

FRIEDBERG'S

FOCUS ON FUTURES

Friedberg Commodity Management Inc.



Volume 2, No. 9 September 27, 1999

Canadian dollar: undervalued – ready to show it?

By Sholom Sanik

The last couple of weeks have seen the Canadian dollar confined to a narrow range, trading on either side of the 67¢ level. We think that is about to change. The rally that began a year ago, when the dollar bottomed just below 63.5¢, ran out of steam when it crossed 69¢. The factors that influence the direction of the dollar now once again support the currency.

Commodity prices: Canada's export-dependent economy has made a de facto devaluation of its currency a necessary evil both to compensate exporters for revenues lost to falling commodity prices and to price the goods competitively. Until now, the various commodity indexes representing different sectors of the economy would take turns being strong. At present, though, the Bridge/Commodity Research Bureau's index of commodity prices, the Journal of Commerce index, and the Goldman Sachs commodity index are at or near their one-year highs. Among these three indexes, all vital commodities in the agricultural, industrial material, and energy areas are well represented. Their coinciding strength may very well mean that commodity prices have bottomed and that the Canadian dollar needn't be priced at these low levels. Indeed, there is good reason for commodity prices to be recovering. While the US economy is slowing down and Japan's is limping along, most of the rest of the world's economies – the customers for Canada's commodity exports – are experiencing strength.

Some confirmation of the association between firm commodity prices and a stronger currency can be seen in the recent coincident strength in the Canadian dollar's two sister commodity-currencies, the Australian and New Zealand dollars (Charts 1 and 2).

Further evidence exists that the weak currency did its job in protecting the export sector. Canada's merchandise trade balance, which for many years has been in surplus, came perilously close to reversing this trend. The monthly surplus was averaging over \$3 billion in the first half of 1996 but had fallen to under \$1 billion by the summer of 1997 (Chart 3). At that time, the currency was trading at about 73¢. During the move down to 63.5¢, the trade balance improved consistently, making a new recovery high of \$2.8 billion in the most recent reporting period.

Interest rates: There is a common notion that the Canadian dollar needs its short-term interest rates to be stronger than those of the US to maintain its poise. Hot, yield-seeking pools of capital are constantly in search of even slightly better returns. For such capital, the choice of North American exposure is determined by these differentials, the theory states. We, too, have espoused this concept. Recent history, however, has shown otherwise. Since the Canadian dollar bottomed at 63.5¢, the spread between Canadian and US short-term interest rates has narrowed from 50 basis points (bps) in favor of the Canadian side to where we are now at 60 bps in favor of the US side. Despite this, the Canadian dollar rose by 7% during this period (Charts 4 & 5).

To understand how the Canadian dollar can withstand such pressure from a seemingly very negative influence, consider the comments from the September 3 edition of a popular newsletter *Idea Global - Financial Markets Today*: ".....supportive for the Canadian dollar is that foreign direct investment is financing the current account deficit. Unlike finicky portfolio inflows, foreign direct investment is not prone to be reversed quickly. Also strong foreign direct investment is usually a sign of an undervalued currency. In the four quarters ending Q2, foreign

In this issue

- 2** **Wheat**
A setback, but the bullish case is intact
- 4** **Precious Metals**
Some short-term glitter in gold, but silver's for real
- 5** **Cocoa**
The shorts are on the run
- 6** **Hotline Update**

Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.com).

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

direct investment totaled a record C\$24.6 billion, more than offsetting C\$10.3 billion current account deficit.”

As well, Canadian 10-year yields are still yielding 20 bps less than comparable US paper, indicating the confidence foreigners are showing in Canada by accepting inferior yields.

This undervalued currency is ready for a strong move to

challenge the highs above 69¢ and perhaps beyond.

[September 10, 1999]

STRATEGY: Remain long December Canadian dollars as per Flash Update of Thursday, September 9. Retain initial sell stop of 66.10 basis December, close only.

