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Crops take it on the chin, and a primer for the USDA's assessment of the damage

The release of monthly USDA supply/demand situation reports is often a boring event. Typically, all the research carried out by the multitudes of analysts, economists, and crop forecasters ensures that a good deal of any effect on prices from the data that the USDA will publish is already "in the market." Although there is a potential for margin of error, the discrepancies between expectations and the final data are typically in the direction of the market, i.e., big crops get bigger, and small crops get smaller.

Anticipating this month's report may prove to be somewhat more exciting than is usually the case. Forecasts for record-size crops have pushed prices of most US agricultural products to multi-decade lows. However, there have been developments in the supply and/or demand side of the markets that we've been following – cotton, soybeans, and wheat – that could significantly affect the bottom line, the estimate for 2000-01 carryover stocks. The following are highlights of what to look for in the September 12 report and beyond:

Cotton

The big story for the cotton market has been the hot and dry weather in the southern US growing regions. It is all but certain that the USDA will cut its estimate for 2000-01 US production of 19.16 million bales. This past week's crop progress report showed that the "good-to-excellent" portion of the crop fell further to 41% from 42% the previous week. On June 30, 56% of the crop was rated in this top category.

Estimates for the new output figure range from 18 to 18.5 million bales. The most specific forecast we've seen is from the International Cotton Advisory Committee on September 5. It estimates that the weather damage will cause the crop to shrink by 800,000 bales to 18.37 million bales, or 4%, from the USDA's August estimate.

The crop damage in the US will be tempered somewhat by a report on September 6 that Australian farmers will harvest 3.53 million bales of cotton, up about 9% from last year. The increase is about 230,000 bales higher than the USDA's August 11 estimate for Australian production.

Even after accounting for the improvement in the Australian crop, US crop losses will still cause global output to drop by 570,000 bales.

Assuming that demand remains constant, global ending stocks will fall to 34.58 million bales, or 37% of consumption. This may seem to be only a small drop from last month's estimate of ending stocks, which represented 38% of consumption. However, when measured in terms of ending stocks as a percentage of consumption at the end of the 1999-00 and 1998-99 seasons (44% and 55%, respectively), we can begin to understand why prices have been strong. As noted in our previous discussion of cotton, we are slowly but surely moving towards to the kind of supply/demand balance that allowed cotton prices to skyrocket in the mid 1990s.

Foreign buyers have been scared off by the high prices.

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

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Although new sales for the current marketing year are still ahead of last year at this time, the margin is shrinking. A couple of weeks ago we were ahead by 23% compared with only 8% after the most recent export commitment report. Actually, this week's exports were the strongest since August 10 at 123,000 bales. Aside from that one extraordinary period when US exporters sold 334,000 bales, average weekly sales have been about 60,000 bales per week since prices started firming. At that pace, achieving the USDA's target for US exports of 8.2 million bales will be a challenge.

That is precisely why we think that this week's improved export figure should be duly noted, coming at a time when prices are right at the top of the range. The sticker shock may be wearing off. Needy buyers may have thrown in the towel and are shifting into a buying mode.

As far as the US crop is concerned, the weather doesn't really matter at this point. Those plantations that have experienced damage are beyond relief.

A USDA estimate above 18 million bales for the US crop is likely priced into the market and will probably trigger a downward correction. Anything in the 18-million-bale neighbourhood or below will usher in a new upleg.

CURRENT STRATEGY: *We were stopped out of our long position in December cotton on September 18. We look for re-entry. Stay very closely tuned..*

Soybeans

The soybean crop has been affected by the hot and dry weather as well, particularly in the growing regions it shares with the cotton crop, the Delta and the Southeastern States. Recent reports show that there has been stress in some of the Midwestern regions as well. The latest crop progress report showed that the "good-to-excellent" part of the crop has declined to 55% compared with a rating of 68% near the end of July.

Forecaster Leslie/ADM surprised the market on Friday morning by posting its estimate for the weather-damaged US crop. It says that according to its survey of grain elevator operators in the Midwest, output for the 2000-01 season will total 2.797 billion bushels, 192 bushels less than the August 11 USDA estimate of 2.989. This is the lowest estimate of any forecaster we've seen thus far. Most analysts have lowered their estimates to between 2.8 and 2.85 billion bushels.

