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Is copper as tight as the market would have us believe?

Copper prices continue to set historical highs (Chart 1). When prices first touched \$1.50 per pound in mid-summer we were skeptical about the market's ability to sustain such lofty levels. The bearish argument was twofold. Economies – primarily in North America and Europe – were slowing, which would inevitably cause demand for industrial commodities to contract. At the same time, runaway prices posed a strong incentive for mines to keep output strong. Mine output in Chile grew at a rate of about 10% per annum for most of 2004, and we believed this pace could easily be maintained, if not exceeded. We were quite wrong.

Output for the past two months for which statistics are available were particularly weak. In July, Chilean output fell 12.2% and was down 8.4% in June. To date, Chilean output in 2005 is 2.7% below the same period in 2004, a far cry from our forecast of double-digit *growth*.

The outlook for demand is mixed. Chinese purchasing – the driving force behind the bull market – remains strong. Through the end of August, customs data show that imports grew 12.2% over the same period in 2004. The effects of two devastating hurricanes on the US economy, and soaring energy costs, however, caused economic forecasts for regions outside Asia to be lowered.

Overall, global mine production has grown by 4.5% through the end of June, according to the International Copper Study Group's (ICSG) September report. Consumption of refined copper has actually fallen by 2.1% in ICSG's study period. Usage is still greater than output, and although the resulting 219,000-tonne deficit is far smaller than the 790,000-tonne deficit we had last year at this time, it is larger than expected. The market is focusing on the fact that any hope of achieving a balanced market in 2005 is fading fast.

The composition of the open interest remains bullish. Commodity funds have liquidated a significant portion of their net-long position without creating even a ripple in the

market. The funds' net-long position peaked way back in March, at 36,000 contracts. Of course, this means that commercial traders have increased their long exposure, which normally is an indication that the market should continue to move in the direction of the trend.

However, the copper market – at least in this sense – is anything but typical. We've illustrated in previous articles how the dramatic drop in warehouse stocks is not necessarily commensurate with other methods of measuring world inventories. While official total global warehouse stocks stand at 125,000 tonnes (more on that in a moment), ICSG lists global inventories at 832,000 tonnes. Thus, the activity of commodity funds and commercials as represented by a detailed analysis of commitment of trader data is not conclusive, because for all we know commodity funds may be holding the inventories and selling on the board to hedge themselves.

So we're not going soft on our generally bearish stance. There are several indicators that should be somewhat disturbing for bears. First, warehouse stocks at the LME have been rising since mid-summer (Charts 2 and 3). The numbers

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are a mere pittance when compared with the 1 million tonnes LME warehouses held at the bear market lows in price. But it is the first time since the bull market began in which we've seen a steady upward trend in warehouse stocks.

While the backwardations in both COMEX and LME spreads are still at very high levels in historical terms, they have fallen from their peaks and have been moving in the opposite direction of price throughout the major upleg from \$1.45 to \$1.65 per pound (Chart 2).

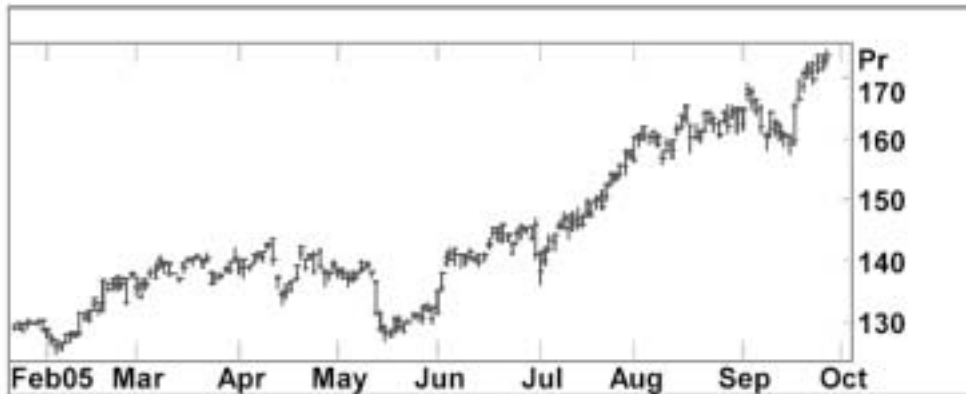
While statistics indicate that the market has slipped fur-

ther into deficit, we maintain our suspicions about their accuracy, given the wide gulf that exists between the various sources of information, as illustrated. Chilean mine capacity has expanded, and it is hard to believe that this capacity will not be utilized, sooner or later.

