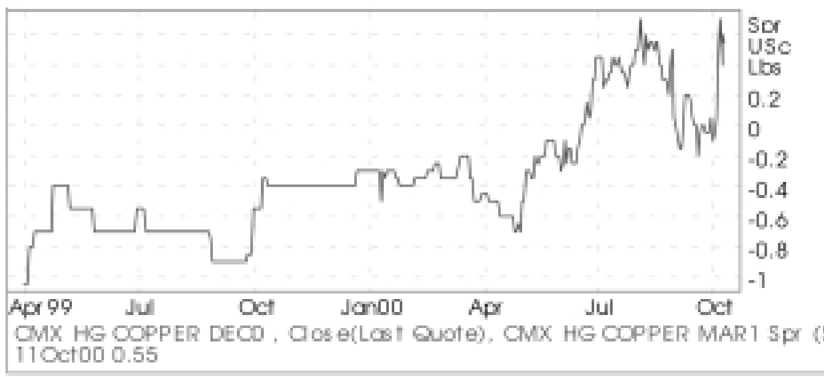


Chart 4 - December/March Spread



Charts courtesy of *Reuters*

SUGAR

Strength beyond fundamentals

Over the past six months the sugar market has been recast from pitiful bear market to star performer of agricultural commodities. The shift in the global production/consumption balance from surplus to deficit drove the market to 11¢ per pound from 5¢.

A brief history of our recent experience with trading this market: We squeezed just about every last penny out of the initial thrust by buying the market at 5.5¢ and liquidating at 10.5¢ per pound. After the market consolidated and looked like it was going to take another leg up, we hopped back onto the long side, but were fortunate to have a tight stop, thus avoiding the big 1.5¢ correction when it finally came. And now, we're back on the long side again.

The reason we're drawing attention to our track record in trading this market is not for gloating rights. Rather – quite to the contrary – we feel we owe an explanation for being long at present. Until recently, the fundamentals were clear. The poor crops in major exporting countries, such as Brazil and Australia, caught the market off guard and short. This and the other bullish factors that made prices skyrocket (see *Focus on Futures*, July 28 and September 18) have been known for many months, and the market has very likely priced a pound of sugar accordingly. If anything, studying the fundamentals that are available would make it far easier to build a bearish case.

On September 28 the International Sugar Organization (ISO) again lowered its forecast for the 2000-01 global production/consumption deficit to 3.15 million tonnes from its September 11 estimate of 3.5 million tonnes. This, in turn, had been lowered from its first estimate back on July 10 for a deficit of 5 million tonnes. The nearly 2-million-tonne difference between the first and most recent estimate is significant, but not overwhelming. More importantly, after the first estimate the market was already trading at these levels. Can we rationalize buying sugar at these levels when in fact the analysts that watch the market closely are telling us that the original move to 11¢ per pound was motivated by an overestimation of the size of the deficit?

Furthermore, just yesterday the ISO issued a very negative report indicating that Brazilian and Australian crops in the 2001-02 season would bounce back and restore the market to surplus. They also cited the questionable outlook for Chinese, Russian, and Indonesian imports and Indian surpluses as bearish factors. They were very clear about the potential negative impact of these developments, stating that "we could be back to square one with six cent sugar again... ." So where's the fire?

There has been one interesting development on the bullish front. It was thought that import tariffs imposed by the Russian government would dry up Russian import activity completely. However, in yesterday's daily sugar report, F.O. Licht said that trade sources report that Russia has imported as much as 600,000 tonnes of sugar over the past 2 weeks – quite a bit of sugar. It seems that the domestic market is so tight and prices so high that traders can import sugar and turn a profit even after being hit with import tariffs that can run as high as 40%. Egypt and Pakistan are expected to be in the market for sizeable purchases later this year as well.

Still, there do not seem to be any factors so dynamic as to warrant a return to the contract highs. The way the market is acting we could easily take out the 1997 highs of 12.5¢ per pound. It is obvious that commodity funds have seized control of this market and are just buying it blindly. As each technical milepost is crossed, more speculators are motivated to jump on the bandwagon. Evidence is close at hand. Tuesday's 29-point rally that took March sugar to a new closing contract high was accompanied by a 12,000 contract, or 9%, increase in open interest. Unless some latter-day Hunt brothers are visiting the sugar pit at the Cocoa, Sugar & Coffee Exchange, that surge in open interest was a massive influx of bullish fund managers following analysis that is not influenced by supply and demand factors in the least.