Leslie/ADM's forecast rewrites the script for soybeans completely. According to its figures, US ending stocks will fall to 280 million bushels at the end of 2000-01 from the August estimate of 465 million bushels, equal to this past season's ending stocks. Growing world demand was expected to be absorbed completely by the bumper crops in the US and Brazil. With ending stocks back to last year's levels, we've regressed significantly. To illustrate, consider that with the August 11 estimates, US ending stocks as a percentage of consumption represented 16.5% of consumption. But at 280 million bushels of ending stocks, that figure drops to below 10% of consumption.

To further complicate matters, there has been talk lately that the USDA is going to lower 1999-00 ending stocks. Recent data indicate that the crush is running about 10 million bushels higher than expected. In addition, based on recent export activity, the USDA should raise annual exports by about 15 million bushels. The net effect of this increased consumption would cut 2000-01 ending stocks further to 265 million bushels, bringing stocks down closer to 9% of consumption.

This past week's bean export sales were 23 million bushels, close to the high end of expectations. Sales have been steady throughout the summer with only two weeks with below-average sales. Meal sales were softer, but even including this week's sales, the 4-week average of 123,000 tonnes was still above the average of the previous 4-week period of 108,000 tonnes.

Leslie/ADM's estimate is probably in the extreme, particularly in light of the fact that some rain-deprived soybean regions saw some precipitation in the past few days. Unlike the cotton crop, soybeans can still see some stress relief from rain at this point. Still, its forecast was greeted by traders with a 15¢-per-bushel rally that erased most of the week's losses. Even if its pessimistic forecast is just in the right ballpark, sub-$5-per-bushel soybean prices are not sustainable. If Leslie/ADM overshot by a wide margin, we will likely see a pullback. Either way, you can forget about the kind of crop we were expecting only a few weeks ago. We feel confident that prices have seen their lows.

CURRENT STRATEGY: *We were stopped out of our long position in November soybeans as per Flash Update of September 15.*

Wheat

The supply problems in the wheat market come from the international arena. Three traditional exporters have experienced crop problems that – to some extent – will surely limit the amount of wheat available for international trade. First, the European Union has been restricting exports of high quality, milling-grade wheat because of fear that domestic shortages will develop as a consequence of drought reduced crops in France and Germany. This factor was the initial catalyst of the recent rally.

Then, on August 25, Statistics Canada released its estimate for Canadian 2000-01 wheat production at 25.4 million tonnes. This was over 1 million tonnes below the August 11 USDA estimate. Canada's wheat output is a vital part of the global export market. Last year its exports represented 15% of total world trade.

The Australian crop has been downgraded as well from the August 11 USDA report by half a million tonnes to 22.51 million tonnes.

India, which usually consumes what it produces, has been harvesting big crops in the past few years. This year, its wheat crop is expected to grow by 5% over last year to 74.3 million tonnes. Although demand is growing along with the explosive growth in population, the USDA estimates that consumption will grow by only 3.2% this year, leaving a production/consumption surplus of almost 3 million tonnes. This explains why the Indian government announced recently that it has plans to make 2 million tonnes available for export. This would neutralize a sizeable chunk of the loss of available exports caused by the crop problems in the EU, Canada, and Australia.

In the US, the combination of spring and winter wheat crops is going to be smaller than last year (61.59 million tonnes vs. 62.66 million tonnes). The wheat crops, however, have not experienced any of the troubles seen in the cotton and soybean crops. This is reflected in analysts' expectations for the September 12 USDA report. The average estimate is for a total crop of 2.273 billion bushels, higher than the August 11 USDA estimate of 2.263 billion bushels. The current crop has not been a bullish factor for prices.

What is bullish on the US side is the outlook for the new winter wheat crop. The hot and dry weather has baked the ground in many regions throughout the southern plains and the Delta, and is making it impossible to seed the crop. Although it is still early, the seeding of the crop on a whole is already behind schedule and will be something for traders to watch for carefully.

US exports have been steady. This week's new sales were 697,000 tonnes, well above the high end of trader's expectations. More importantly on the export front, China is expected to lift its self-imposed trading ban on US wheat imports. Besides the fact that by doing business with US farmers it will be making itself a better candidate to recieve the highly valued most-favored-nation status, it can ill afford not to. This year's crop of 102 million tonnes is significantly smaller than last year's crop of 114 million tonnes. Chinese 2000-01 carryover stocks are estimated at 14% of consumption compared with last year's figure of 21%. It is very reasonable to speculate that China will soon become a good customer for US wheat.