We remain sidelined. We believe, however, that the close-to-300% increase in price is not a fair representation of the current supply/demand fundamentals, and we would therefore eventually like to explore the short side. Stay tuned.

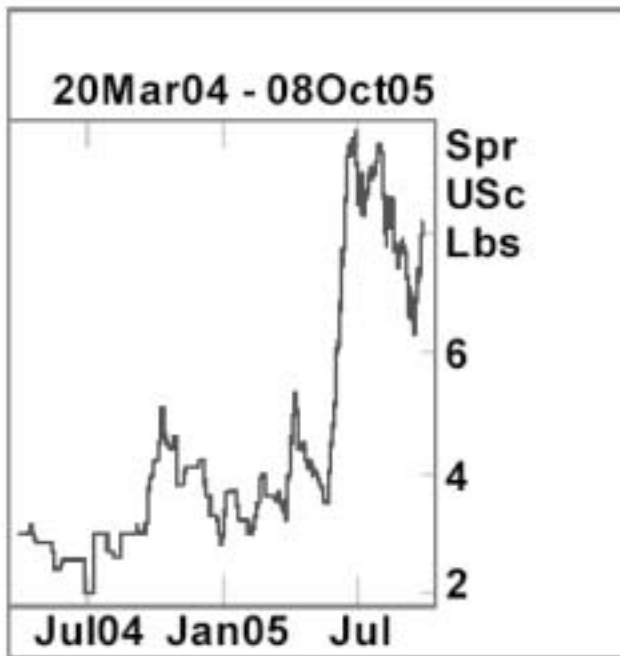
[Sept. 27, 2005]

Chart 1 – December copper



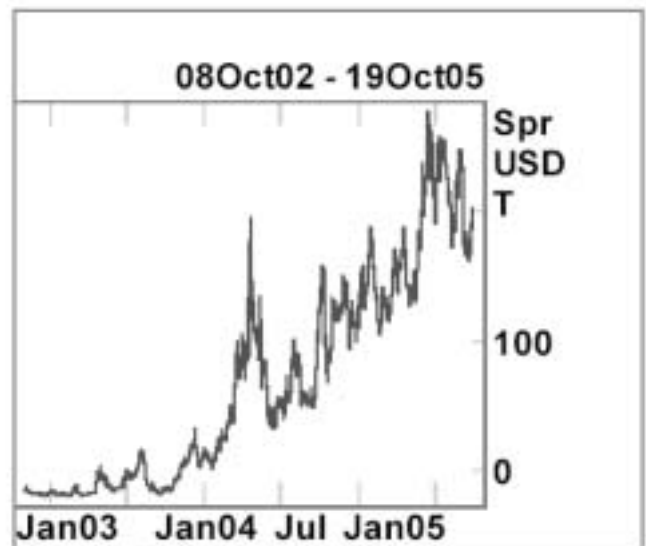
Courtesy Reuters

Chart 2 – Comex December/March



Courtesy Reuters

Chart 3 – LME spot/3-month spread



Courtesy Reuters

SUGAR**Ethanol demand adds to sugar bull**

The July 27 issue of *Focus on Futures* concluded: "If you're fortunate enough to be long, stay that way. Both open interest and speculative long positions are growing, so look for the inevitable, but temporary, setbacks that will result to establish new long positions." Prices continued to set yet another round of multi-year highs until August 4 and then experienced a sharp counter-trend correction – which indeed turned out to be temporary. The market has since proceeded to levels not seen since October 2000 (Chart 4).

Open interest is a primary issue here. The dramatic rise in outstanding contracts has fueled debate as to whether this rally represents the supply/demand situation fairly or whether speculators have driven prices well beyond that point.

Interestingly, the most recent leg of this bull run occurred just as open interest pulled back from its highs by about 8%. Normally, this would be considered a "healthy shakeout of weak-handed longs." The drop in open interest was certainly constructive for committed bulls in that it provided some confidence that the buying that drove prices to multi-year highs was carried out by knowledgeable commercial traders. But the extraordinary rise in open interest to a peak just shy of 500,000 contracts renders the correction insignificant in terms of alleviating what would be considered dramatically overbought conditions in all but the most unique cases. The question then arises: Just how unique is the underlying fundamental story?

It's all about ethanol. Petroleum prices are spiraling out of control, and the march towards commercial viability for bio fuels is in full swing. Enough market segments around the globe have already achieved this plateau – all the way down to the consumer retail level – to cause immediate surges in ethanol usage.