While we still retain our general friendly stance on sugar prices, we acknowledge that unless information surfaces that would indicate otherwise, the fundamentals do not justify these new price plateaus. So there you have it: We've laid our souls bare – we are long this market because we think the funds are going to drive it to the moon. When we detect that they're getting tired, we hope to be gone faster than you can imagine.

[October 12, 2000]

CURRENT STRATEGY: *Liquidated long March sugar as per Flash Update of October 20.*

SOYBEANS

A strong dollar masks bullish fundamentals

Aside from a few select commodities whose supplies are tight enough to make them desirable at just about any cost (namely petroleum products), prices of many of the commodities that we watch are being depressed – in part – by the extraordinary and prolonged strength of the US dollar, which has appreciated by close to 20% since the beginning of the year (Chart 5). Demand shrinks as goods become more expensive in local terms.

While it is quite logical to assume that a strong dollar has been a factor in discouraging traditional soybean customers, recent export data indicate otherwise. Pent-up demand exists in this market and is beginning to surface. Last week's USDA export commitments of 1 million tonnes were substantially above the high end of trader's estimates of 650,000 tonnes. Average weekly commitments for the past 4 weeks were 800,000 tonnes, which was a substantial improvement over the average of the previous 4 weeks of 440,000 tonnes. Export inspections for the week, a measure of actual shipments, came in at 875,000 tonnes, also considerably above analysts' estimates.

The October USDA supply/demand situation report reflected the pessimism about demand by lowering the estimate for US exports by nearly 1 million tonnes from the September report, to 26.2 million tonnes. Total commitments for the marketing year are still running just a tad behind last year at this time. If, however, exports continue at the pace of recent activity, we could assume that the USDA's projection for demand to slow will be adjusted.

Bill Gary of *Price Perceptions* (October 21) points out that some important agricultural analysts, such as William Tierney of Kansas State University and oilseed publication *Oil World*, question the USDA's soybean figures and remind us that the USDA has made somewhat of a habit of overestimating soybean ending stocks in recent years. The USDA kicked off the 2000-01 season with a forecast for ending stocks of over 16 million tonnes. Now that the crop is being harvested and we have a fairly good idea of its size, ending stocks are 10 million tonnes, even with the likely-overstated October estimate. If, indeed, the September estimate for annual exports proves to be more accurate, ending stocks would fall to 9 million tonnes.

At the global level, consumption of protein feed grew dramatically in the1990s. Soybean production rose to meet the demand and did not subside when the Asian crisis hit. Inventories built up from 1997 through 1999 and became burdensome, eventually driving prices as low as $4 per bushel in mid-1999. At the end of the 1998-99 season, global ending stocks represented 16.4% of consumption. According to the USDA's October estimates, ending stocks will drop to 14.7% of consumption. If the USDA takes the recent brisk export business into account and raises its forecast for annual US exports back to the September level of about 27.2 million tonnes, as we suspect they will, ending stocks will drop to 14.1% of total usage.

In the bearish camp, South American output continues to grow. Brazilian and Argentinian crops will yield 3.5 million tonnes, or 6.5% more than last year. The two countries' exports comprise about 32% of world trade. Their increased production, however, has already been accounted for in the world balance, and as illustrated above, stocks have tightened regardless. Besides, there is a pretty big window from now until the Southern-Hemisphere crops are harvested next spring. If the US crop continues to be downgraded and export business continues to surprise, importers may find themselves waiting anxiously for those crops to come in.

Open interest has increased rather dramatically by 75,000 contracts, or 60%, since the end of August (Chart 6). As the crop is harvested, it is normal to see a lot of harvest selling, which would account for such large increases. However, commitment-of-traders data show that the commercial presence on the long side of the market has increased over the past few weeks, indicating that speculative interests are becoming prominent on the short side. We like that.

In summary, we acknowledge that the powerful US dollar is a negative for bulls. For the moment, though, importers seem needy enough and are willing to put up with the premium it is costing them. *[October 26, 2000]*

STRATEGY: *Remain long January soybeans as per Flash Update of October 20. Maintain initial stops at 464.50, close only.*

