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No sign of slowing sugar output – yet

In an era when prices of many commodity markets – petroleum, grains, metals – are trading at either multi-year or – in some cases – record highs, sugar is a lonely standout. After faltering just shy of the 20¢-per-pound mark in early 2006, prices have fallen steadily. The world's two largest sugar producing countries – Brazil and India – took advantage of high prices and went on a sugar-planting binge. The result was a dramatic swing from a modest global production/consumption deficit to two consecutive marketing years with burdensome surpluses.

In August, The International Sugar Organization estimated the 2007-08 global surplus at 10.8 million tonnes, up from 10.29 million tonnes in 2006-07. Ending stocks will grow to a record high of 73 million tonnes, or 46.3% of consumption, up from 38% at the end of the 2005-06 season.

Indian output continues to soar with production expected to reach 33.5 million tonnes, up from 29 million tonnes in 2006-07. To appreciate the mechanics of the developing glut, consider that despite the fact that domestic consumption in India has increased along with its population growth, it still consumes only 20 million tonnes domestically, leaving 13.5 million tonnes. In the outgoing 2006-07 marketing year, it exported a scant 1.5 million tonnes, which still pushed 7.5 million tonnes into an increasingly burdensome stockpile.

Last week, the government announced a series of measures intended to lower inventories. First, until now, Indian ethanol producers were allowed to use only a byproduct of sugar, molasses, for making ethanol. The government lifted this restriction allowing processors to use the more economical sugarcane juice. The government also said that it was considering extending a domestic freight subsidy that encourages millers to export for one year. This would seem to be a rather logical step, but the matter is not that simple, because a significant increase in exports would apparently not be in the spirit of certain WTO ordinances.

The ethanol factor conjured up comparisons with Brazil, where more than half the sugarcane grown is devoted to ethanol production. But there really is no comparison. In Brazil, the infrastructure of the ethanol industry is fully mature, whereas in India the amount of commercially viable ethanol that can be produced and consumed any time in the near future is a drop in the bucket.

We believe that the current sharp rally, which began on

September 19, is directly attributable to these items and that neither issue is important enough to have any material effect on what is otherwise a severe bear market.

Although total EU output has been in decline since subsidies were cut in 2005, most EU countries have been producing above their quotas. A recent F.O. Licht estimate put 2007-08 EU production at 17.45 million tonnes, down only a bit from 2006-07 output of 17.95 million tonnes.

Crude oil prices have climbed to record highs, but ethanol prices have been contained, which should spur demand. And indeed it has in the one place where it actually matters for sugar – Brazil. Like India, however, Brazil has grown enough sugar to satisfy domestic food and fuel demand as well as export food and fuel demand.

The big difference between India and Brazil is that Brazil uses the entire crop every year, which leaves little if any carryover stocks. A disappointing 2008-09 in Brazil would certainly single-handedly end the bear market. Another potentially bullish factor is that at some point, producing countries will pare back production and replace sugar acreage with more profitable crops. Until then, it is going to take time to work off the huge inventories that have been built up over the past two years.

We recommend maintaining short positions. A close above 11¢ per pound, basis the near month, should be used as a stop. *[September 25, 2007]*

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Chart 1 – March sugar



Courtesy Reuters

COTTON

Prices retreat as markets await fresh global output data

The cotton market participated in the broad commodity sell-off associated with the collapse of the sub-prime mortgage market this past summer. The market was in the midst of a correction when the crisis hit – December cotton had already slipped by 7¢ per pound from the 69¢-per-pound level. Prices continued to tumble throughout August, bottomed at 57¢ per pound, and subsequently bounced sharply, but to date have not been able to retake the highs (Chart 2).

The recurrent theme that sees weaker demand for commodities as a fallout from economic contraction is wearing thin. First, the stock market, which led the charge and supposedly foretold a looming recession, saw the Dow Jones Industrial Average make a fresh all-time high on October 1.

To dispel the notion that commodity usage will be affected, copper prices – which have the strongest direct correlation to economic activity – roared back to pre-sub-prime levels. We believe that this is a very strong indication that we have returned to a normal environment in which each commodity market will see its respective prices move based on its own supply/demand fundamentals.

