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Cotton: Runaway production and sinking demand equals one wicked bear market

Cotton is trading at 29¢ per pound. It has not been this low since 1972, and it's not hard to understand why. There is a reasonably close correlation between world GDP growth rates and cotton consumption. With output maintaining a steady upwards course and economies around the globe weak and weakening, there does not seem to be an end in sight to this bear market.

With generous protection from Washington in the form of a guaranteed price floor of 50¢ per pound, tumbling prices have not deterred US farmers from planting cotton. In its October supply/demand situation report, the USDA raised its estimate for 2001-02 US production to a record 20.07 million bales. This compares with a drought-ravaged 2000-01 output of 17.19 million bales.

Mill use in the US this season is estimated to decline by 580,000 bales, to 8.3 million bales, making this the second year in a row of poor domestic demand. Yesterday's US Census Bureau report painted an even bleaker picture, showing mill usage for September falling to an annualized rate of 7.87 million bales.

To illustrate just how weak US demand is, consider that average mill usage from 1995-96 through 1999-00 was 10.7 million bales. This will leave the US with 8.8 million bales of carryover stocks (51% of consumption) at the end of the 2001-02 season, more than double the 3.92 million bales (23% of consumption) at the end of the 1999-00 season.

While big crops and shrinking demand in the US are the most prominent features of this bear market, the situation in the rest of the world has contributed to the weakness as well. Global production has increased substantially in the past three years, while consumption has remained flat. The USDA estimates 2001-02 global production at 96.07 million bales, up almost 8 million bales from 2000-01. Consumption remains stagnant at 92.08 million bales, up only 370,000 bales from last season.

Cotton has replaced cocoa as the commodity with the most burdensome carryover stocks. According to the USDA, global carryover stocks at the end of 2001-02 will stand at 43.26 million bales, or 47% of consumption, compared with 42.5% at the end of the 2000-01 season.

The only bright spot in the statistics camp is actually a very bright spot. The USDA estimates that exports will jump this year by 33%, to 9 million bales. Export commitments as of yester-

day's weekly export report stood at 6.3 million bales compared with only 3.4 million bales at the same time last year. Shipments of 1.9 million bales are more than double this time last year.

With the marketing year having begun on August 1, we are well on the way to meeting the USDA target of 9 million bales, and perhaps surpassing it. In fact, exports have been strong enough to compensate for slack mill usage in the sense that total consumption in the US of 17.3 million bales (domestic use plus exports) is estimated to be 1.65 million bales, or 10%, higher than last year.

Having cited all these predominantly bearish statistics, we believe that at 29¢ per pound, the selling may be overdone. Global stocks at the end of the 1998-99 season reached 44.89 million bales, or 52% of consumption, but prices held at 48¢ (Chart 1). The last time we came anywhere close to

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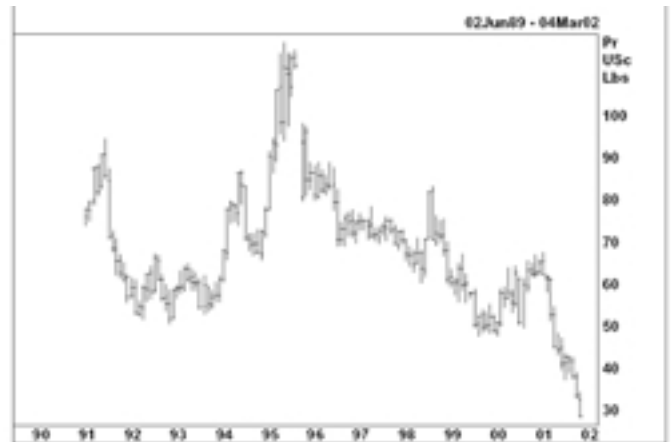
current price levels – at the end of the 1985-86 season – stocks rose to over 47 million bales, or 62% of consumption. While the forecast for ending stocks for the current season, at 47% of consumption, is certainly overwhelming, it could very well be out of sync with historical standards.

Traders have discounted perfect harvest weather, but with only 48% of the US crop harvested, compared with 59% at this time last year, the US crop is not completely in the bag. The Commitment of Traders data show that commodity funds are sitting on a very large net short position of 23,000 contracts (total open interest is 61,000 contracts).

While there is precious little to be found in the fundamentals to provide a rationale to recommend a long position, it is difficult not to be enticed by these low prices. We're watching closely for any turn in the fundamentals that could trigger a powerful short-covering rally. [October 26, 2001]

STRATEGY: *Stay tuned*

Chart 1 – Nearest Contract Cotton



Charts Courtesy REUTERS

CRUDE OIL

Do very bearish fundamentals justify these prices?

