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Soybeans: not another drought!

Although a very wet spring delayed planting of the 2013-14 US soybean crop, ideal weather materialized after the crop made it into the ground, which – for a while anyway – seemed adequate to mitigate the potential problems associated with a shorter growing season. The July USDA crop report forecast a record 2013-14 US soybean crop. Before the release of the August USDA crop report, both old and new-crop soybean prices traded down to fresh season lows. Soybean and soy product prices looked much lower. For technical analysts, it was a make-or-break of the bull market that began in 2006 as prices came to challenge a long-term uptrend line (Chart 1).

Even before the release of the August crop report, hot and dry conditions emerged, and analysts began trimming their crop estimates. The July crop estimate was 3.42 billion bushels, based on record acreage of 77.7 million acres and a record yield of 44.5 bushels per acre (bpa). The average guesstimates for the August report called for a crop of 3.338 billion bushels and yields of 43.472 bpa. As it turns out, analysts underestimated the crop damage. The USDA slashed the acreage estimate by 500,000 acres and lowered the yield to 42.6 bpa, for a crop that would reach only 3.255 billion bushels.

The estimate for US ending stocks fell to 220 million bushels, down 75 million bushels from the July estimate, and is a throwback to the era of tight supplies. The USDA report sparked a rally, and with continued deterioration of the weather picture, November soybean prices have traded up to new highs for the year (Chart 2).

Normally, by late August, the crops are far more mature. But because they were planted late, they are still vulnerable to the hot and dry weather that is hitting key growing regions in the Midwest.

Estimates are tumbling, with one widely watched and well regarded analyst lowering the yield estimate to 41.8 bpa. Assuming that acreage and the harvested-to-planted ratio will not be revised downwards – which they likely will be, if conditions do not improve – the crop would reach only 3.193 billion bushels, a long way from the 3.42-billion-bushel July estimate.

The estimates for demand – domestic and export – are

not particularly optimistic. Without rain, ending stocks will be revised down to about 160 million bushels, or 5% of consumption, down from the potential bear-market July estimate of 9% and even lower than the 6.9% August estimate. All in all, a fairly impressive bullish case.

Although there is a good chance that we are staring at a US crop failure, there is a bearish case as well.

The South American crop has not been planted, but there has been a lot of debate about the size of Brazilian soy area for the 2013-14 crop. Just a couple of weeks ago, with prices falling, analysts were saying that Brazilian farmers were not likely to expand acreage. But as the poor weather in the US has sent prices soaring, those estimates have risen substantially. One estimate says that soy area will grow by close to 5% from last season.

US export sales have been strong. Commitments for the 2013-14 marketing year, which begins on September 1 stand at 690 million bushels, well ahead of the norm for this early in the year. However, this can be attributed to low prices that foreign purchasers have not seen for a sustained period in years. The challenge will be to see new sales continue this strong now that prices have increased so much.

November beans have now rallied by over \$2 per bushel, or close to 20%. There is still a possibility of salvaging crops if timely rains appear, so trying to jump on the trend could turn into a trading disaster. We remain sidelined..

[Sholom Sanik, August 27, 2013]

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Chart 1 – Weekly nearest contract soybeans



Courtesy Bloomberg LP

Chart 2 – November soybeans



Courtesy Bloomberg LP

COPPER

All China, all the time

Back in June, copper prices were poised to crack the \$3-per-pound level. The market bounced sharply – by close to 15% – but has since retraced a sizeable chunk of that rally (Chart 3). Was the rally warranted or just a due-course correction?

To be sure, there have been some bullish developments. On August 21, in its most recent update of the global balance sheet, The International Copper Study Group (ICSG)

reported that for May, refined copper slipped into a 17,000-tonne deficit, the first monthly shortfall in six months. While production growth remained robust, demand, primarily from China, grew at a faster clip. Year to date, the market remains in surplus, but if current trends continue, that could be gone in a hurry.

Global economic growth has been steady, but not earth-shattering, and it was reflected in consumption patterns. In

the ICSG's study period of January through May, US demand was unchanged from the same period last year, but consumption in all other regions, including Europe, Africa, and Asia (excluding China) was negative. The Chinese compensation factor, however, overwhelms the sluggishness in the rest of the world.

It was widely expected that once the torrid pace of Chinese economic growth would slow, so would copper usage. And that was true up until several months ago. Economic data have surprised to the upside, however, and it has been reflected in apparent Chinese demand.

Chinese imports for July were 291,000 tonnes, up 14% year-over-year. That was the fourth consecutive monthly increase and the highest level since last September. Moreover, the stored inventories sitting in bonded warehouses – which according to some accounts reached close to 1 million tonnes early this year – has been whittled down. One analyst says that the stockpile has fallen to 300,000 tonnes. If this is accurate, it would mean that the imported copper is being used for industrial purposes, rather than just being locked up in financing deals.

