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FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



Volume 15, No. 8 November 21, 2012

Burdensome cotton supplies keep prices contained – for now

The October USDA crop report for cotton was a bear's fantasy. The forecast for global 2012-13 output was revised up by 2.3 million bales, while consumption was lowered by 680,000 bales from the September estimate. Crop estimates for just about all major producers – including the world's four largest, China, India, the US, and Pakistan – were raised. The net effect was an increase in the estimate for ending stocks to 79.11 million bales, 2.6 million bales above the already-record-high ending stocks estimate reported in September. Ending stocks as a percentage of consumption will jump to 74%, up from the September estimate of 71.1%. That compares with 67.4% at the end of 2011-12. That would be the highest inventory level of any major internationally-traded commodity that we know of – this year or any other year.

This, of course, explains why cotton prices have fallen from the \$2.15-per-pound peak set in early 2011 (Chart 1). Are we headed down even further, back to the 2009 lows?

The first matter that requires explanation, though, is why, after selling off on October 11 immediately after the release of the USDA report, the market rallied from 70¢ per pound to close to 80¢ per pound over the following few sessions, if the market is in fact as bearish as the global balance sheet implies.

It seems to have been a temporary problem. Certified stocks in the US, which can be delivered at the exchange, have fallen to historic lows. This ignited fears that a squeeze will follow on the December contract. Some early-harvested cotton has been of poor quality, and traders are concerned that it may not meet deliverable grade. The December/March spread, which had been in a moderate contango since the summer, quickly spiked to a 2-cent backwardation (Chart 2).

The US harvest is 38% complete, in line with the 5-year average of 39% for this time of year, and the tight stock situation should be alleviated soon enough. The first small increase in certified stocks, indeed, ended the panic. Prices and spreads reverted.

The demand side has not been particularly supportive. The USDA forecast is calling for US exports of 11.6 million bales, down only 1% from 2011-12. Commitments for the 2012-13

marketing year, which began on August 1, however, stand at 5.6 million bales, down 16% from the same time last year.

A closer look reveals a bit of a silver lining, though. At 1.55 million bales, or 27% of sales to date, shipments are stronger than last year at this time when shipments were only 1 million bales, or 15% of sales to date. Which could mean that the demand is there, but buyers are confident of lower prices down the road.

We're not actually bearish, though, and we have no interest in being short this market. The market could drift lower with harvest pressure, but the downside is limited. As we've pointed out in the past, production costs have increased significantly to around current price levels, which is generally not a great incentive to grow cotton when you can grow alternative, more profitable crops.

To illustrate, November 2013 soybeans, which represent the crop that will be planted next spring and harvested in the fall, are trading at \$13.35 per bushel, \$2.30 per bushel below spot November. December 2013 cotton is trading at 77¢ per pound, 4.5¢ per pound *above* spot December. And yet soybean prices are still near their historical highs *vis-à-vis* cotton (Chart 3). In fact, in an early forecast for 2013-14 acreage, Informa Economics estimates that soybean acreage would

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climb by 2.7 million acres, to 79.9 million acres. Cotton acres, on the other hand, are estimated to fall by 2.36 million acres, to 10 million acres. It's not much of a stretch to assume that a similar pattern will emerge in other producing nations as well.

Prices would have to rise substantially within the next couple of months to incentivize increased cotton plantings, in the US and abroad, and precisely because global inventories

are so large, that is not a likely scenario. The decision to plant much less cotton could be misguided if demand exceeds expectations and we eat into the monster stockpiles at a faster rate than anticipated.

We are long December cotton, with a stop at 69¢ per pound. We recommend rolling to December 2013, placing initial stops at 72.5¢ per pound, close only.

[October 24, 2012]

Chart 1 – December cotton



Courtesy Reuters

Chart 2 – December/March cotton spread



Courtesy Reuters

Chart 3 – November 2013 soybeans/December 2013 cotton ratio



Courtesy Reuters

WHEAT

The bull is just dozing

For the most part, the devastating summer drought of 2012 left US wheat output unscathed. Combined winter- and summer-wheat planted area of 55.7 million acres was 2.4% greater than in 2011-12, but production grew by 13.5%, to 2.27 billion bushels.

Regardless, wheat prices rallied to 5-year highs. The driving force behind the spike to \$9.50 per bushel was yet another FSU crop failure. In 2011-12, output recovered to 114 million tonnes from a devastating drought-reduced 81-million-tonne crop in 2010-11. The October USDA estimate for the 2012-13 crop was a downwardly-revised 77 million tonnes.