Chart 5 - US Dollar Index

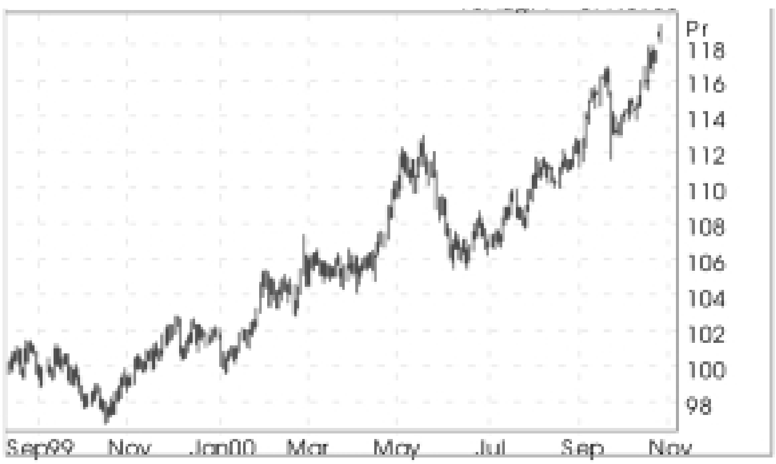
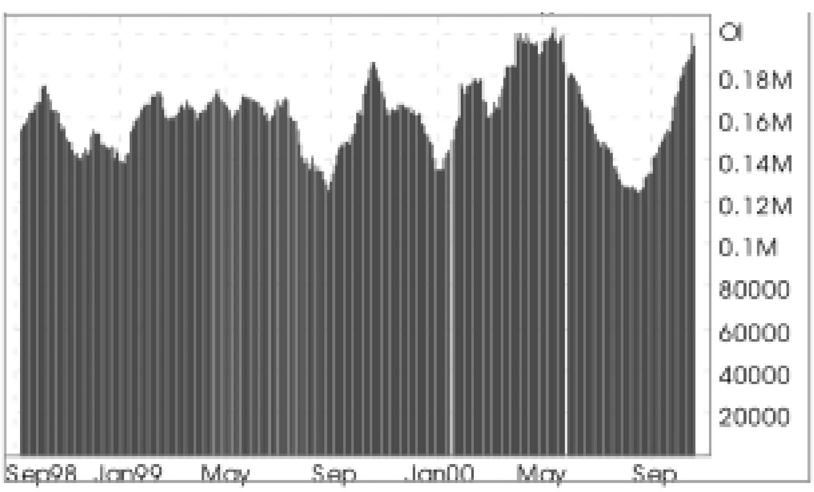


Chart 6 - Soybean Open Interest



Charts courtesy of *Reuters*

COTTON

Prices back off, but fundamentals remain constructive

At first, the much anticipated USDA October production figure for the US 2000-01 cotton crop looked as though it would gratify bulls in a big way. After the mid-September report, the crop suffered substantially from hot and dry weather. The USDA conducted a special survey in early October to assure that the October report would be up to date. The figure came in at 17.49 million bales, down from September's 18.32 million bales and below the average trade estimate of 17.76 million bales. Just a few months ago we were talking about a crop of close to 20 million bales, which would have been a major recovery from the 1999-00 crop of only 16.97 million bales. Shortly after the market opened on the day of the report, the market ran up to just shy of the 3¢-per-pound trading limit and contract highs. But that was it. Over the next few sessions, the market tumbled by as much as 5¢ per pound. What happened?

The US production figure drew the headlines, but a closer inspection of the data revealed that adjustments to other key figures in the US and abroad actually caused the forecast for ending stocks to rise slightly. US domestic consumption and exports were lowered by 400,000 bales. Despite the sharply lower US crop, global production increased slightly, because Pakistani and Chinese production were raised by 1 million bales. With production a little higher and consumption a little lower, the estimate for ending stocks grew by 650,000 bales, to 35 million bales, or 37.7% of consumption, compared with the September estimate of 37.1% of consumption. It doesn't seem to be much of a difference – indeed we believe it is not – but the market was overbought and due for a buy-the-rumor-sell-the-news correction.

Furthermore, we discussed the drag that the strong US dollar has been on commodity prices in our soybean report released earlier today. Cotton prices have probably suffered from the same problem; however, we showed how soybean demand seemed to be strong regardless, evidenced by a very healthy export market. The cotton market has shown a similar pattern.

The current marketing year got off to a strong start, which supported the USDA's early forecast for a jump of almost 20% in US exports for 2000-01. Prices had risen by about 25% since the start of the year, however, and for a while seemed to discourage buyers. When prices were near their peak in September, there were a few weeks in which there was almost no export business at all. The USDA responded by lowering its estimate for annual exports in its October report to 7.6 million bales from earlier forecasts (as high as 8.2 million bales in July).

