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Drought down under tightens global wheat supplies

Wheat prices are pushing through the long-held resistance level of \$4.35 per bushel (Chart 1). Both fully-grown and harvested Northern Hemisphere crops and early season Southern Hemisphere crops are smaller than last year and threaten to draw global ending stocks down to dangerously low levels.

The September USDA supply/demand situation report estimated the 2006-07 US crop at 49.03 million tonnes, down from 58.74 and 57.28 million tonnes in 2004-05 and 2005-06 respectively. Aside from the disastrous 2002-03 season – when output reached only 43.76 million tonnes – we'd have to go back to 1988-89 to find such a small crop. The average guesstimate for this Friday's new wheat estimate is for output to slip a bit further, to 48.9 million tonnes.

The USDA estimates US exports for 2006-07 at 24.49 million tonnes, far smaller than last season's 27.47 million tonnes. But with domestic consumption of 31 million tonnes, ending stocks will still be drawn down to 11.68 million tonnes, or 21% of consumption, close to the inventory levels of the mid 1990s, which ultimately saw US prices skyrocket to \$7 per bushel.

Matters become increasingly complicated when we consider the progress of crops in the other producing countries, which traditionally have had the ability to compensate for a poor US crop.

EU crops are about average size, but somewhat smaller than last year's, and there are no member countries that will have enough surplus to export any more wheat than is already built into market expectations.

FSU crops are expected to fall 12 million tonnes, or about 13%, from 2005-06, and exports are already estimated to fall 5 million tonnes, which given the dramatically smaller crops, seems to be a somewhat conservative estimate.

The real problems appear in the Southern Hemisphere. The USDA's September estimate for the Australian crop was 19.5 million tonnes, but drought has ravaged the crop, leading the USDA's Australian counterpart, ABARE, to slash its forecast down to 16.4 million tonnes. In recent days, press

reports have published estimates that see output as low as 13 million tonnes. The current estimate for exports of 16.5 million tonnes is obviously significantly overstated.

The USDA's September forecast for the 2006-07 Argentinean crop responded to early-season dry weather. The estimate was lowered by just 250,000 tonnes from the August estimate, to 13.25 million tonnes. This would still be an improvement over last year's 12.5-million-tonne crop, but far shy of 2004-05 output of 16 million tonnes.

The Argentinean situation carries little potential for upside, but plenty of downside possibilities. About 5 million tonnes is consumed domestically, and the balance is exported, mostly to Brazil. If Argentina cannot deliver, Brazil must meet its import needs elsewhere, because Argentina has no inventories to dip into. Based on 5.3 million planted hectares, the 13.25-million-tonne estimate already assumes normal yields. Thus, even a solid improvement in the precipitation situation will allow only a marginal uptick in output. A continuation of the dry weather patten will exacerbate an already tight global situation.

Rounding out the list of major exporters, Canada's wheat harvest is about 95% complete, and there is no reason to assume that Statistics Canada's 25.9 million-tonne estimate

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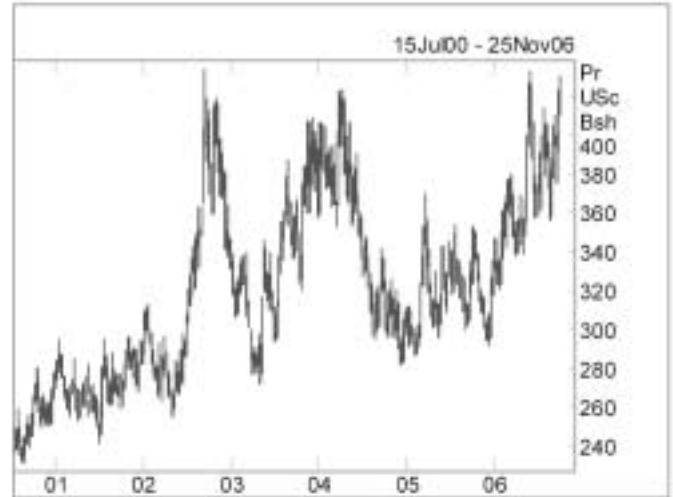
Putting it all together, after adjusting for the much smaller Australian crop and the other small changes since the release of the September USDA estimate, global ending stocks are set to slip below 20% of consumption, by far the lowest inventory level in modern history. The 2004-05 and 2005-06 seasons ended with stocks at 24.8% and 23.4% of usage, respectively.

US export commitments are running 23% behind last year at this time, which indicates even lower foreign demand for US wheat than the USDA forecast.

At present we are in a supply-driven rally. If demand remains stagnant, prices may have trouble moving much further north from present levels. But with the supply side finding itself as fragile as we've illustrated above, any surprise from the demand side will send the market to \$5 per bushel and beyond.