Exchange warehouse data also indicate a tightening market. Chart 4 shows that combined inventories at LME, Shanghai, and COMEX warehouses have fallen substantially over the past two months.

Another bullish factor for copper – of a longer-term nature – is rising production costs. Costs vary from region

to region, but declining ore grades in the major mining centers, in addition to rising labor costs and higher energy costs everywhere, mean more expensive extraction. A case in point is Chile. The country produces about one third of the world's copper. The Chilean state-owned mining company Codelco, which alone accounts for about 11% of global output, reported on August 30 that cash production costs for the first half of 2013 were \$1.71 per pound. That's up from \$1.47 in the first half of 2012.

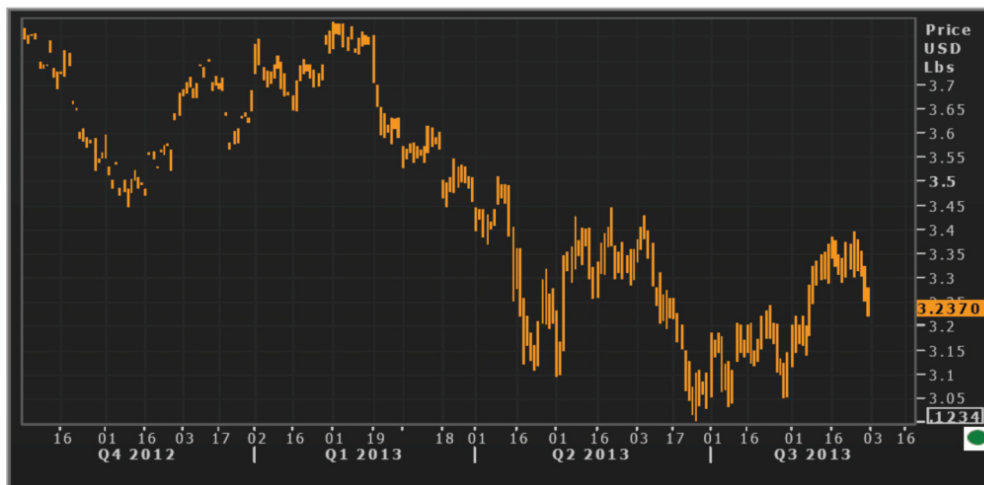
On the bearish side of the equation, production has been strong, and without the single bullish factor of Chinese demand – large as it may be – surpluses will continue to expand. Chilean output has been down year-over-year in only one month this year – in April, by a modest 1.2%. For July, the most recent month for which data are available, output was up an extraordinary 16.3% year-over-year. That brought year-to-date output to a gain of about 6.5%. That's in line with early expectations, but still a very robust number.

In conclusion, it is a single-issue bull market. If Chinese imports were to back off again, there would be precious little to keep prices from collapsing. Still, history has shown that the Chinese phenomenon, for this and many other commodities, can last for sustained periods of time.

We advise using the recent setback in prices to cover short positions. This would replace our current protective stop of \$3.45 per pound, basis nearest contract.

[Sholom Sanik, August 30, 2013]

Chart 3 – December copper



Courtesy Bloomberg LP

Chart 4 – Combined warehouse stocks



COTTON

The dismantling of the Chinese cotton monster

Turning bearish on the cotton market back in July after a long stint of bullishness gave us a severe case of whipsaw. December cotton sailed right through our 88¢-per-pound buy stop, on its way to 93¢. Within a few days of the peak, prices plunged, on their way back to 82¢.

During the planting-decision season, there was little incentive for farmers to plant a large cotton crop. Global inventories were burdensome, to say the least, and soybean planting was a more profitable alternative. The most recent estimate for US cotton acreage was 10.2 million acres, down from 12.31 million acres in 2012-13 and 14.74 million acres in 2011-12. The smaller crop seemed adequate to meet both domestic and export requirements.

As the growing season progressed, however, the crop was hit with bad weather. Yields deteriorated, and estimates for a high abandonment rate grew. The August 12 USDA monthly crop report lowered the crop estimate to 13.05 million bales, down from the 13.5-million-bale July estimate. More importantly, it was significantly below the average street guesstimate of 13.75 million bales. The abandonment rate rose to 25%, about the same as last year, but not as bad as the 36% seen in the disastrous 2011-12 crop year. Still, it was much worse than the previous 10-year average of only 10%.

Weather has improved since the August crop report and is likely to be reflected in the September crop report estimates, but much of the damage is likely done.

The status of the US crop, however, is merely a diversion from the broader issues, which are decidedly bearish. Actually, to be more accurate, it should be *issue*, in the singular.