The September USDA supply/demand situation report contained bearish revisions for the US. Planted acreage was lowered by 210,000 acres, but the estimate for yield was increased substantially from the August estimate, from 783 pounds per acre to 811. The net effect was an increase in the

forecast for 2007-08 ending stocks to 6.2 million bales, or 29.1% of consumption, up from the August estimate of 27.2%. Weather forecasts seemed negative throughout most of the summer, but the effect on the crop, for the most part, was minimal. As of the most recent weekly crop progress report, the good-to-excellent portion of the crop was 52%, down from 54% on August 6, which does not seem too bad considering the steady stream of anecdotal evidence of poor weather.

The estimate for total global output was revised upwards by 1.26 million bales, which included increases to Indian and Pakistani production of about 500,000 bales each and a similar drop in West African production.

The impact on the global balance sheet, however, was inconsequential because of a downwards revision to last year's carryover stocks of just over 1 million bales. Ending stocks for 2007-08, are now forecast at 51.56 million bales, or 40.34% of consumption, unchanged from the August estimate. This will be the lowest carryout since 1994-95 when inventories were just 37.7% of consumption.

The key indicator for the demand side is, of course, US exports. The USDA is forecasting a rather large increase for 2007-08, to 16.7 million bales, 3.7 million bales above disappointing 2006-07 exports. While we haven't seen any extraordinary weekly tallies so far this year, sales have been

steady. Commitments stand at 4.8 million bales, 2 million bales higher than last year at this time. Shipments are also 1 million bales ahead of last year's pace. It is quite early in the season, but the USDA forecast is on track.

If there is a problem with the bullish case, it is that stories have been circulating that the output forecasts for India, China, and Brazil are slated for significant upward revisions. A rough estimate garnered from press and analyst reports that contained

this information could add an additional 5 to 6 million bales to 2007-08 global ending stocks, which would effectively bring a grinding halt to the bull market. The October 12 situation report should shed more light on this matter.

In the meantime, the 61.50 stop close we recommended on August 3 has held up so far, and we advise maintaining long positions using the same strategy.

[September 26, 2007]

Chart 2 – December cotton



Courtesy Reuters

COPPER

Persistent deficits inspire a magnificent rally

In August the world was falling apart. Stock and commodity prices were in freefall. Copper – the harbinger of industrial commodities – took a nasty dive of roughly 18% (Chart 3). The Dow Jones Industrial Average, the CRB Index, and copper have all since returned to their pre-subprime highs and beyond. Although all these markets had already moved significantly off their lows in anticipation of a move by the Fed, the 50 basis point cut in the Fed Funds rate on Sept. 18 sent prices flying.

To be sure, economists are divided over the wisdom and potential effectiveness of the rate cut, which raises the question of whether the exuberance of the markets was not somewhat irrational. Perhaps. Our goal is to determine whether copper prices should have fallen as much as they did and whether this move back to the highs is warranted. And the answers are clear to us. The supply/demand fundamentals are as bullish as they've been in some time.

In a report released on October 2, The International

Copper Study Group (ICSG) said that the global copper balance sheet would show a surplus of 110,000 tonnes by the end of 2007 and 250,000 tonnes in 2008. Unless there's a big shakeup in the market, that is not the way the picture is unfolding.

According to the ICSG's monthly data, the deficit has been growing since the beginning of the year. Through the first half of 2007, the deficit has climbed to 343,000 tonnes, compared with a balanced market at this time last year. The above year-end estimates are filtered with seasonal adjustments, but the current seasonally adjusted data still make a forecast for surplus seem unrealistic at this time – a first-half deficit of 131,000 tonnes, compared with a 208,000-tonne surplus at this time last year.

Global mine output is up 4.8% for the year, while total refined production is growing at only 4.3%. Usage, on the other hand, is growing at 8.3% over last year. A significant footnote is that without Chinese consumption, usage in the

rest of the world is growing at less than 1%. Strip away other developing economies, such as Russia and India, and we find that consumption is contracting.

Chile produces over 30% of the world's copper, and as such, its output is often seen as a proxy for global production. In September, the IMF forecast that Chilean output would grow at an annualized rate of 3% in the foreseeable future. Through the end of August, output is actually growing at a slightly better rate of 3.5%, but still below the growth in the rate of consumption and well below capacity.