World production has been declining since 1998. Consumption, on the other hand, has been inching up. We've been out of the long side of this market for a while now as traders focused on the US crops. The September 12 USDA report will enlighten us by attaching numbers to the issues discussed above. We believe that sooner or later, the combination of smaller crops and growing world demand will collide and make wheat prices at these levels look ridiculously cheap. *[September 11, 2000]*

STRATEGY: *Remain sidelined but closely tuned.*

SUGAR

Overcooked

After a spectacular rise during which sugar prices more than doubled in price from March through July, the market settled back for introspection. October sugar posted an inter-day high of 11.16¢ per pound on August 3, backed off, and bounced back and forth in a very tight range on either side of 10.50¢ per pound, groping for direction.

Little in the way of bullish developments has been presented to the market for many weeks now, leaving bulls to feed off the initial spate of news that brought an abrupt halt to the bear market. We've known for some time now that the 2000-01 marketing year was going to mark the first season in five in which the market was going to swing from production/consumption surplus to deficit. Exporters such as Brazil, the European Union, and Australia were going to see significant shortfalls in their crops. Surpluses of several million tonnes were quickly turning to a deficit of similar size.

This story, however, was becoming stale. The first tipoff that the market had probably over-extended the gains to some degree came on September 11 when the International Sugar Organization (ISO) reported that the deficit for 2000-01 would be 3.5 million tonnes. While this is a pretty chunky figure, it was smaller than the ISO's July 10 forecast for a deficit of 5 million tonnes. The market maintained the 10.50¢ per pound level after the August report. However, with a fresh 1.5 million tonnes thrown into the equation, it did not seem to make too much sense for the market to continue to value a pound of sugar at the same price.

A number of bearish factors have been hanging over the market for some time, which have contributed to the ISO's lowering its estimated deficit. For example, sugar statistician F.O. Licht says that European Union production was probably underestimated by about 500,000 tonnes. Brazilians, who are big users of ethanol, have seen the government respond to the country's 20% smaller sugar crop by ratcheting up the permissible ratio of gasoline to ethanol. This was expected to free up about 2 million tonnes of sugar. India is going to have a surplus and has announced that it will soon make available about 1 million tonnes to the export market.

On the demand side, questions were raised whether China would look to the export market to compensate for its lame crop or if it would dip into stocks to meet a domestic shortfall. China's buying habits can make or break the price level of any commodity.

One of the things that we hung our hat on in maintaining our long position, despite the obvious stagnation, was that the open interest had not ballooned as is typically the case when a commodity puts on the kind of performance that sugar did (see *Focus on Futures*, "Commodities on the move," August 31). We did caution, however, that the speculative long position was large when viewed in terms of the size of the commercial long position. Still, the relatively modest level of open interest seemed to be an indication that the market was able to shake off the bearish adjustments to the supply/demand balance with a high-level consolidation rather than a sharp selloff. We reasoned that the trade must be meeting each test of the bottom of the range with fresh buying, supporting the price.

Inching our stop towards the market did in fact protect us when the market finally broke on September 15, because we were taken out with the market only slightly below the previous night's close. When the losses of the relentless pounding the market took early in the session are added to those of the downtrend that began on August 3, the market has given up over 20% of the rally.

Further confirmation that the market was pricing too large a deficit came just this morning, when E.D.&F. Man released its first forecast of what the 2000-01 marketing year would look like. It calls for a deficit of 1.18 million tonnes compared with a surplus of 7.7 million tonnes last year, which is a far cry from the ISO's original estimate of a 5 million tonne deficit.

We remain friendly for the long term, but for the moment, the very formidable speculative net long position of 50,000 contracts is all the proof we need that the strength at the top of the range was not generated by commercial interests. A healthy liquidation coupled with evidence that constructive fundamentals persist will rekindle our interest. *[September 18, 2000]*

STRATEGY: *We were stopped out of our long position at 10.29, basis October, as per Flash Update of September 15. Stay tuned.*

Chart 1 – October Sugar

Courtesy Reuters

COPPER

Strong fundamentals but a tad overbought

Copper prices were last seen at these levels when they were on their way down in mid-1997, just as the world was getting a grip on the Asian crisis and the destructive effect it would have on demand for commodities (Chart 2). Back then, LME copper stocks were at about the same level they are now, but were on their way to doubling over the next three years.