There is ongoing uncertainty regarding the future of Chinese imports. As we discussed in our most recent article on cotton (see *Focus on Futures*, July 12), Chinese carryover

stocks have ballooned to over 58 million bales. That's up from 50 million bales in 2012-13 and dramatically higher than 31 million bales in 2011-12.

The Chinese government is reportedly in the process of overhauling its stockpiling policies, which effectively made it cheaper for cotton users to import rather than buy domestically grown cotton. The USDA estimates that Chinese imports from all sources will fall by close to 50% from 2012-13, although some analysts see continued robust Chinese imports for the foreseeable future. Hard evidence suggests that Chinese imports have already slowed down materially. For the new 2013-14 marketing year, which began August 1, total Chinese purchases from the US, including shipped and unshipped, total 488,000 bales. In the comparable period last year, 1.821 million bales were sold to China.

The forecast for global ending stocks was revised in August to 93.77 million bales, or 85.36% of usage, down slightly from the July estimate of 85.9%. Lower production estimates for the US and China were partially offset by an increase in the estimate for carry-in stocks from the 2012-13 marketing year. But with the magnitude of the overhang we're looking at, the downward revision in ending stocks is largely meaningless.

If China were to start chipping away at its stockpile, the market would collapse. The rally that stopped us out of our short position was the result of an unwarranted focus on the US crop. We do not believe these price levels are sustainable.

Cotton is a particularly volatile market. Look to reestablish conservative short positions in December cotton on rallies. Place initial stops at 90¢ per pound, close only. Risk-averse accounts, not prepared to risk such large losses, should avoid the trade. *[Sholom Sanik, September 12, 2013]*

Chart 5 – December cotton



Courtesy Bloomberg LP

SUGAR

The fading surplus

Sugar prices have bounced off multi-year lows, possibly because of the upcoming expiry of the October contract, a prevalent pattern for expiries over that past year and a half (see *Focus on Futures*, July 5). Developments on the supply/demand front have been mixed.

On the bullish side, although Brazilian cane area was higher than last year, several bouts of unfavorable weather over the past several months have prompted analysts to trim estimates for sugar output by about 2 million tonnes, down to about the same as last year's. A frost in late July damaged this year's crops and could have implications for next year's crop as well.

Aside from the outright loss of output from crops that are unusable for sugar production, sucrose content in partially frost-affected cane is generally lower, which provides a further incentive for processors to bump up the ethanol/sugar ratio, in favor of ethanol. Indeed, one estimate puts the ratio at 57/43 in favor of ethanol, the highest figure we've seen in some time.

An excellent Indian crop is developing, however, and that could temper the bullish effect of lower Brazilian production on the market. Like in many countries, falling sugar prices resulted in smaller cane and beet area for the 2013-14 crop. But the annual June-through-September monsoon was very strong this year. Despite the smaller cultivated

area, Indian farmers will harvest a bumper crop. The current forecast is 25 million tonnes, compared with 2012-13 output of 24.6 million tonnes, but up sharply from early-season estimates that were as low as 22 million tonnes.

Based on the early-season production estimates and domestic consumption of about 23 million tonnes, we believed that Indian exports would not be a factor in world trade. The optimistic outlook for the coming crop has changed that, and some analysts are now saying that India can export 3 million tonnes in the 2013-14 marketing year, which if realized, would certainly be a bearish factor.

With full knowledge of the balance between lower-than-expected output from Brazil and higher-than-expected output from India, sugar analysts have continued to lower their estimates for the global production/consumption surplus for 2013-14. For 2012-13, the balance sheet showed a cumbersome 10-million-tonne surplus. Early-season forecasts for the 2013-14 global balance sheet called for a 6- to 7-million-tonne surplus, down from a 2012-13 surplus of 10 million tonnes, but have moved down steadily.

The fall in Brazilian output and the uptick in Indian production seem to cancel each other out, but the expectation of rising consumption patterns in developing countries has been significant. For example, Indonesian consumption is forecast to climb by more than 10% from last year. That's

an increase of more than 500,000 tonnes, which is a substantial amount, particularly when considering that the country is a net importer.

Estimates for the 2013-14 balance have now fallen to a surplus of about 2 million tonnes. Still a surplus, yes, but the market has been tightening. A quote from a September 5 report of an analyst at sugar statistician Czarnikow put it best: "The strength of the physical market is telling us that the supply side of the market, rather than being challenged

to find demand, is actually challenged to meet demand."

The current spring off the bottom in prices may indeed prove to be yet another pre-expiry short-covering event. However, with prices where they are now, the incentive not to plant sugar is still prominent. The good fortune of a fantastic monsoon to produce a great crop from lower plantings will not necessarily repeat. We maintain our strategy of buying long-term out-of-the-money call options.

[Sholom Sanik, September 16, 2013]

Chart 6 – March sugar



Courtesy Bloomberg LP

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