The most sensitive market, of course, is in Brazil, where ethanol has been an alternative for consumers for years now. About half the country's sugar crop is turned into ethanol, and the exact ratio of fuel to food has emerged as the single most important factor to influence the world sugar price. And there is still room to push that ratio further to the fuel side. Ethanol remains cost effective until its price reaches 70% of gasoline at the pump at which point the advantage is lost

because gasoline delivers better mileage. At present, prices are roughly 50% of gasoline, which means that ethanol usage should expand as long as the price of gasoline remains at current levels or higher.

Domestic Brazilian consumption is estimated to grow by close to 8% in 2005. Exports represent about 16% of total Brazilian usage and are expected to be the same as 2004 exports, but not for lack of interest. After domestic usage there is simply no exportable surplus remaining. If there is any excess, there are eager customers standing by. For example, the US is a customer for Brazilian ethanol, but there is a prohibitive 50% tariff on imports. To avoid paying this tariff, exporters ship through certain Caribbean countries. But if petroleum stays at these price levels, US users will be able to import directly, pay the tariff, and remain profitable. As a result, US imports are likely to increase substantially.

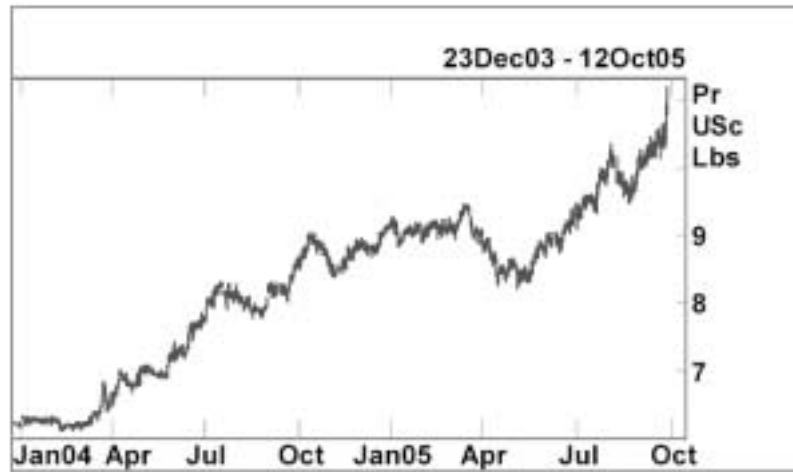
Another important issue is India. The 2005-06 harvest is expected to rebound from back-to-back drought-reduced crops. A full recovery that would not deplete inventories any further would be in the 20-million-tonne neighborhood. Several months ago analysts were talking about 18 million tonnes. That, however, was during the first half of the monsoon season when precipitation was normal. But the second half was mostly dry, and as a result, we are now hearing about estimates in the 17-million-tonne range. India's transition to importer these past two seasons was a key factor in this bull market, and if the crop does not surprise to the upside, we can assume that we will see further Indian importing.

In conclusion, the market really does not know just how big the ethanol story is, because there is very little experience with it. As new markets develop and old markets grow, it is impossible to know when demand will stabilize. Certainly, the incentive to produce greater amounts exists if the price of ethanol continues to rise. As long as it retains a discount to petroleum that proves to be economically practical, consumption will continue to grow and strip supplies from the food side of the balance sheet.

We reiterate our July 27 recommendation.

[Sept. 29, 2005]

Chart 4 – October sugar



Courtesy Reuters

SOYBEANS

Record global crops, but tightness persists

For most of this past summer, hot and dry weather threatened to reduce yields for the 2005-06 US soybean crop. But the crop muddled through and then some. In its September supply/demand situation report, the USDA raised its estimate for the US crop by 1.78 million tonnes from its August estimate, to 77.74 million tonnes (2.856 million bushels). The average of analysts' guesstimates was 76.67 million tonnes. Although this will still be considerably smaller than last year's perfect-weather crop of 85.48 million tonnes, it will still be the third largest crop on record. The estimate for yields is 39.6 bushels per acre (bpa), up from last month's 38.7 bpa and above the 38.42-bpa average yield of the past five years.

After falling precipitously from close to \$8 per bushel in late June, prices continued to slip after the September 13 release of the report and now sit at \$5.65 per bushel.

Traders have focused all their attention on prospects for the US crop, but there are other matters that merit scrutiny. The harvest is well under way, and the estimates are not likely to change very much from here on in.