This mornings's USDA weekly export commitment report showed net new sales of 167,000 bales, which was above the high end of the range of analysts' expectations and significantly above the average of the previous 4 weeks of 62,000 bales. The last two reporting periods have altered the complexion of the export market. Average weekly commitments for October were 103,000 bales compared with 67,000 bales for September.

Today's US Census Bureau's cotton consumption report for September was negative. Mill consumption was 2% below last September and combined stocks held in mills and public storage were up 4% over the comparable period last year. Total US consumption was 9.85 million bales, towards the low end of analysts' estimates, compared with the USDA's estimate for 10.1 million bales.

Developments on the supply side have been supportive. The weather in the Southern US cotton regions has been wet and continues to be a problem. With 40% of the crop still to be harvested, the plants are still subject to yield and quality losses. Also, there was a report indicating that the crop in Uzbekistan, a key producer, suffered from wet weather that could cut yields by as much as 20%.

To summarize: The smaller US crop and brisk exports are definitely bullish fundamentals to be reckoned with. The bearish influence of the US dollar does not seem to have had an important influence on US exports. Open interest has been drifting lower, shedding about 10,000 contracts and with it many of the weak-handed bulls (yes, including us). We anticipate that robust foreign demand will have a tightening effect on the global supply/demand balance. We remain friendly and are watching carefully. *[October 26, 2000]*

STRATEGY: *Remain sidelined, but closely tuned.*

HOTLINE UPDATE

Flash Update: **Tuesday, September 26, 2000**
Good morning for Tuesday, September 26, 12:10 pm. This is a Flash Update. We have bought December cotton at 63.60, placing our initial stop at 60.60, close only.

Flash Update: **Thursday, September 28, 2000**
Good morning for Thursday, September 28, 10:15 am. This is a Flash Update. We have purchased December wheat at 259.75, placing our initial stop at 245, close only.

Friday, September 29, 2000
Good afternoon for Friday, September 20, 5:20 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December copper, with our stop revised to 91.25; long December cotton, with our initial stop at 60.60; and long December wheat, with our initial stop at 245. All stops are close only.

Flash Update: **Monday, October 2, 2000**
Good afternoon for Monday, October 2, 2:00 pm. This is a Flash Update. We have liquidated our long December copper position at 90.30.

Flash Update: **Wednesday, October 4, 2000**
Good morning for Wednesday, October 4, 10:05 am. This is a Flash Update. We have purchased March sugar at 9.70, placing our initial stop at 8.90, close only.

Flash Update: **Friday, October 6, 2000**
Good morning for Friday, October 6, 9:10 am. This is a Flash Update. We have purchased December copper at 91.10, placing our initial stop at 87.90, close only.

Friday, October 6, 2000
Good afternoon for Friday, October 6, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December cotton, with our stop revised to 61.50; long December wheat, with our stop at 245; long March sugar, with our stop revised to 9.45; and long December copper, with our initial stop at 87.90. All stops are close only.

Friday, October 13, 2000
Good afternoon for Friday, October 13, 5:05 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long December cotton, with our stop revised to 62.50; long December wheat, with our stop revised to 259; long March sugar, with our stop revised to 9.90; and long December copper, with our stop at 87.90. All stops are close only.

Flash Update: **Monday, October 16, 2000**
Good morning for Monday, October 16, 11:20 am. This is a Flash Update. We have liquidated our long December cotton position at 62.50.

Flash Update: **Tuesday, October 17, 2000**
Good morning for Tuesday, October 17, 10:20 am. This is a Flash update. We have liquidated our long December copper position at 87.85.

Flash Update: **Friday, October 20, 2000**
Good morning for Friday, October 20, 10:45 am. This is a Flash Update. We have one new recommendation. We have bought January soybeans at 484 1/2, placing our initial stop at 464 1/2, close only.

Flash Update: **Friday, October 20, 2000**
Good afternoon for Friday, October 20, 1:30 pm. This is a Flash Update. We have liquidated our long March sugar position at 10.86.

Friday, October 20, 2000
Good afternoon for Friday, October 20, 5:00 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 259; and long January soybeans, with our initial stop at 464 1/2. All stops are close only.

Flash Update: **Monday, October 23, 2000**
Good morning for Monday, October 23, 11:00 am. This is a Flash Update. We have liquidated our long December wheat positions at 258 1/2.

Friday, October 27, 2000
Good afternoon for Friday, October 27, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long January soybeans, with our stop at 464 1/2. All stops are close only.

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