Chart 1 – Australian dollar

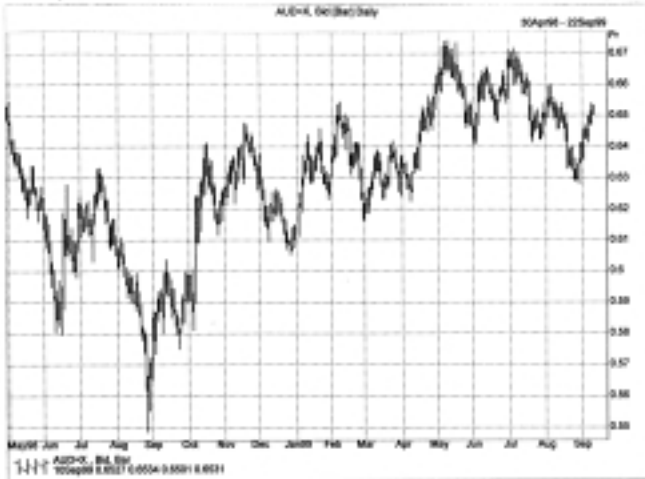


Chart 2 – New Zealand dollar

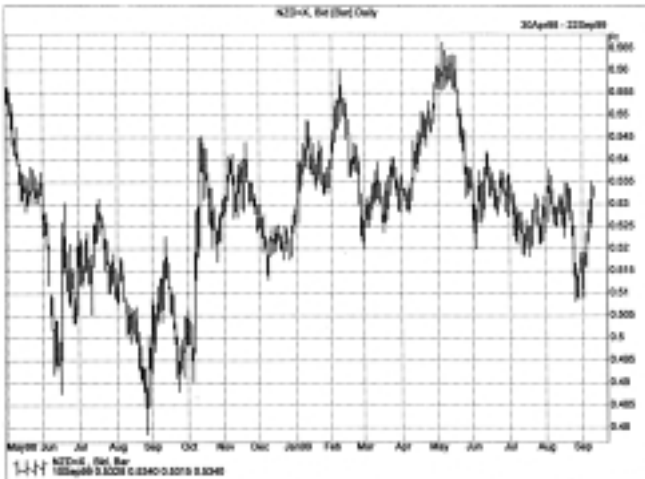


Chart 3 – Canadian Merchandise Trade Balance

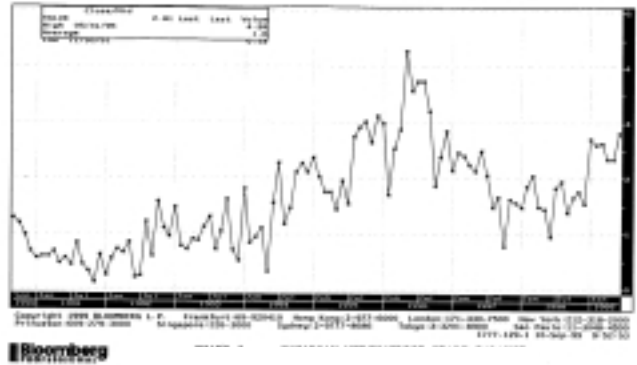


Chart 4 (TOP) – Spread Between Canadian and US Short-Term Rates

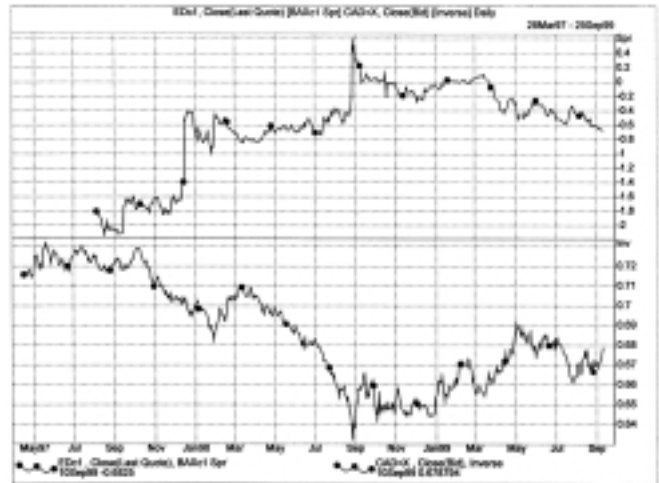


Chart 5 (BOTTOM) – Canadian Dollar

WHEAT

A setback, but the bullish case is intact

The timing of our recent foray into the wheat market was, well..... a little less than perfect.