[September 28, 2006]

Chart 1 – Nearest contract wheat



Courtesy Reuters

COPPER

Consolidation at lofty levels

Considering the fantastic rise in copper prices we've seen over the past few years and the resulting volatility, the market has been confined to a relatively narrow range in recent months (Chart 2). For what the Commitment of Traders data are worth in this case (there is probably much over-the-counter activity that is not transparent to the market), the casual observer might be surprised to learn that commodity funds have been selling this market and have actually been net short since this past spring. The flip side, of course, is that commercials have been the buyers, which could be interpreted to mean that the supply/demand fundamentals remain bullish. Is this the case?

Certainly, there are headline-grabbing issues that paint a bullish picture. Chronic labor strife in Chile, the world's largest copper producing country, is often cited as the reason for market strength. August was a dismal month, with mine production down 12.3% over August 2005. But that was the worst month so far this year. The rest of the year has been looking pretty strong. June and July were up 9.1% and 10% respectively. Average monthly production for the year through August was up 2.26% over the same period in 2005.

For a stretch in 2004, Chilean copper output was growing at a rate of 10% per month, and given the massive capital investment into new mining facilities over the past decade, this is clearly what then industry was targeting and what it is capable of. So while the constant labor action by unions – as well as significant technical malfunctions – have definitely curtailed supplies in terms of potential, the situation is not disastrous and by itself is not the only factor keeping prices this high.

Besides, robust secondary refined production, or the recycling of scrap, is compensating for a good chunk of any shortfall that may result from sluggish mine production.

If anything, it is demand that is maintaining the market's strength. For the first half of 2006, usage was up 2.6% over the same period last year, while global mine production was flat. Were it not for secondary production, we'd be back in deficit territory. The International Copper Study Group's (ICSG) global balance sheet shows that we're running a surplus through the end of June of 13,000 tonnes, but that surplus has fallen over the past couple of months from a peak of 77,000 tonnes.

The ICSG numbers are dated, however, and more current data suggest that torrid pace of demand we saw in the first half of 2006 may not be sustainable.

China consumes about 22% of the world's refined copper, which makes following Chinese demand something of a worthy proxy for general demand. Usage grew by 9% in 2005, but a September 27 report out of China estimates that – presumably based on recently released data – demand is expected to grow by only 5.8% in 2006 and by 5.3% in 2007. Supporting this forecast was a September 24 customs report that showed a steep 34.5% fall in August imports of refined copper. A significant shift to substitutes such as aluminum is partially responsible.

The import data seem to be a big event, but tell only part of the story, because most of the copper consumed in China – about 85% – is refined in China. Still, overall, the report estimates refined consumption fell 3% from January

through July according to the same report.

The inter-month spreads at both COMEX and LME have collapsed (Chart 3). Although this has not meant very much over the past few years, because prices continued to steam ahead even during periods when the spreads took sharp dips, it does not mean that this traditional indicator of tightness – or lack thereof – will remain meaningless indefinitely.

Warehouse stock movements have been volatile, but when all three warehouse systems – LME, COMEX, and Shanghai – are viewed as a whole, the changes have been unremarkable, and the total global stock level is back to

where it was several months ago.

We are not so bold as to recommend a short position, but we retain a bearish bias. In summary, the major points are these: Booming economies in both the industrialized nations and emerging economies are not growing at quite the pace they were over the past couple of years, which as illustrated, will slow down consumption. Then, Chilean production will return to double-digit growth sooner or later. The motivation is certainly there with prices at these levels. At \$3.5 per pound, the market is skating on thin ice.

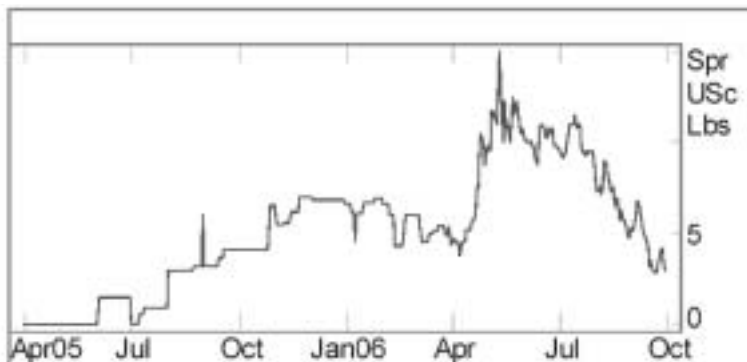
[September 29, 2006]

Chart 2 – Nearest contract copper



Courtesy Reuters

Chart 3 – Comex December/March copper spread



Courtesy Reuters

SOYBEANS

Why so weak?