As we noted in previous discussions on the soybean market, the USDA and other analysts have maintained their annual habit of starting off the estimate of the Brazilian crop way up in the sky before a single seed has been planted, only to be disappointed as soon the crop begins to develop. This season the street is adopting a more sober approach. The early USDA estimate was 62 million tonnes (66 million tonnes in last year's August report), and we're down to 60 million tonnes for the September estimate. On September 20, *Oil World* lowered

its estimate to 58 million tonnes.

The September 24 issue of *Price Perceptions* summarizes the reasons why even the above forecasts are not likely to be met and why its own forecast is calling for a Brazilian crop of only 55.9 million tonnes: tight credit conditions, growing sugar is more profitable, high fertilizer and fuel costs, and a strong Brazilian currency, which makes exports too expensive for many overseas buyers. All of the above should discourage the kind of plantings that would be required to achieve a record crop. In fact as the seeding season begins, there are reports that plantings are indeed down from last year.

Plugging *Oil World's* Brazilian estimate into the USDA global balance sheet does not make the outlook any more bullish, however, because it simultaneously increased its estimate for Argentina by 2.6 million tonnes. Still, even with the additional 600,000 tonnes added to ending stocks, the global balance presents a tightening picture.

The upward revision to the US crop was balanced out with the drop in the Brazilian estimate. Other adjustments, such as a downward revision to 2004-05 global ending stocks and an increase in the consumption estimate, contributed to a fairly substantial drop in inventories. The estimate for 2005-06 global ending stocks fell to 44.92 million tonnes, or 20.9% of consumption, down from last month's estimate of 48.27 million tonnes, or 23.6% of consumption.

Last year's global crop was a record by a fair chunk, and we're expected to build on that this coming season. But output is not keeping pace with consumption – as illustrated. In

the early years of this decade, ending stocks fluctuated between 16.5% and 18.5% of consumption, and we seem to be heading back in that direction, which should be a disappointment for bears, considering the jump in production.

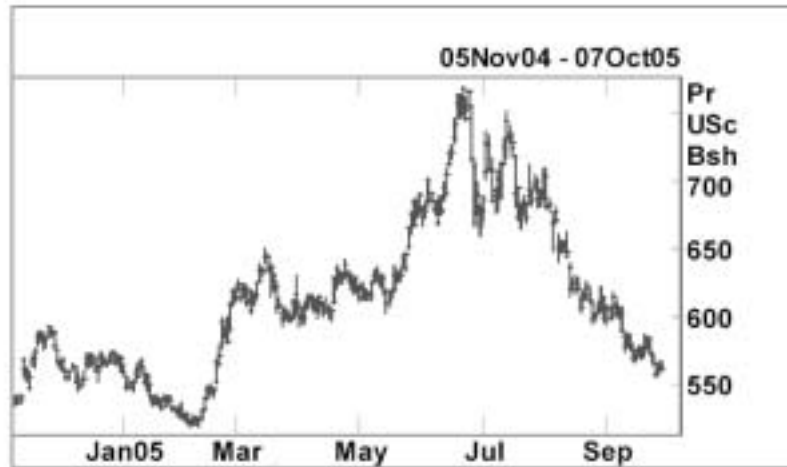
US bean export commitments are lagging last year's pace, but that is being partially offset by meal commitments, which are out ahead of last year's pace. Regardless, the USDA is very upbeat about near-term prospects. It raised its forecast

for annual sales by 550,000 tonnes from last month to a record 30.35 million tonnes.

We do not believe that current prices accurately reflect the global balance sheet. The market is weak, though, and fighting the trend can be dangerous. We are bullish, particularly because prices have fallen so far, so we recommend a cautious accumulation of long positions.

[Sept. 29, 2005]

Chart 5 – November soybeans



Courtesy Reuters

CORN

The US crop surprises to the upside

December corn made fresh contract lows this week. Looking back to the middle of the summer when North Americans were coping with relentless, sweltering heat, and when crops were allegedly withering away, it was hard to imagine corn prices sliding to multi-decade lows. But the crops survived, and prices came tumbling down.

Even more so than with soybeans, the success of the 2005-06 US corn crop is nothing short of amazing. Corn matures earlier than soybeans, so the window for beneficial rains to “save” the crop is smaller. Even as the drought lightened up a bit, it did not seem to matter very much. Right up until this past week's crop progress report, yields seemed to be heading for a great disappointment. Only 52% of the crop was rated good-to-excellent, compared with 71% at the same time last year.