First, a little history. The market action in wheat had been rather impressive since early summer and looked poised to shake off the bear market blues with a break above \$3 per bushel. In the initial phase of this summer’s rally in the grain markets, wheat had no particularly good reason to participate. Crops of important growers outside the US (e.g., China,

Canada), which at one time formed the basis of the supply-side bullish case, were being upgraded. Exports were okay but nothing impressive. Regardless, wheat was being dragged along with the weather scare in corn, because its price is determined in part by its status as a feed grain. Considering that their crutch – corn prices – had faltered, wheat prices held up quite well when the market corrected. Until last Wednesday, that is, when wheat plunged 13.5¢ in one ses-

sion. The market continues to droop. What happened? Do the fundamentals still favor higher prices?

The news that initially triggered the decline was weather-related. The winter wheat regions had been dry, and there was concern about the level of soil moisture for the upcoming planting season. Some heavy rains alleviated those fears, erasing any premium that was built into the market on account of this issue. The size of the decline, though, would indicate that there were other factors involved.

US exports are one of the best measures of demand, because they represent over 25% global export trade. Indeed, US export commitments are running 10% behind the same time last year. It is US exports, then, that become the item to watch for anticipating future movements in price. Coupled with news stories of storage facilities bursting at the seams – indicating weak domestic demand as well – the selloff was not entirely unjustified.

Bull markets in commodities are typically demand driven. Aside from extreme cases, like the drought in the summer of 1988 when US crops shrunk by about 30% from previous years, a smaller crop will not cause more than a ripple in an efficient market. In such a process, inventories will be tapped, pushing prices moderately higher, which will entice greater production the following season. Hence, the market is resupplied. With analysts focusing most of their attention on the US picture, the global scene is being overlooked. The process of replenishing inventories at that level, however, is not following the script.

The trend of falling wheat production has been followed by a trend in falling ending stocks. The pattern continues with the USDA's forecast for the 1999-00 season, despite its pessimistic estimate of consumption patterns (Table 1).

In comparing the global situation in wheat with that of corn, we find the two markets headed in different directions and an illustration that is typical of the contrast between wheat and many other commodities in reestablishing plentiful inventories (Tables 1 & 2).

The trend in recent export commitment data confirms ideas that emerging countries are getting back on their feet. It also calls into question the USDA's lowering its estimate of annual US exports by 25 million bushels to 1.125 billion bushels in the September 10 supply/demand situation report. Today's commitment came in at 684,000 tonnes, which was right at the high end of analysts' expectations. Last week's disappointing total of 323,000 – which was significantly below the previous 4-week average of 620,000 tonnes – put a damper on the outlook for exports but can perhaps be explained away by taking note that that period included the holiday weekend. It should also be noted that much of the big export numbers earlier this month and late last month were registered when prices were at their highs, indicating that

when there is demand, prices are not nearly high enough to be a deterrent. If we eliminate the holiday-shortened week, the recent trend would yield an annual export figure of about 100 million bushels above the USDA's. When this amount is lopped off US ending stocks, it alters the view that US inventories are burdensome.

A bullish factor on the supply side that can't be ignored is the Canadian crop. Canada's largest wheat producing province, Saskatchewan, is behind in harvesting, because of cool, wet weather. It has harvested only 40% of the crop. This compares with 99% last year at this time and a 77% five-year average.

The longer the wheat stays in the field, the greater the chance of yield loss. We won't have an accurate estimate of what was lost for some time, so this will overhang the market.

