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FOCUS ON FUTURES

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The management and staff of Friedberg Mercantile Group join all of humanity in mourning the victims of the murderous attacks, perpetrated on US soil, against the citizens of the entire Free World. We extend our deepest sympathies to the families and friends of these victims and wish fervently for the speedy recovery of the wounded. We pray to the Almighty that He impart wisdom and resolve to our leaders and help us eradicate all Evil from this world.

Corn: The USDA surprises on the US side, but overall conditions remain bullish

In contrast to the volatility experienced earlier this summer, corn prices have been in a holding pattern since mid-August. During this period, December corn has held in a tight range, mostly between $2.25 and $2.32 per bushel.

Crop conditions have deteriorated throughout the summer. The most recent crop progress report showed that the good-to-excellent portion of the crop declined to 54% from 64% on July 30. It was a foregone conclusion that the USDA would slash production in its September crop report from an already reduced 9.266 billion bushel estimate in the August report. Private forecasters were painting a very bearish picture in the weeks leading up to the report. Trade estimates ranged from a low of 8.866 billion bushels to 9.204 billion bushels, with most established analysts hovering around the 9 billion bushel area.

It was quite the surprise, then, when the USDA figures were released Friday morning. Traders were somewhat confused to find that the September estimate was only 28 million bushels below the previous month's estimate, a relatively insignificant amount. A 25 million bushel increase in the estimate of domestic usage was countered by a similar decrease in the forecast for 2001-02 exports. Robust demand towards the end of the 2000-01 marketing year contributed to a 65 million bushel drop in last year's ending stocks. This was the biggest factor in the reduced estimate of 2001-02 ending stocks, to 1.361 billion bushels from last month's 1.459 billion bushels.

To boot, the weekly export report was a disappointment for bulls as well. Net new sales were a paltry 405,000 tonnes – less than half of the previous week's total and considerably lower than expectations of between 600,000 and 850,000 tonnes. Exports were very strong during the summer. The previous 4 weeks saw combined average sales of old and new crop corn of 974,000 tonnes. With the US dollar weakening, traders were expecting the firm pace of exports to continue. All in all, not a very bullish picture on the US side of the equation.

At the global level, however, the balance between supply and demand continues to tighten. In August, the USDA low-

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ered Chinese output by 10 million tonnes from its July estimate. There was talk that the USDA had gone a bit too far and would modify that large reduction in the September report, but it did not. The Chinese situation does not remain entirely bullish, though, because the USDA raised its estimate for exports by 3 million tonnes.

Global production was revised downwards by 2 million tonnes, to 579 million tonnes. This is almost 30 million tonnes below early season estimates. Production is moving closer to the output levels of the bull market years of the mid-1990s. Average production from the 1994-95 season through the 1997-98 season was 560 million tonnes, a period during which corn prices rose by as much as $3 per bushel.

Demand, on the other hand, continues to reflect population growth. While we are not likely to see the growth spurts in consumption that we did in the 1990s, demand continues to grow steadily. The USDA revised global demand upwards by 2.5 million tonnes, to a record 616 million tonnes. As a result, ending stocks will fall by 5.5 million tonnes from the August estimate, to 118.5 million tonnes, or 19.23% of consumption. This compares with 20.20% of consumption in August, but much lower than early season estimates of 25% of consumption.

The market's response to the report, however, focused on the US side, and as such, December corn lost 5.25¢ per bushel, ending the session at the bottom of the recent trading range. Given the importance of the US crop to world trade, the market's reaction was not unwarranted. The USDA's very modest downward revision to the US crop was completely out of sync with what was anticipated.

We continue to believe, as illustrated, that the big picture remains bullish. One cannot ignore the now clearly established pattern of sideways/downwards global output growth against a backdrop of ever-increasing demand. Prices remain cheap by historical standards. *[September 17, 2001]*

CURRENT STRATEGY: *Stopped out of our long position as per Flash Update of Sept. 19.*

GOLD

Can gold get past its poor commodity fundamentals?

Gold prices jumped about $25 per ounce in the days following the attacks on the World Trade Center and the Pentagon. Prices have since backed off, but have maintained most of the gains, while traders absorb the events of September 11 and assess their longer-term impact on the economy and on the way people invest.

For the most part, analysts have been cautious with their forecasts. It has been a long time since geopolitical strife has been able to push gold prices up substantially. Selling into any rally caused by the initial panic of a tense situation has proved time and again to be a winning strategy. Considering the magnitude of the crisis that we face, the rally was rather feeble. We did not even manage to break the $297 per ounce level, the high of the previous rally back in May (Chart 1).

Looking at fundamentals, developments regarding the balance between mine supply and fabrication demand indicate that bulls are fighting an uphill battle in what has become an environment of ample supply. Any ideas that fabrication demand was holding steady were quashed by the September 19 Gold Fields Mineral Services (GFMS) report. Global fabrication demand was down 3% for the first half of 2001, to 1,783 tonnes. It estimates that demand will fall 4% in the second half of the year.