The current rally has taken us through the top of the congestion between 75¢ and 85¢ per pound in which the market has been trapped for the past year. We've seen a substantial buildup in open interest both here (Chart 3) and in London. Are we looking at a speculative bubble, or do the supply/demand fundamentals support the strength?

The most recent tidbit of data was actually quite bullish. The world's largest copper mine, Chile's Escondida, reported just the other day that production for August was 78,000 tonnes, down 17% from last August's output. This was especially constructive, because July output was up 15% over July 1999, which had reversed the trend of prior months that showed Chilean output slipping consistently. It was not unreasonable to assume that miners were inspired to turn up production to take advantage of the rich prices. This month's sharp drop in output puts the trend of stagnant output back on track.

Despite the fact that output of refined copper at the global level is still growing at about 3%, stocks continue to be drawn down. In its latest report, the International Copper Study Group (ICSG) estimates that consumption in the first six months of this year was 7.7 million tonnes compared with 7.1 million tonnes in the same period last year, an increase of 8.3%. The resulting deficit of 349,000 tonnes for the year thus far is up from last month's figure of 230,000 tonnes. There is little doubt about the direction of the fundamentals.

While the daily multi-thousand-tonne drops in LME warehouse stocks provide a comforting backdrop to staying long this market, we should be aware of the standard negatives that emerge whenever the price of a commodity runs up the way copper has.

Chinese imports rose more than 50% this year through the end of August to over 500,000 tonnes and probably were responsible for a big chunk of the gain in price. Aside from the demand attributable to China's 8% economic growth, the government is developing infrastructure in rural areas that will use a lot of copper.

Given the huge population, the story is enticing. However, analysts say that the buying binge has already created a glut that has shown up in part at the Shanghai Futures Exchange warehouses, where copper stocks have increased to 95,000 tonnes compared with 60,000 tonnes at the beginning of the year.

Scrap supplies, some grades of which are comparable in quality to freshly mined copper, have been finding their way to the market. According to ICSG, scrap makes up over 13% of supplies. Attractive prices make the cost of scrap recovery worthwhile, and we can expect scrap to continue to be an important factor.

The supply/demand fundamentals definitely do support the strength in prices as illustrated clearly in the above data. Many analysts are talking about deficits that will continue to grow. We've seen forecasts of the deficit doubling to 700,000 tonnes by the end of 2002. On the other hand, high prices will bring some of the lost production back and discourage discretionary purchases.

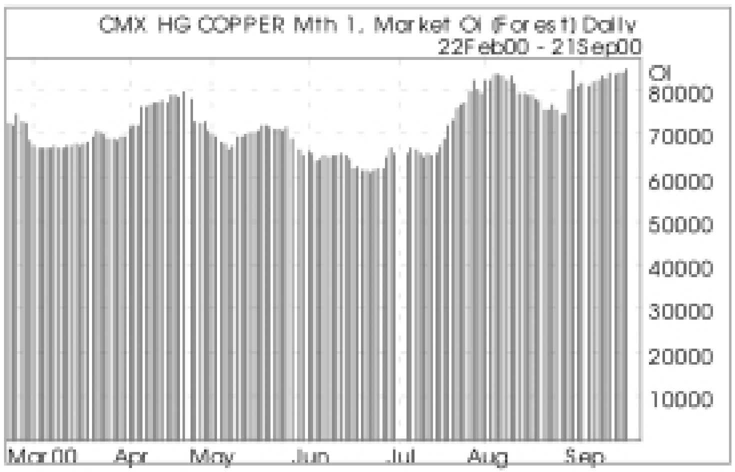
As far as trading is concerned, a robust open interest figure is excusable as long as prices keep rising. Once the price begins to consolidate and open interest continues to rise, we'll begin moving our stop towards the market.