The real culprit for this decline, we feel, is the liquidation of a huge speculative long position. Open interest is very high. Even after shedding some 6,000 contracts on this drop, there is a lot of excess baggage, with the total at 125,000. According to Steven Briesie's *Bullish Review* (September 13) commercials were almost at a maximum-size short position (based on historical precedent). The specs on the other side were spooked by the string of bearish headline news and triggered the correction. A further decline in open interest without significantly lower prices would be the constructive pattern to look for.

Our timing left something to be desired, but smaller crops and budding new demand are a potent combination that should bring higher prices in the future.

[September 23, 1999]

STRATEGY: *Remain long December wheat as per Flash Update of Sept. 15, using initial stops of 265.25, stop close only.*

Table 1 – WORLD WHEAT PRODUCTION

	PRODUCTION	CONSUMPTION	ENDING STOCKS	STOCKS-TO-CONSUMPTION
1997-98	609	584	139	24%
1998-99	588	591	135	23%
1999-00	576	588	124	21%

Table 2 – WORLD CORN PRODUCTION

	PRODUCTION	CONSUMPTION	ENDING STOCKS	STOCKS-TO-CONSUMPTION
1997-98	573	580	86	15%
1998-99	602	584	104	18%
1999-00	591	592	104	18%

PRECIOUS METALS

Some short-term glitter in gold, but silver's for real

Silver prices have been in a relatively narrow trading range for most of this year (Chart 6). As the chart illustrates, they haven't really been in an up- or downtrend. They were, however, coming perilously close to the bottom end of the band. Then, on September 21, help came in the form of the second, 25-tonne tranche of the Bank of England's gold sale program. Common sense would dictate that a sale of that size would put pressure on prices. Indeed, back on July 6, at the first tranche of the sale, gold prices dropped \$5 an ounce initially and remained weak for a few weeks. This sale was far different. Participants must have thought of it as an IPO of an Internet stock, because it was eight times oversubscribed and sparked a long overdue short-covering rally that by week's end spanned \$15 an ounce, or 6%. Commodity funds and gold miners headed for the exits in droves. Gold miner Gold Fields of South Africa bought 12.5% of the sale to cover a hedge.

The magnitude of the interest was certainly a surprise and raises the question of whether there is demand out there that the market is not aware of. A light case can be made that the tide has turned, with the US dollar weakening, making gold more attractive to gold purchasers outside the US. Perhaps the gold market is sniffing a bit of inflation and is tracking commodity prices, which have shown signs of life lately, particularly petroleum prices.

The first leg of this rally in gold, however, was a mere preamble to what was to follow. Over the weekend the European Central Bank dropped a bombshell by announcing that 15 European central banks had committed themselves to limiting gold sales to a total of 400 tonnes per year. This total includes the balance of the 415 tonnes to be sold by the Bank of England and the 1,300 tonnes the Bank of Switzerland intends to sell. Gold opened \$15 an ounce higher on Monday morning, again dragging silver along for the ride.

At this juncture silver was likely nudged out of its doldrums with some help from the extraordinary move in gold. Nevertheless, we do not believe that the long-term dynamics have changed with regard to being long silver outright or being

short the gold/silver ratio. True, the effects of the process of demonetization will be delayed somewhat. This announcement by the European Central Bank is going to cause a considerable change of sentiment that will keep a steady stream of short-covering in the market.

Consider, though, that the demonetization of gold began because it no longer made sense for central banks to hold gold in a post-gold-standard world. Ultimately, the gold remaining in central bank vaults will find its way to market. It only means that some form of control can be felt in the market and the fear of the unknown is somewhat diminished. The 2,000 tonnes to be sold is not loose change, and still represents a formidable amount of gold, which will pressure prices when they come to market.

Silver, on the other hand, is still running production/consumption deficits and has no source from which to compensate the 100 to 200 million ounces of deficit that have been accumulating each year this decade.

Contrasting the open interest totals of silver and gold reveals much about what is happening in these markets. At 210,000 contracts, gold open interest is very large and is only a sampling of what the invisible short position looks like on the over-the-counter market.