Prices have been in a holding pattern since July (Chart 4). The expectation of fresh supply from soon-to-be-harvested Southern Hemisphere crops and the promise of larger Northern Hemisphere winter wheat crops have consolidated prices.

In addition, apparent rationing of demand has set in. Consider that the USDA forecast for total 2012-13 US exports is 32.66 million tonnes, which – if achieved – would be 14.4% above 2011-12 total sales. Trouble is, US export commitments stand at 14.7 million tonnes, 9% below last year at this time. Buyers are scarce.

The USDA estimate for global consumption is 680.66

million tonnes, down 2% from 2011-12. Output is estimated to fall by 5%, to 658 million tonnes, leaving a formidable production/consumption deficit and a drawdown in ending stocks to 25% of usage, down from 28% in 2011-12 and 30% in 2010-11. Despite the slide in the level of global inventories, the market can survive handily. We are still far from the danger zone seen in 2006-07 and 2007-08, when ending stocks fell to 21% of usage. Nevertheless, the market remains vulnerable.

As mentioned earlier, both the supply and demand sides must cooperate. Seeding of the US 2013-14 winter wheat crop is almost complete. The USDA does not release its first comprehensive winter wheat acreage estimate until January. Private forecasters estimate that US farmers will plant about 57 million acres of winter and spring wheat, roughly 1 million acres more than this past season.

The first problem is that the season got off to a weak start. The most recent crop progress report shows that only 39% of the crop is in the good-to-excellent category. That compares with 49% last year at this time and is the lowest early-season rating since the USDA began keeping these statistics in 1985. Of course, it's still very early, and weather in the actual post-winter growing season is far more important.

FSU crops should bounce back, but the Northern Hemisphere crops are not available for 6 or 7 months, so they should not really be a huge factor in the near term. The focus now shifts to the Southern Hemisphere, and the outlook does not seem to support ideas that those crops can alleviate tightness.

Argentinean exports for the 2012-13 marketing year are estimated at 5.5 million tonnes, compared with last year's

export sales of 12.7 million tonnes. The key exporting nation has seen production fall into a precipitous decline. This year, excessive precipitation delayed the planting season. In 2010-11, output was 17.2 million tonnes, followed by 15.5 million tonnes in 2011-12. The October USDA crop report estimated this year's crop at 11.50 million tonnes, but a November 1 USDA attaché report lowered the estimate further, to 10.8 million tonnes. Some private forecasts put the crop as low as 10 million tonnes.

Australia is a vital exporter to the Asian market and is following a pattern similar to Argentina's. Last year it harvested a record 29.52-million-tonne crop, but output is expected to fall sharply to 23 million tonnes. Here, too, more up-to-date estimates put the crop at 21 million tonnes.

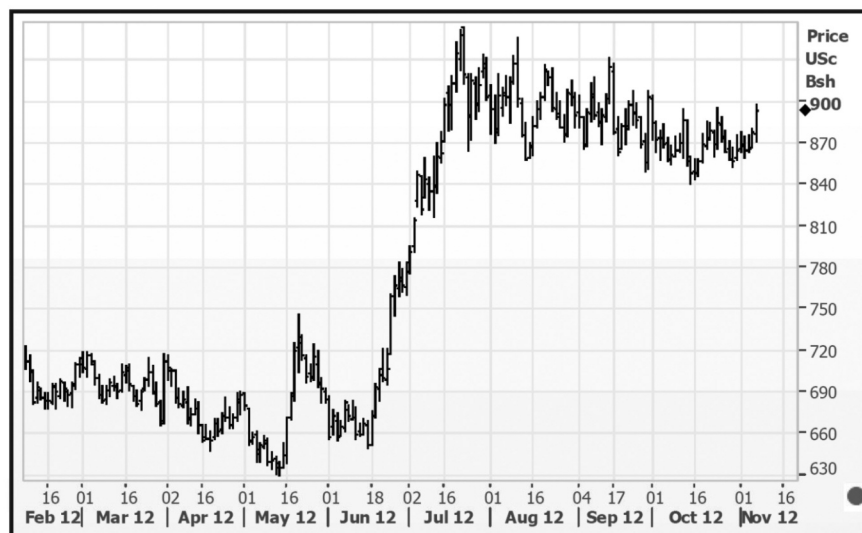
The Ukraine announced an export ban that would commence on November 15, but then waffled and said the ban was under review. In any case, the market is tight, particularly for food-quality milling-grade wheat.

Prices could be contained if demand remains as sluggish as it's been. However, any return to normal consumption trends, which we believe is inevitable, leaves the market vulnerable to return to the dangerously low inventory levels we witnessed between 2006 and 2008.