[September 20, 2000]

CURRENT STRATEGY: *Remain long December copper as per Flash Update of August 23. Raise stops to 90.25, close only.*

Chart 2 – Monthly Spot Copper

Chart 3 – NYMEX Copper Open Interest



Charts courtesy of *Reuters*

COTTON

Taking a well-deserved break

The September 11 USDA supply/demand situation report showed that the hot and dry August in the Southern US had lopped 4.5% off the cotton crop from the USDA's August 11 estimate of 19.16 million bales. In the days before the release of the September report, December cotton (Chart 4) traded as high as 67¢ per pound – a price last seen in March 1999 (Chart 5) – as traders discounted a worst-case-scenario. The new estimate of 18.33 million bales was in line with traders' expectations, which explains why the market has been trading lower ever since the report was released. We believe that the recent downdraft in the market belies strong underlying fundamentals and view this correction as just that – a pullback that is correcting overbought conditions.

The big issue that traders will focus on in the coming weeks will be the USDA's October revision of the US crop size. The September estimate reflects crop surveys that ended on September 1. Analysts will provide different estimates over how much crop damage occurred from September 1 onwards, but one thing is certain: The crops continued to deteriorate. In what has become something of a weekly ritual this summer, Monday's crop progress report showed that the good-to-excellent portion of the crop had dropped again, this time by 2 percentage points to 34%.

Now that summer is over, the tropical storm season has arrived. While the precipitation has arrived too late to be of any benefit to drought-damaged crops, it is not too late to cause damage of a different sort. The bolls are exposed and vulnerable. Heavy rains can reduce both quality and yield. Tropical storm Helene is currently threatening the Southeast.

In acknowledging that its September report did not account for late breaking developments, the USDA has announced that it would do a special survey of cotton and soybean areas in early October. With the US crop making up 16% of world production and its exports 18% of world trade, it is not difficult to see why the outcome of that survey could set the tone of cotton prices for some time to come.

Dunavant Enterprises, a leading cotton merchant and one of the precious few sources of information in this market, released a report on September 15 that for the most part confirmed the USDA production and consumption figures. The one area that it cast some doubt on was the estimate for domestic consumption at 10.2 million bales. Although US domestic consumption comprises 12% of world use, there has been little growth in that area for several years now. Dynamic growth patterns have been seen at the global level (Table 1). Dunavant said that demand will continue to be strong in China, Turkey, Brazil, and Mexico.

Table 1 – USDA US and World Consumption

Millions of bales	1998-99	1999-00	2000-01*
US	10.4	10.24	10.2
Foreign	74.73	81.22	82.27
Total	85.13	91.45	92.57

**September estimate*

As such, when looking at the demand side, we must focus our attention on US exports. The USDA revised exports down by 300,000 bales in September, to 7.9 million bales. The marketing year began very strong, at times running close to 25% ahead of 1999-00, but then tapered off as high prices chased buyers away. This week's new sales were weak at 44,000 bales and below analysts' expectations of exports somewhere between 50,000 and 100,000 bales.

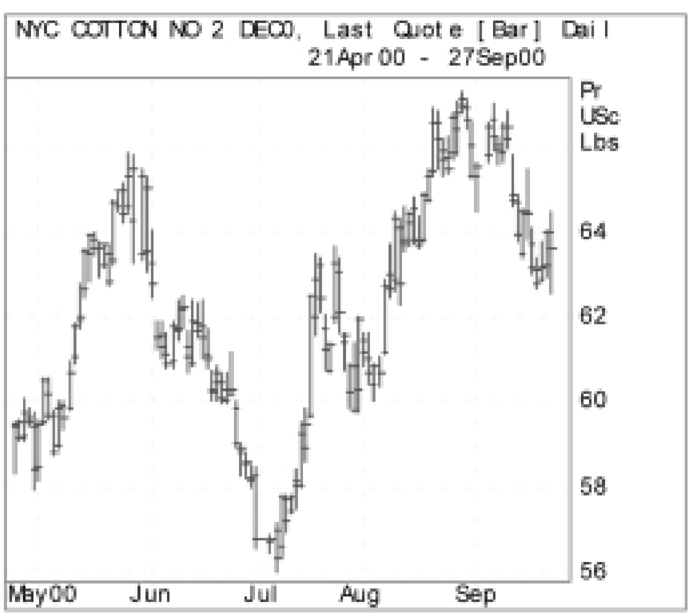
Even with the downward revision in US exports, the target is optimistic, because it assumes a 16% increase over 1999-00 and an 82% jump over an Asian-crisis-ravaged 1998-99. Still, Dunavant says that we are on track to meet the 7.9-million-bale forecast.