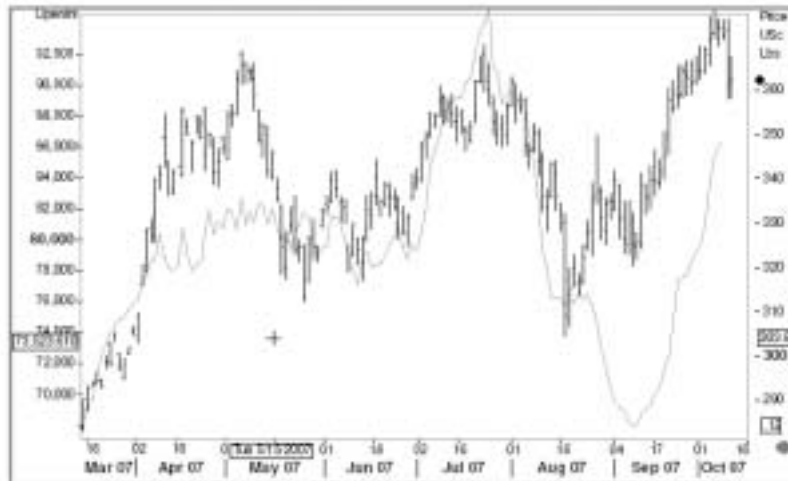
Earlier this year, global warehouse stocks began to build (Chart 4). Although still well shy of the 1-million-tonne-plus buildup of five years ago, the move from 75,000 tonnes to close to 300,000 tonnes in the span of a few months seemed commensurate with the unwinding of the massive bull market. Prices rose six-fold in a three-year period, but we were heading into surplus territory to stay –

or so we thought. Inventories at LME, Shanghai, and COMEX warehouses have now slipped back to 200,000 tonnes.

On a technical note, the market has probably overshot to some degree for the near term, perhaps because of short-covering by bears who were completely shocked by the market's ability to climb back to the \$3.70 per pound level, even after the subprime crisis was expected to create a contagion effect that would halt growth in the US and around the globe. Indeed, a read of the sharp rise in open interest (Chart 3) shows that speculative buying continues to grow, but with prices failing to making new highs, indicating that a temporary top may be in place.

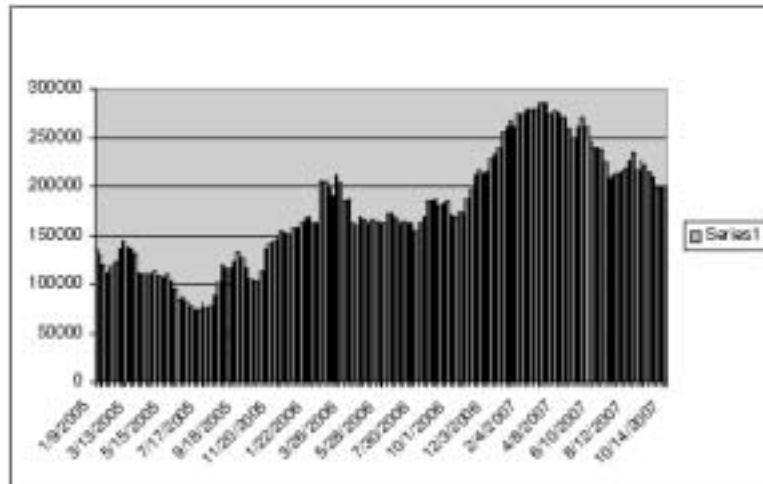
We see no reason to abandon our generally bullish posture, however, while the market continues to be in deficit and draws down global inventories. We recommend viewing setbacks as buying opportunities. *[October 10, 2007]*

Chart 3 – December copper (bar0, Comex open interest (line)



Courtesy Reuters

Chart 4 – Global warehouse stocks



CORN

Overstated ethanol consumption?

Corn prices rallied in September (Chart 5). Long-suffering bulls who watched wheat and soybeans enjoy exciting bull markets were led to believe that their day had come. It was not to be.

There were a number of stories that inspired the rally. A Chinese government agency announced that it would be encouraging imports to quell rising domestic prices. The story was stretched a bit, and as word began to circulate that China would become a net importer of corn, speculative juices began to flow. Over the past few seasons, China has been exporting 3 to 5 million tonnes. Any headline that even breathes ideas of China importing a commodity is sure to bring out buying.

Arguably the most comprehensive reason for the rally was the September 20 release of a report by Informa Economics that spring 2008 corn area would dive sharply, by 4.7 million acres, or 5% lower than 2007. While this would certainly be a very bullish factor, planting decisions for 2008 are many months away, and the motivations for choosing one crop over another can change dramatically.