Despite the bullish data and an ample supply of anecdotal evidence of disastrous yields, the crop was in fine shape. Technology seems to have played a large role, as drought resistant hybrids allowed subsoil moisture to act as

a partial substitute for fresh precipitation. The September USDA supply/demand situation report revised US output upwards by 7.33 million tonnes, to 270.23 million tonnes. Traders were expecting the USDA to lower the estimate – the average guesstimate was 261.11 million tonnes.

After weeks of falling prices the quarterly stocks report provided some relief for bulls. The September 30 report showed that US corn inventories stood at 53.6 million tonnes, compared with a guesstimate of 54.8 million tonnes. By no means is this a low stock level for the US. In fact, stocks are at their highest level for this quarter since 1992-93. The significance, however, is that as the street underestimated the crop, it may also be underestimating demand.

Corn-based ethanol production and consumption are responding to high energy prices and are probably responsible in part for the higher-than-expected domestic consumption indicated in the quarterly stocks report. The USDA estimates that 2005-06 ethanol usage in the US will expand to the corn equivalent of 38.07 million tonnes, or 17.25% of

domestic consumption, up from last season's 33.63 million tonnes, or 15% of domestic consumption. The most recently released government data illustrate how tight the ethanol market has become. Output for June was 249,000 barrels per day, but usage was 277,000 barrels per day.

Although the US crop is definitely going to be a lot bigger than we thought it would be two months ago, the global balance sheet shows that we are back to production/consumption deficits, which will draw already-low inventories down further. Actually, 2004-05 was the first season in many in which there was a surplus, mainly because of the blockbuster US crop. Because of the improved outlook for the US crop, the USDA revised its global ending stock estimate upwards by 3.7 million tonnes this month, to 111.77 million tonnes, or 16.45% of consumption, up from 15.95% the previous month, but still a fair drop from 2004-05 ending stocks of 127.81 million tonnes, or 18.76% of consumption.

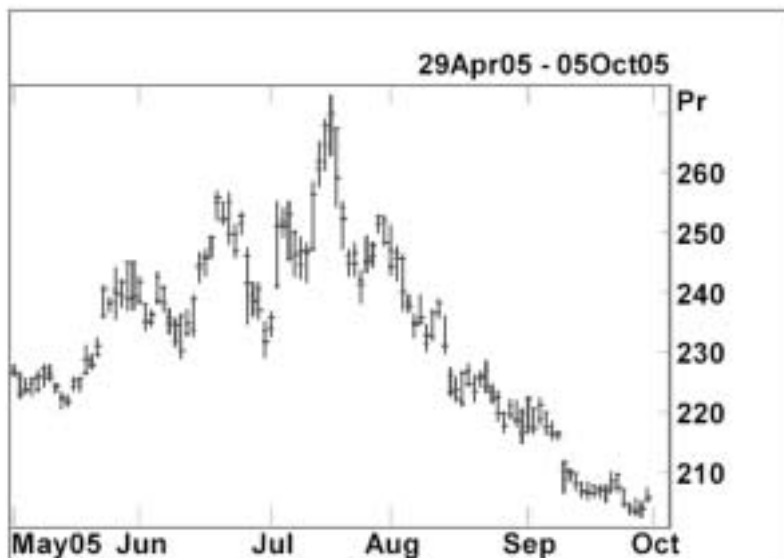
Katrina certainly created a setback in the US export infrastructure. Some viewed the delay in shipments as bearish because the situation would just create a buildup in supplies when the silos have to make room for the new crop.

We took a bit of longer-term approach. It is well known that overseas purchasers of commodities have shifted their strategies in recent years to a just-in-time inventory system. This year's hurricanes underscored the potential danger of maintaining light inventories.

We don't know of any specific shortages that developed among importing nations. But consider that for three weeks, shipments all but ground to a halt. The first week in September, corn shipments were 425,000 tonnes, but dropped to zero the next two weeks. The average for this time of the year is about 900,000 tonnes per week. Volumes have since returned to normal. Perhaps importing nations may be forced to overhaul their policies after being presented with a stark illustration that being caught short is not an irrational fear.

The market is well supplied at the moment as we head into the US harvest. But our long-term bullish bias remains, particularly since we have returned to global deficits. The funds are heavily short this market, which has exaggerated the weakness in prices – in our opinion. We recommend the cautious accumulation of long positions. [Sept. 30, 2005]

Chart 6 – December corn



Courtesy Reuters

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