The presence of a large speculative contingent is to be expected and is the subject of much of the discussion about the near-term outlook for this market. Open interest is indeed huge, having increased some 30,000 contracts, to over 70,000 contracts since mid-summer. It is clearly in need for some pruning to eliminate some of the speculative influences and to allow for a more accurate reflection of fundamental realities. However, when viewed in a broader, historical perspective, we find that the level of the open interest is not as overwhelming as it has been at times in not-too-ancient history. In 1998, when cotton prices spiked to over 80¢ per pound, open interest topped 90,000 contracts (Chart 6).

As it is, world carryover stocks at 37% of consumption are at the lowest level since the big rally in the 1995 when prices topped $1 per pound. If US production comes in with a worst-case-scenario figure on October 12, say something in the order of 17.8 million bales – the evidence is pointing in that direction – we feel confident that this market will take out the recent highs and add a leg to this developing bull market. *[September 22, 2000]*

STRATEGY: *We were stopped out of our long position in December cotton on September 18. We look for re-entry. Stay very closely tuned.*

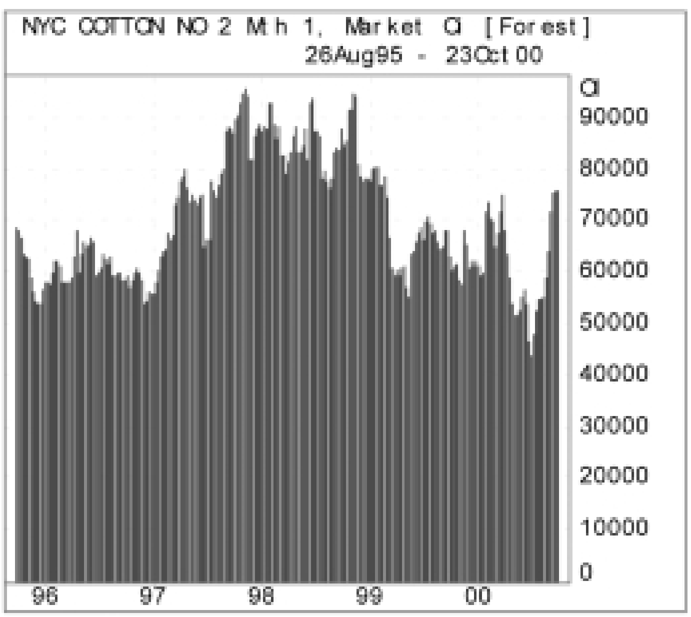
Chart 4 – December Cotton



Courtesy Reuters

Chart 5 – Weekly Spot Cotton

Chart 6 – Cotton Open Interest



Charts courtesy of *Reuters*

HOTLINE UPDATE

Friday, September 8, 2000:
Good afternoon for Friday, September 8, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December cotton, with our stop at 63.50; long December cocoa, with our stop at 765; long October sugar, with our stop revised to 10.30; long December copper, with our stop revised to 87.00; and long November soybeans, with our stop revised to 490. All stops are close only.

***Flash Update:* September 15, 2000:**
Good afternoon for Friday, September 15, 12:40 pm. The following is a Flash Update. We have been stopped out of our long October sugar position at 10.29. We have also been stopped out of our long November soybean position at 489.

Friday, September 15, 2000:
Good afternoon for Friday, September 15, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December cotton, with our stop revised to 63.75; long December cocoa, with our stop revised to 797; long December copper, with our stop revised to 88.00. All stops are close only.

***Flash Update:* Monday, September 18, 2000:**
Good afternoon for Monday, September 18, 12:10 pm. This is a Flash Update. We have liquidated our long December cotton position at 63.71.

***Flash Update:* Wednesday, September 20, 2000:**
Good afternoon for Wednesday, September 20, 2:00 pm. This is a Flash Update. We have liquidated our long December cocoa position at 797.

Friday, September 22, 2000:
Good afternoon for Friday, September 22, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December copper, with our stop revised to 90.25. All stops are close only.

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