Silver open interest stands below 80,000 contracts and is very moderate relative to historical levels (Chart 7). Since the Warren Buffett bubble burst, silver has been moving in a sluggish formation. Whipsawed silver bulls have lost confidence. On the other side of the fence, though, this backdrop creates a fertile breeding ground for contrarians.

In summation, we feel that after the short-covering in the gold market is over, the market will run out of steam and return to its bear market confines. Silver does not have the constraints of demonetization and will eventually respond to what are clearly bullish supply/demand fundamentals, even if the initial push came from its weaker partner, gold. [September 27, 1999]

STRATEGY: Remain long December as per Flash Update of Sept. 2, using initial stops of 490, close only.

Chart 6 – Silver

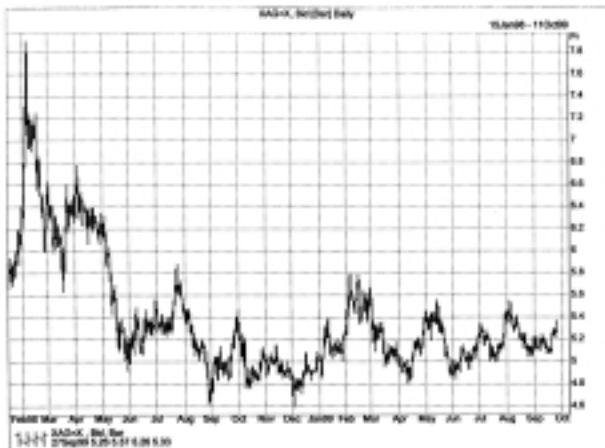
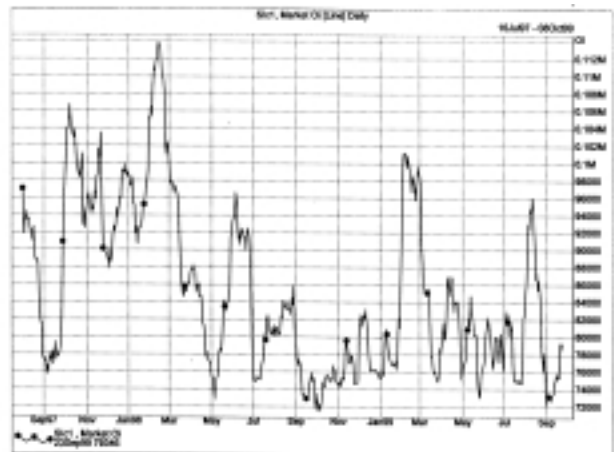


Chart 7 – Silver Open Interest



COCOA

The shorts are on the run

Being long cocoa, gives us a déjà vu kind of tingle. Be clear about our intentions, though. This trade is not deeply rooted in supply/demand fundamentals, at least not for starters. If anything, quite frankly, the fundamental outlook is anything but bullish, on both the supply and demand side. The Ivory Coast, which grows over a third of the world's cocoa, has been pumping out bumper crops since 1995. The USDA attaché in the Ivory Coast released the most recent estimate of the coming 1999-00 crop at 1.2 million tonnes, which would be 20,000 tonnes above last year's crop.

In the past few years, output from some of the second-tier producers has been dwindling. It was thought their output would continue to decline. Recently, however, estimates have shown upcoming crops of these producers to be stabilizing. They include Brazil, Nigeria, and Indonesia. The most bearish factor on the supply side is the overhang of ending stocks, which is said to amount to as much as 50% of consumption.

Demand has been a disappointment as well. The cocoa market, followed the script of most other commodities since 1997. Consumption growth rates that were higher in emerging countries than developed countries were expected to eat into burdensome inventories. All was well until the Asian crisis struck, and growth rates to plummeted. A commodity like cocoa was especially vulnerable, because it is after all still a luxury in countries where per capita income can be the equivalent of a few dollars a month. Companies like Mars, Nestlé, and Cadbury Schweppes, which built factories in anticipation of a fresh wave of demand, were forced to either cut production sharply or close plants completely, thus limiting their demand for beans. What business, then, do we have trading this market from the long side?