Almost all commodity prices collapsed in the aftermath of the September 11 attacks. In responding to a situation in which inventories were already burdensome because of over-production and slack consumption, the market determined that an environment of fear and uncertainty would prevail and serve only to crimp demand further.

Somewhat surprisingly, energy markets were hit with some of the most severe selling. Although declining economic activity would surely cause a buildup of inventories of crude oil and its products – particularly jet fuel, as flyers stay home and airlines chop flight schedules – one would have thought that new and renewed tensions in the Middle East would leave at least some price premium to account for the not-so-far-fetched possibility of supply disruptions from key producers such as Saudi Arabia.

But that was not the case. When the news first broke, the market spiked by \$2 per barrel and held for a few days. After that, prices fell rapidly and sharply. December crude nose-dived by as much as \$9 per barrel over the following week and a half. Now, after a bounce of \$1.5 per barrel, prices have stabilized at just over \$22 per barrel, a level not seen since the autumn of 1999 (Chart 2). Where do we go from here?

On the surface, it would seem difficult to build a bullish case. With poor economic statistics and fear of biological warfare creating a gloomy mood in the US, consumers are staying put, and consumption can clearly be expected to drop. Over the past few weeks, API statistics have already shown a significant build in petroleum products (Charts 3 & 4). Distillate stocks have not been this high in almost two years.

After suffering through the Asian crisis in the late 1990s and watching crude prices fall to \$10 per barrel, OPEC producers slashed production several times, driving prices to well over \$30 per barrel. Until September 11 and despite weak economic conditions, the cartel maintained its stranglehold on the market, with West Texas fluctuating between \$28

and \$32 per barrel over the past year.

Currently, the OPEC basket price is hovering at around \$19 per barrel. The informal price stability mechanism that allows OPEC producers to cut output by 500,000 barrels per day if the basket price trades below the \$22-\$28 barrel range for 10 consecutive days has not been implemented, even though today is the 26th straight day in which it is trading below the target range.

There are two possible explanations for OPEC's inaction. It may be under behind-the-scenes political pressure from the US and UK to allow prices to remain weak for economic-stimulus value. Secondly, the tone in the market is so negative that the output cuts might not be effective yet in propping up prices, which would compromise its credibility and subsequently its ability to halt price slides by merely suggesting output cuts, as it has done many times in the past.

So while it may seem that the bearish supply/demand fundamentals have overwhelmed OPEC's control of this market, we're not counting it out yet. OPEC ministers are meeting with heavyweight non-OPEC producers Russia, Norway, and Mexico, among others, to discuss coordinating output restrictions. So far, Mexico has dissented, but these alliances have underpinned output curbs in the past. The fact that the meetings are taking place at all shows at least a degree of cooperation.

Ahead of the regular OPEC meeting scheduled for November 14, Saudi Arabia and UAE announced yesterday that OPEC is ready to cut. The market popped on this news on Monday, but the rally faded after Mexico bowed out of the OPEC/non-OPEC alliance. In any case, we can be sure that there will be production cuts that will attempt to match the drop in consumption. It is only a question of time and quantity.

Another bullish factor is talk that the Federal government is talking about increasing the Strategic Petroleum Reserve to 1 billion barrels from the current 545 million barrels. In addition, Chinese officials visited the US after the

attacks to get some advice on establishing their own strategic reserve. The Chinese angle is a bit futuristic because it does not have the infrastructure available yet to stockpile significant amounts. The US interest in beefing up its reserve, however, is not futuristic at all and could tighten up supplies during the period that the government does its buying.

Finally, with bombs dropping in Afghanistan and political sensitivities and sensibilities being challenged, we cannot ignore the possibility (or anticipation of the possibility) of

supply disruptions from the Middle East.

The market remains weak, even though some OPEC members have dangled a 1-million-bpd cut in front of the media. Still, we believe that the vulnerability of the environment we live in warrants a stab at the long side.

[October 30, 2001]

CURRENT STRATEGY: Liquidated long January crude oil as per Flash Update of Wednesday, October 31.