Regardless, all major USDA reports in September were bearish for the old crop, and that is why the rally could not hold.

The supply/demand situation report raised the estimate for US 2007-08 ending stocks to 42.55 million tonnes (1.675 billion bushels), or 13% of consumption, up from the August estimate of 11.9% of consumption. In itself, this may not seem too overwhelming a revision. When considering, however, that early season estimates were looking for the US carryover to sink to 7.5% of consumption, one has to stop to wonder why all the concern about corn shortages. US farmers met the "ethanol" call.

Even more damaging to the bull case, was the USDA's first downward revision to the portion of the US crop that will be used for ethanol. Corn/ethanol usage for 2006-07 was lowered by a relatively small amount, 630,000 tonnes.

The revision to 2007-08 usage was dropped by 2.5 million tonnes.

The street assumed that ethanol consumption had nowhere to go but up. This report may have been the rude awakening that we may have overstated the growth of the biofuel market in the US. While even these changes do not alter the overall picture too much, it should be somewhat disquieting for bulls that USDA may have misjudged the ethanol market and that there may be more downward revisions to come.

The September 28 quarterly stock report provided no help for bulls either. Inventories as of September 1 stood at 33.1 million tonnes. Although down sharply from last year's level of 50 million tonnes, analysts were off the mark with their average guesstimate of 29.1 million tonnes.

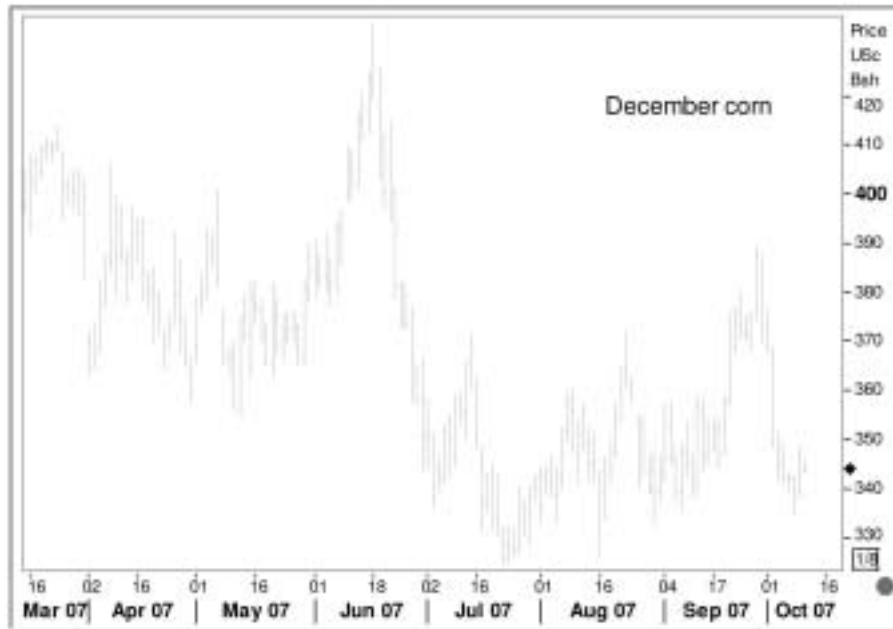
The USDA revised its estimate for annual US exports upwards by 2.5 million tonnes, or 4.5%, to reflect an extraordinary surge in weekly sales data. As of last week, commitments for new crop sales stood at 21.5 million tonnes, substantially ahead of last year's commitments at this time year of 15.65 million tonnes. If this were to continue, it may mitigate some of the loss of demand in the ethanol market. But a good chunk of these commitments came from a three-week period in which commitments averaged 1.8 million tonnes, clearly an unsustainable pace. This past week's sales, which were reflective of business conducted when prices flirted with \$4 per bushel, came off significantly, to 1.15 million tonnes.

In the near term, we can expect harvest pressure to keep a lid on prices. We are anxious to see if the USDA will further trim its still optimistic 83.7-million-tonne (3.3-billion-bushel) forecast for corn/ethanol consumption.

We retain our bearish bias, but we are not recommending a short position at this time. Do stay tuned.

[October 10, 2007]

Chart 5 – December corn



Courtesy Reuters

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