Well, we think that speculative shorts that are looking simplistically at the downtrend (Chart 8) and taking the fundamentals at face value are trapped and are covering. Although the open interest is not that high by historical standards, it has risen considerably in the past few months (Chart

9). The Commitment of Traders report shows clearly that there is a huge speculative short position and that as of the end of the last reporting period (September 21), the shorts have not even begun to cover.

The fascination with cocoa among commodity traders lies not only in distant memories of prices many times of what it trades for now and perhaps fantasies of a return to those levels. It involves understanding the unique nature of cocoa. It certainly is a commodity like no other in that it can only be grown in a few select spots on the planet, namely within 10 degrees of the equator. Run your finger along the circumference of a globe and you'll find that there is not a single country in these narrow boundaries that is either politically or economically stable – typically, they are neither. A crop failure in any of the important producing countries would be devastating. Which is why talking about commodity prices, or even soft commodity prices collectively, is at times a misnomer. Take sugar for example. Sugar can and does grow in virtually every region in the world, save for the north and south poles. You can never truly have a shortage of sugar. But, you can run out of cocoa.

All this may sound a bit futuristic. What will make it more realistic is if the recovery in emerging economies gets back on track. The infrastructure for producing chocolate products for hundreds of millions of Chinese and Russian peasants is in place. They only need to restart the plants that were brought to an abrupt halt over the past two years. If we do see evidence that this is happening, then this "open interest" play can turn into a long-term fundamental position.

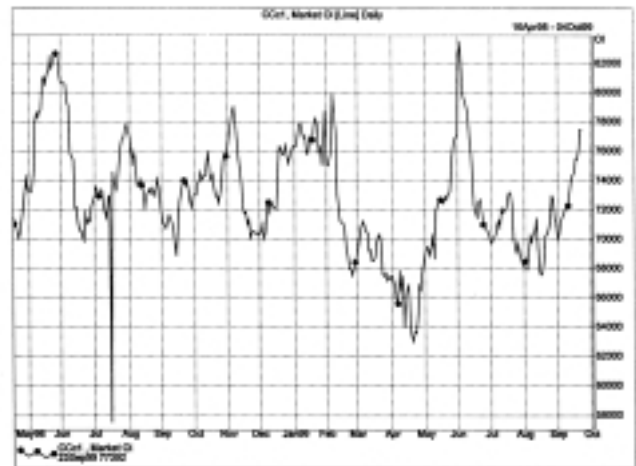
If the shorts do cover and prices stagnate, then the downtrend will likely resume. Although the information is not readily available, we will also watch carefully for production activity in emerging countries. *[September 27, 1999]*

STRATEGY: Remain long as per Flash Update of September 23, using initial stops of 905, close only.

Chart 8 – Cocoa



Chart 9 – Cocoa Open Interest



HOTLINE UPDATE

Flash Update: Wednesday, September 1, 1999:

Good afternoon for Wednesday, September 1, 1:15 pm. We have a correction in our Flash Update from Tuesday, August 31. The corrected version follows: Good afternoon for Tuesday, August 31, 12:00 pm. This is a Flash Update. We have one new recommendation. Liquidate long December T-bonds at the market, presently trading at 113-29.

Flash Update: Wednesday, September 1, 1999:

Good afternoon for Wednesday September 1, 5:10 pm. This is a Flash Update. We have one new recommendation: Buy December silver at the market, presently trading on ACCESS at 5.1850.

Flash Update: Thursday, September 2, 1999:

Good afternoon for Thursday, September 2, 5:15 pm. This is a Flash Update. We have sold short November crude oil on ACCESS at 21.56.

Friday, September 3, 1999:

Good afternoon for Friday, September 3, 5:20 pm. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Tuesday August 31, via Flash Update, we advised liquidating long December T-bonds at the market, then trading at 113-29.
- On Wednesday, September 1, via Flash Update, we advised buying December silver at the market, then trading at 5.1850.
- On Thursday September 2, via Flash Update, we advised selling short November crude oil at the market, then trading at 21.56.