Chart 2 – Weekly crude, nearest contract



Charts Courtesy REUTERS

Chart 3 – API gasoline stocks

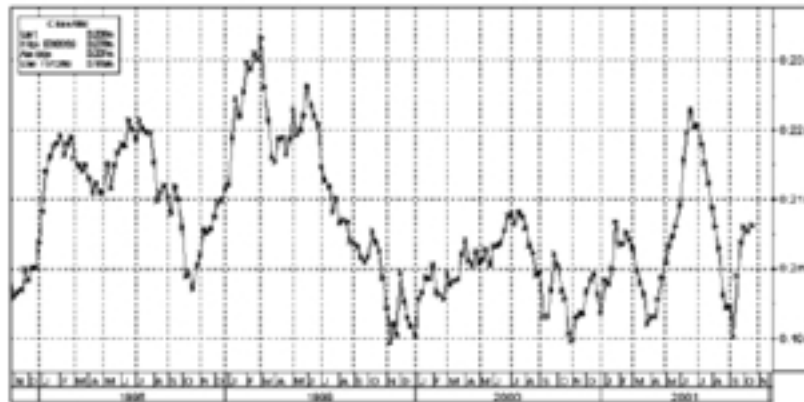


Chart courtesy Bloomberg

Chart 4 – API distillate stocks

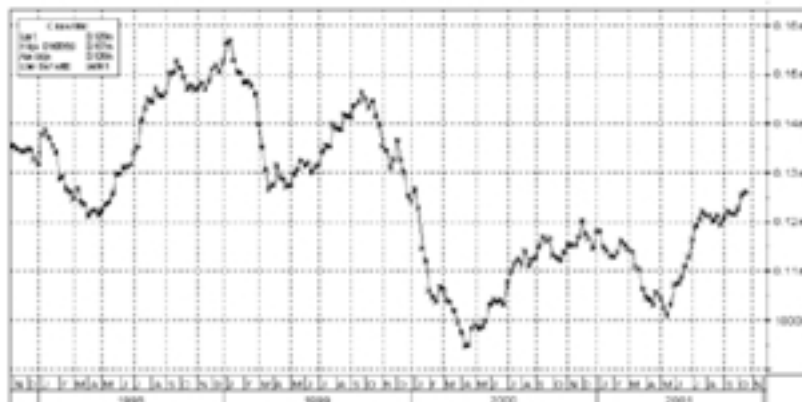


Chart courtesy Bloomberg

GOLD

Holding steady against a backdrop of sliding fabrication demand

Gold bugs have little to cheer about these days. The post-September 11 market was a disappointment. The market reached its highest level in the moments after COMEX reopened on September 14, with December gold briefly touching \$300 per ounce, but it's been downhill ever since.

The outlook for fabrication demand couldn't be worse. We haven't seen any hard numbers since Gold Fields Mineral Services (GFMS) reported on September 19 that global fabrication for the first half of 2001 was down 3% and that it will fall a further 4% in the second half. However, one very interesting piece of information we have seen on the news wires in recent days comes from India, the world's largest importer and fabricator of gold. During the festive season, dealers typically import somewhere between 10,000 and 15,000 bars per day, but are now importing only 1,000 bars per day.

Yesterday's US October consumer confidence index fell to a 7-year low of 85.5 from September's 97. Significantly, analysts were totally off the mark, as the average guesstimate for the figure was 95.6, indicating that the degree of consumer apathy has not yet been fully factored into the markets. The gloomy mood is not limited to the US. Data for the UK released yesterday show that consumer confidence has fallen for the fourth month in a row.

We feel, however, that there is a case to be made for the bulls. On the surface there isn't much of an inflation angle to inspire investments in gold. With the bleak economic outlook and the CRB having matched the Asian crisis lows, worrying about inflation is not a fashionable pursuit these days. Bond traders are certainly showing no inflationary concerns as they watch yields plummet to record lows.

Hawkish economists, however, look further ahead and point to the fact that there has been no letup in rampant money-supply growth. The most recent data available show that M2 is growing at a record clip of 16% per annum.

Much discussion of gold prices focuses on the weak economy and the sluggish demand we can expect because of it. Indeed, preliminary third-quarter GDP data showed that the economy shrunk by 0.4%. Less attention, however, was given to the accompanying deflator, which came in at 2.1%, higher than the expected 1.7%. At 0.4%, the September headline CPI was higher than expected as well.

These worrisome statistics are typically dismissed by analysts and blamed on the energy component. While prices at NYMEX have collapsed and to some degree have filtered down to the retail level, we expect that this will be short lived. OPEC announced just yesterday that it is prepared to cut production enough to get the OPEC basket price back up to \$25 per barrel from the current \$19 per barrel.

In any case, while we are not predicting runaway inflation, we have not written off the possibility of price pressures.