Spot soybean prices dipped to lows not seen since February 2005 (Chart 4). Its counterparts in the neighboring pits at the Chicago Board of Trade can make the exact opposite claim, with both scoring multi-year highs this past week. The contrast is stark and for the most part reflects fundamental realities.

Despite the sharp drop in the estimate for US soybean

acreage contained in the June 30 USDA acreage report – greeted with a 30¢-per-bushel rally – the September USDA supply/demand situation report is now looking for a record 2006-07 US crop of 84.18 million tonnes (3.093 billion bushels), up just a tad from last season’s 84 million tonnes (3.086 billion bushels).

Although soy area was revised down sharply, it is still

3.9% above 2005-06 planted acreage. The crop is currently expected to be just slightly higher than last year because the USDA assumes that the record yield of 43.3 bushels per acre (bpa) cannot be duplicated. The current estimate is 41.8 bpa. Experience of the past several seasons, however, has taught us not to underestimate yields of any US crop. The September USDA yield estimate was an upward revision from 39.6 bpa.

In tracking the weekly crop condition reports, we find that the good-to-excellent portion of the crop improved from 53% in the first week of August to 62% as of this past week's report. So we'd have to say that the chance of yet another increase in the crop estimate is entirely possible, if not probable.

South American crops are getting larger every year. In 2005-06 the Brazilian crop grew to 55 million tonnes from 53 million tonnes a year earlier, while Argentinean output jumped to 40.5 million tonnes from 39.5 million tonnes. Early forecasts for 2006-07 – the crop has not been planted yet – are for further increases, to 41.3 and 56 million tonnes respectively. Soil moisture is friendly for the upcoming planting season.

There is a bit of a problem here, though. The Argentinean government's agriculture arm has announced that soy area will increase to between 15.5 and 15.8 million hectares from 15.3 million hectares in 2005-06, which would make sense of the USDA early forecast. Brazilian analysts, however, have stated that soy area is expected to fall by as much as 7%, citing a strong local currency, burdensome farm debt, and Asian soy rust. This effectively makes achieving a

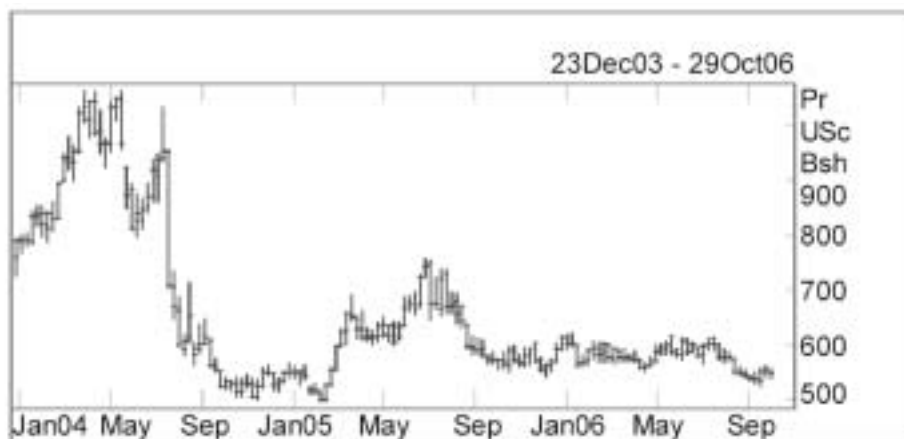
56-million-tonne crop nearly impossible.

The US, Brazil, and Argentina combined grew 82% of the world's soybeans in 2005-06. So we've pretty much covered the supply side of the equation completely, and the situation emerges somewhat inconclusive. The US may have a great crop, but with prices where they are, what incentive is there for Brazilian farmers to increase acreage?

The demand side provides some bullish relief. The USDA is forecasting record global demand of 220 million tonnes, 3% above last season. US exports are estimated at 30.62 million tonnes, 20% above last year's sluggish performance. With only one month gone in the marketing year, US export commitments stand at 8.8 million tonnes, close to 50% ahead of last year's pace. Although it is very early, we've put some pretty impressive weekly numbers on the board, a fair bit above average. So perhaps there is some pent up demand in the system that is being drawn to these attractive prices.

Global ending stocks for 2006-07 are estimated at 24% of consumption, the same as last year, so we'll assume that this is the level that the market considers comfortable and amply supplied. Again, it is very early, even for the fully grown US crop, which is about to go into harvest, because the estimates can change, but especially for South American crops. The bullish surprises can come in the form of the end of the trend of growing Brazilian crops and increased demand. We have a bearish bias, but we are certainly not going to recommend a short sale at these levels. Stand aside. *[September 29, 2006]*

Chart 4 – Spot soybeans



Courtesy Reuters

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