December wheat closed below \$8.50 per bushel twice in mid-October, which unfortunately triggered the stop on our long position. Re-establish long positions in March Chicago Board of Trade wheat, placing stops at \$8.60, close only. Alternatively, buy March Kansas City Board of Trade wheat, placing initial stops at \$9.00, close only.

[November 8, 2012]

Chart 4 – December wheat



Courtesy Reuters

COCOA**Demand is better than believed**

We begin our discussion of the cocoa market with an observation. On October 15 – the day before the release of European grind data – December cocoa settled at \$2,354 per tonne (Chart 5). The grind results were dismal, but better than expected. Third-quarter grindings were down 16.2% year-over-year. Analysts had expected a decline of 15% to 20%. Similarly, a couple of days later, the North American figures came in down 2.19%, “better” than analysts’ guesstimates of a decline between 3% and 10%. Traders actually bid the market up by \$1,500 per tonne, allegedly relieved that the numbers were not worse.

The rally was lost, but the market has had four weeks to absorb the implications of falling demand implicit in the grind numbers. Still, prices are holding above the pre-grind level. Commodities in general – the other softs, energy, base metals, and now grains – have experienced a broad selloff, so it pays to take note of markets that might be bucking the trend.

As far as the European grind is concerned, one large German processor claims that its results were omitted completely from the survey. Although there were no hard figures accompanying this news, it does seem that the total European grind would have been considerably higher with the inclusion of the missing grinder. And this explains, at least in part, why the market had such a bullish reaction to what was ostensibly bearish news.

While the harbinger of cocoa demand is grinding activity, the trend in end-product prices may be the true leading indicator of consumption. Over the past few months, we’ve pointed out that the price of cocoa butter has been rising. The European butter/bean ratio has now jumped to 2 times the spot London bean price. Supplies have been run down and the market for the end product is robust. Asian ratios are not quite as strong, but have also risen to 1.6. While powder prices have slipped, the combined ratio is still trading near multi-year highs (Chart 6). The ability of bean prices to maintain current levels could very well mean that bean purchases by processors are stronger than grinding activity allows us to believe. That’s partly because the reporting mechanisms of even the Western countries are

flawed – as illustrated – and partly because origin-country grindings are also not reported accurately.

In any case, the demand side is showing signs of life, and the production side will not be able to keep up, if in fact consumption growth is larger than the market believed was possible.

The 2011-12 crop year for West African cocoa is over, and the final results show that output in the world’s two largest producers was lower than in the previous season. There are conflicting estimates regarding the amount of final Ivorian arrivals. The average estimate is about 1.45 million tonnes, compared with 1.51 million tonnes in 2011-12. Early arrivals are running about the same as last year at this time.

Ghana – the world’s second largest producer – harvested an extraordinary crop in 2011-12 of over 1 million tonnes, 25% to 30% above what it had been producing in prior years. The 2011-12 crop slipped back to 880,000 tonnes, and the government forecast for the 2012-13 marketing year that began recently is for a further drop to 800,000 tonnes.

With less than two months of arrival data available, it is much too early to forecast the 2012-13 West African crops. We usually get a better idea in mid-December when we reach the half-way mark of the main crop.

At least one analyst is forecasting a 150,000-tonne production/consumption deficit for 2012-13, up from 100,000-tonne surplus this past marketing year.

The market received an unexpected boost from a political event. On November 14 Ivorian President Alassane Ouattara announced that he was dissolving the government. December cocoa jumped \$81 per tonne. Not that there is any known connection between the current government’s policies and low cocoa prices. Rather, traders have vivid memories of 2011 when the government-free country experienced chaos, which resulted in the withholding of 500,000 tonnes of cocoa beans.

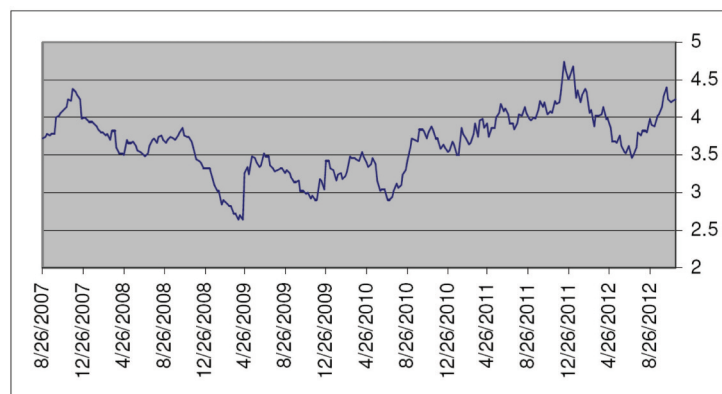
The onus is on producers to meet better-than-expected demand. Roll December long positions to March, maintaining stops at \$2,300, close only. *[November 14, 2012]*

Chart 5 – December cocoa



Courtesy Reuters

Chart 6 – Combined butter/powder ratio



CORN

Inventories are shrinking, but so is demand

Corn demand has been very weak. The most striking evidence can be found in the US export market. Even as prices have fallen from mid-August right through the harvest period, nobody has been buying.