Low interest rates facilitated by the Fed's easiness is actual-

ly creating a rather bullish factor. Through the 1990s, a major bearish influence for the gold market was the popularity of producer forward sales. Any strength was always greeted with either central bank sales or producer hedge programs, capping any rallies before they could get off the ground. But with interest rates so low, the contango that made forward sales so attractive by allowing mining companies to lock in prices well above the cost of production is now almost flat. As it is, according to GFMS, net producer hedging dried up completely in 2000.

The Fed Funds futures has already factored in another 25 basis points (bps) cut for next week's FOMC meeting, with some economists talking about a 50 bps cut. Interest rates will remain low in the foreseeable future, and it will take much higher gold prices to bring hedgers back to this market in a meaningful way, in effect removing a formidable stumbling block to higher gold prices.

Short-term prospects for gold prices are on solid ground from a technical perspective. Speculators piled onto the long side after the September 11 attacks. Open interest grew by over 15,000 contracts in just 2 weeks.

In hindsight, this buying was carried out by weak hands, because it was not able to push the market through the highs. The \$25 per ounce selloff dispensed with those longs (yes, including us), with the open interest now below the level it was at before the attacks. Chart 5 shows that the longer-term trend that began this past spring is still intact with a pattern of higher lows on setbacks.

In conclusion, the physical consumption fundamentals remain bearish, and we should not expect to see much relief on that front for the time being. Still, we continue to believe that the investment climate has changed and that the percentage of gold held in serious portfolios will rise – slowly at first, but gaining momentum as the bear market in equities drags on. Look for recommendations to enter the long side.

[November 1, 2001]

STRATEGY: *Stay tuned*

Chart 5 – Spot Gold



Chart Courtesy REUTERS

WHEAT

Weather problems everywhere and strong US exports paint a bullish picture

Understandably, we don't trust rallies in the wheat market. We've been turned back more times than we care to count. On October 12, after the USDA released its monthly supply/demand situation report, we felt that *déjà vu* feeling. A 1.1 million tonne downward revision to the estimate for global consumption combined with some other adjustments would increase 2001-02 ending stocks by 1.65 million tonnes. A healthy US export market is one of the primary requirements for achieving higher prices, but the forecast was lowered by just under 700,000 tonnes. None of the revisions was very dramatic. Still, with our track record in this market and the market only a stone's throw from contract lows, the long position we took on just days earlier seemed in jeopardy. But here we are, three weeks and 20¢ per bushel later and still alive in the position.

Actually, it is more of a challenge to explain why the market was so weak until the past few weeks than to explain the recent strength. When the USDA made its shocking revision to Chinese wheat stocks back in its May supply/demand situation report, it was difficult to imagine wheat prices ever recovering. After years of declining global production, the bull market that we believed was inevitable was gone, just like that. China, it was feared, was eliminated as a potential customer for US wheat and could very well enter the export business.

But in the months following the May report, the sting of the monumental revision was gone. Downward revisions to Chinese production estimates were persistent, and by the time the USDA's August report was released, 2001-02 output had been slashed by 10 million tonnes since the May forecast. This, along with other adjustments, left Chinese ending stocks at 32 million tonnes (28% of consumption) compared with 46 million tonnes (40% of consumption) in the May report.

While we did not need any fresh inspirations to be bullish on the long-term fundamentals, a number of developments in recent weeks have prompted short covering.

Argentina is a key producer and exporter of wheat, accounting for about 10% of world trade. Heavy rains over the past few weeks have wreaked havoc with the crop that was planted in the spring and is being harvested now. More than half of the wheat regions are under water, which has caused fungal diseases. Preliminary estimates by analysts have cut the USDA's October forecast for 2001-02 Argentinean output by 1 million tonnes, to 16.5 million tonnes, putting to rest the official government fantasy of a 20-million-tonne crop.

The just-planted US winter wheat crop is roughing it in the early going. Farmers got the crop in the ground ahead of schedule this year. As of Monday's crop progress report, 90% of the crop was planted, compared with 80% in the last week of October last year. Speed, however, has not been able to battle the forces of nature. It is extremely dry in the plains, and the crop is progressing poorly. The portion of the crop rated good-to-excellent is only 50%, compared with the 66% average of the past 4 years.

US ending stocks have been plentiful in recent years, which kept prices at bay despite last season's poor winter wheat crop, among the smallest in decades. But can the US survive another bad showing of the winter wheat crop? US 2001-02 ending stocks are already forecast to decline by 6.6 million tonnes, or 25%, from 2000-01, a drop from 37% of consumption to 29% of consumption.

Exports have been very strong lately, with commitments averaging 623,000 tonnes the past 4 weeks, compared with an average of 478,000 tonnes in the previous 4-week period. Commitments are still running about 700,000 tonnes below this time last year. Even if commitments continue at a slower pace than we've seen lately, we're in fine shape to exceed the USDA's forecast of 29.65 million tonnes for the year.