Flash Update: Tuesday, September 7, 1999:

Good xxxx for Tuesday, September 7, xxxx. This is a Flash Update. We have one new recommendation. Cover short November crude oil at the market, presently trading at 22.58.

Flash Update: Thursday, September 9, 1999:

Good morning for Thursday, September 9, 8:00 am. This is a Flash Update. We have one new recommendation: We have purchased December Canadian dollar at 67.32, placing an initial stop at 66.10, close only.

Flash Update: Tuesday, September 14, 1999:

Good afternoon for Tuesday, September 14, 8:15 am. This is a Flash Update. We have sold short December T-bonds at 113-24, placing an initial stop at 118-24, close only.

Flash Update: Wednesday September 15, 1999:

Good afternoon for Wednesday, September 15, 12:05 pm. This is a Flash Update. We have bought December wheat at 285.25, with an initial stop at 265.25, close only.

Flash Update: Friday, September 17, 1999:

Good afternoon for Friday, September 17, 1:30 pm. This is a Flash Update. Cover short December cocoa at the market, presently trading at 920.

Tuesday, September 21, 1999:

Good afternoon for Tuesday, September 21, 5:30 pm. There are no changes or new recommendations. The following is a recap of all recommendations to made to date since September 1, for both the Hotline and the trading committee.

- On Wednesday, September 1, we revised our Flash Update of August 31, to liquidate long December T-bonds at the market, then trading at 113-29, and to buy September silver at the market, then trading at 5.1850.
- On Thursday September 2, we sold short November crude oil at 21.56. On Tuesday, September 7, via Flash Update, we advised covering short November crude oil at 22.58.
- On Thursday, September 9, we bought December Canadian dollars at 67.32, placing a stop at 66.10, close only.
- On Tuesday, September 14, we sold short December T-bonds at 113-24, placing a stop at 118-24, close only.
- On Wednesday, September 15, we bought December wheat at 285.25, placing a stop at 265.25, close only.
- On Friday, September 17, we advised covering short December cocoa at the market, then trading at 920.

Flash Update: Thursday, September 23, 1999:

Good morning for Thursday, September 23, 8:30 am. This is a Flash Update. We have purchased December cocoa at 965, risking an initial stop at 905, close only.

Flash Update: Friday, September 24, 1999:

Good morning for Friday, September 24, 9:20 am. This is a Flash Update. We have sold short December copper at 81.50, placing an initial stop at 86.00, close only. We have also sold short December Dollar Index, traded on the Finex, at 99.22, placing an initial stop at 100.90, close only.

Friday, September 24, 1999:

Good afternoon for Friday, September 24, 5:00 pm. The following is a recap of our current open positions, and our stop prices.

We are long December silver; long December Canadian dollar, risking a 66.10 stop; short December T-bonds risking a 115-30 stop, long December wheat risking a 265.25 stop, long December cocoa, risking a 905 stop; short December copper, risking an 86 stop; and short December Dollar Index, risking a 100.90 stop. All stops are close only.

Friedberg's Focus on Futures is published by Friedberg Commodity Management Inc., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3. Contents copyright © 1999 by Friedberg Commodity Management Inc. All rights reserved. Reproduction in whole or in part without permission is prohibited. Brief extracts may be made with due acknowledgement.

Subscription Enquiries for
Friedberg's Focus on Futures
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
(416) 364-1171

All enquiries concerning trading accounts should be directed to:
In Canada
Friedberg Mercantile Group
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 350-2903
Attn: Sholom Sanik

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1901
New York, N.Y. 10005
(212) 943-5300

All statements made herein, while not guaranteed, are based on information considered reliable and are believed by us to be accurate. Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

The U.S. broker-dealer, Friedberg Mercantile Group, Inc. NY, takes full responsibility for the contents of this market letter. U.S. residents wishing to effect any transactions in any security discussed in this report should contact Friedberg Mercantile Group, Inc. NY, toll-free at 1-800-474-2663.