The USDA finally stopped slashing its forecast for 2012-13 US exports in the November crop report, maintaining the 29.2-million-tonne October forecast, which would amount to only 74% of 2011-12 final sales of 39.2 million tonnes. A glance at the progress of sales, however, shows that even this estimate – for the moment anyway – seems wildly optimistic.

Since the September 1 start of the 2012-13 marketing year, weekly commitments have averaged an absolutely anemic 135,000 tonnes, compared with 885,000 tonnes last year during the same period. Commitments-to-date, which include outstanding unshipped sales from the previous marketing year, stand at 11.2 million tonnes, only 52% of the

21.5 million tonnes registered last year at this juncture of the season.

The situation, though, is not quite as bleak as it appears. Eastern European and South American origins have been available at discounts to US prices. With prices trading at record levels, foreign buyers have been shopping for bargains, meeting their needs outside the US.

The aggressive buying from US competitors, however, has its limitations. The discounts have disappeared and, more significantly – particularly in Brazil and Argentina – supplies available for export have been run down. Eventually we should start to see the return of traditional US customers.

There are other factors that will ultimately spur demand for US corn. Since 2008-09, EU corn imports have averaged about 3.3 million tonnes per annum. However, the estimates for 2012-13 EU corn crops have fallen precipi-

tously over the past few months – from a high of 65 million tonnes in the summer, to the current estimate of 54.65 million tonnes. The USDA has tried to keep pace, with commensurate increases in the amount the member countries will have to import. The November crop report raised the import estimate by 1.5 million tonnes from the October estimate, to 6.5 million tonnes. But that estimate is seriously outdated. Several analysts have raised their forecasts for EU imports to as high as 12 million tonnes.

Another issue is that until a few months ago there was an abundance of feed wheat available as a substitute for corn. Chart 7 shows that from mid-2011 through mid-2012, wheat prices had collapsed *vis-à-vis* their traditional relationship with corn prices, making wheat an attractive alternative. But because of the disastrous FSU wheat crop this past season, the market for feed wheat has tightened, and the wheat/corn spread has moved back into its normal historical range. Any pent-up demand for carbohydrate feed

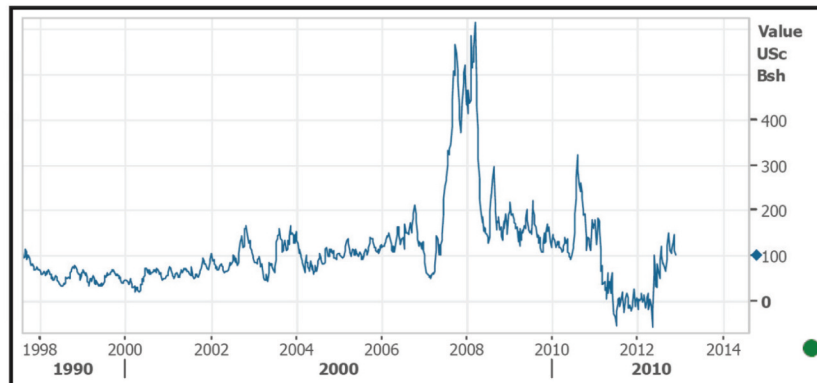
should drift back to corn.

The estimate for global ending stocks is 117.99 million tonnes, or 13.8% of consumption, the lowest carryout since the 1973-74 season. With the opportunity to lock in record prices for the coming spring's plantings, there is little doubt that US farmers will attempt to plant a lot of corn. With good weather, they should harvest a record crop. But it's a race against time. That crop will be harvested next autumn, and even South American crops will not be available for several months. In the meantime, the drought-compromised US crop will suffice, but only if the forecasts for much slower demand from the export, domestic feed, and ethanol markets are accurate.

The market tested the recent lows (Chart 8), but our protective \$6.95-per-bushel sell stop recommended on October 14 was not breached. Roll long December corn to March and maintain the same stop.

[November 21, 2012]

Chart 7 – Wheat/corn spread



Courtesy Reuters

Chart 8 – March corn



Courtesy Reuters

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