Some production notes from Europe round out the bullish picture. The USDA attaché in Spain reports that drought cut this year's crop by 2 million tonnes, or close to 30%. Consequently, Spain will need to import 3.5 million tonnes of wheat to meet domestic needs. The EU has eliminated the levy on soft red winter wheat (SRW), making Spain, which has already purchased 280,000 tonnes of SRW, potentially an even more valued customer for US exporters.

The UK had an absolutely miserable crop as well. Output fell 4.7 million tonnes, or 40%, from the previous season, which makes the British potential customers of US wheat as well.

It should also be noted that wheat was one of only a handful of commodities that remained strong in the aftermath of the September 11 attacks, including the related corn and soy markets. We view this as a clear indication that there are strong bullish fundamentals at work in this market, as per the above discussion.

Although the market became a bit soggy as December wheat approached the \$3 per bushel level, the issues that caught the attention of traders and gave us the rally are still likely to support the market. The long-term outlook is on solid ground.

[November 2, 2001]

STRATEGY: Remain long December wheat. Raise stops to 280.5, close only.

Chart 6 – December CBOT Wheat

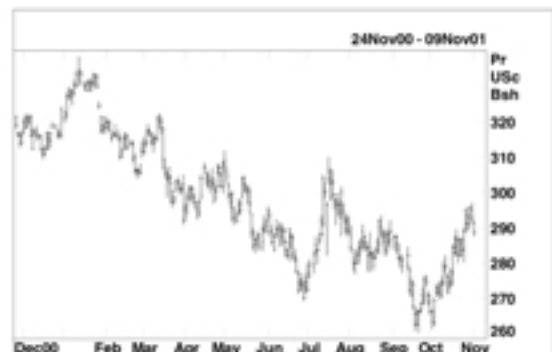


Chart Courtesy REUTERS

HOTLINE UPDATE

Friday, October 5, 2001:

Good afternoon for Friday, October 5, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December gold, with our stop at 279.5, and long December 10-year notes, with our stop at 107-10/32. All stops are close only.

Flash Update – Monday, October 8, 2001:

Good morning for Monday, October 8, 11:20 am. This is a Flash Update. We have purchased December wheat at 274, placing our initial stop at 265, close only.

Friday, October 12, 2001:

Good afternoon for Friday, October 12, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December gold, with our stop at 279.5; long December 10-year notes, with our stop at 107-10/32; and long December wheat with our stop revised to 267. All stops are close only.

Flash Update – Thursday, October 18, 2001:

Good morning for Thursday, October 18, 11:50 am. This is a Flash Update. We have purchased March sugar at 6.60, placing our initial stop at 6.10, close only.

Friday, October 19, 2001:

Good afternoon for Friday, October 19, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December gold, with our stop at 279.5; long December 10-year notes, with our stop at 107-10/32; long December wheat with our stop revised to 270.5; and long March sugar with our initial stop at 6.10. All stops are close only.

Flash Update – Monday, October 22, 2001:

Good afternoon for Monday, October 22, 12:55 pm. This is a Flash Update. We have liquidated our long December gold position at 276.70.

Flash Update – Tuesday, October 23, 2001:

Good morning for Tuesday, October 23, 9:05 am. This is a Flash Update. We have sold short December mini S&P at 1094.25, placing our initial stop at 1113, close only.

Flash Update – Thursday, October 25, 2001:

Good morning for Thursday, October 25, 9:05 am. This is a Flash Update. We have purchased January crude oil at 22.56, placing our initial stop at 20.56, close only.

Friday, October 26, 2001

Good afternoon for Friday, October 26, 4:35 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December 10-year notes, with our stop at 107-10/32; long December wheat, with our stop at 270.50, long March sugar, with our stop revised to 6.50; short December mini S&P, with our stop at 1113; and long January crude oil, with our stop revised to 21.25. All stops are close only.

Flash Update – Wednesday, October 31, 2001:

Good afternoon for Wednesday, October 31, 1:55 pm. This is a Flash Update. We have liquidated our long January crude oil position at 21.30.

Flash Update – Friday, November 2, 2001:

Good morning for Friday, November 2, 9:15 am. This is a Flash Update. We have liquidated our long December 10-year note position at 111-18.5/32.

Friday, November 2, 2001:

Good afternoon for Friday, November 2, 4:30 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 revised to 280.50; long March sugar, with our stop at 6.50; and short December mini S&P, with our stop at 1113. All stops are close only.

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