There has been talk about a decline in mine production. Years of falling gold prices have made many high cost-mines unprofitable, and the theory was that closure of such mines would eventually usher in an era of flat to falling production. In what was probably the biggest surprise contained in the GFMS report, we find that this has not happened yet.

The report estimates that global mine production rose 4% in the first half of 2001. While there may have been cutbacks in output in countries with high production costs, other regions with lower costs picked up the slack. Production in Indonesia, for example, increased by 39 tonnes. Collapsing currencies in key producing countries such as Australia and South Africa have allowed average cash costs to fall by an additional $16 per ounce, which will further postpone production cutbacks.

Before the terrorist attacks, most discussion about gold prices focused on how jewelry and industrial demand would be affected by the economy. The chances of a meaningful recovery in the fourth quarter and improving consumer confidence that would be a prerequisite for increased jewelry demand was certainly compromised on September 11.

The September US Consumer Confidence Index, the first to be released since the calamity, read 97.6, a steep fall from the previous month's 114 and below the street's guesstimate of 105.1. In fact, part of the survey that is used to arrive at this statistic was taken before September 11, which means that in all likelihood, the number is much smaller.

In light of the above issues, it is and will continue to be difficult to build a bullish case when applying traditional commodity fundamentals to gold. Gold, however, is not like other commodities and indeed has not acted like any other commodity during this crisis.

Concern among traders that demand will contract and that military activity would interrupt shipping capabilities has pushed the CRB Index down about 4% since September 11.

Gold, on the other hand, has held up near the top of the post-September 11 range. It put in a particularly good performance on September 24, when crude oil prices fell a whopping $4 per barrel, or 15%. Gold closed the session at the high of the day, down only $2 per ounce. We believe that

this may have been a defining moment in the gold market when it parted company with ideas that it is merely an inflation hedge and that its movements will be governed by factors that affect most other commodities.

Although gold has definitely undergone dramatic changes since it began to be demonetized by central banks, it has retained some status as a financial asset. The world as we knew it changed on September 11, and it is conceivable that with financial and government institutions vulnerable in a way that they have never been before, a strong perception among investors may surface that gold may recapture – albeit unofficially – some of its lost monetary attributes.

There is no evidence that speculators alone have fueled the rally. Open interest has increased during this rally, rising back to the high end of the range of the past few months, to just below 130,000 contracts. Still, it is very low by historical standards. In 1999 open interest was as high as 200,000 contracts (Chart 2). In addition, gold stocks – as measured by the Philadelphia XAU Index (Chart 3) – have barely moved since September 11, a further indication that speculators have not yet piled on to the long side of this market.

In conclusion, it is early in the game. A combination of raw fear and uncertainty about the future may have kept gold prices firm thus far. We, however, were bullish before September 11, because we felt that a rocky financial world may draw money away from what has become traditional hard assets in the past two decades and back into the age-old traditional hard asset, gold. In the post-September 11 world, this theory is beginning to look like a reality.
[September 21, 2001]

STRATEGY: *Remain long December gold. Raise stops to 279.50, close only.*

Chart 1 – December Comex Gold

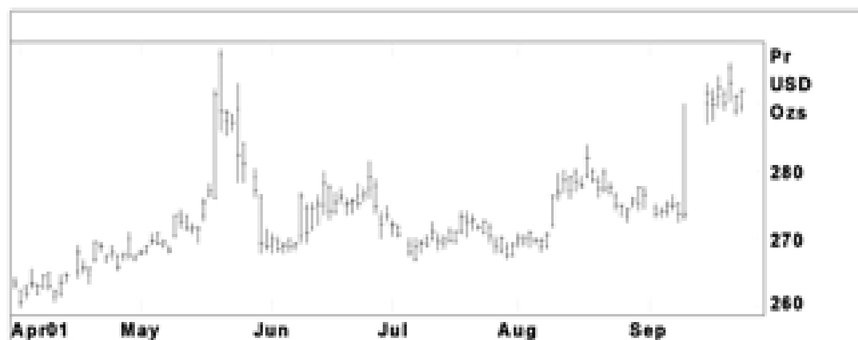


Chart 2 – Comex open interest

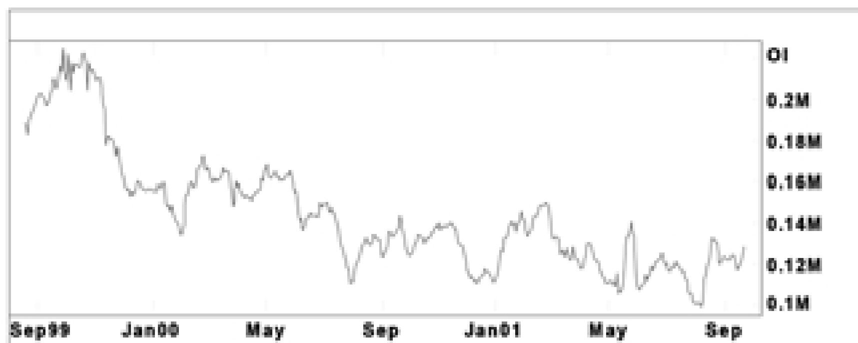
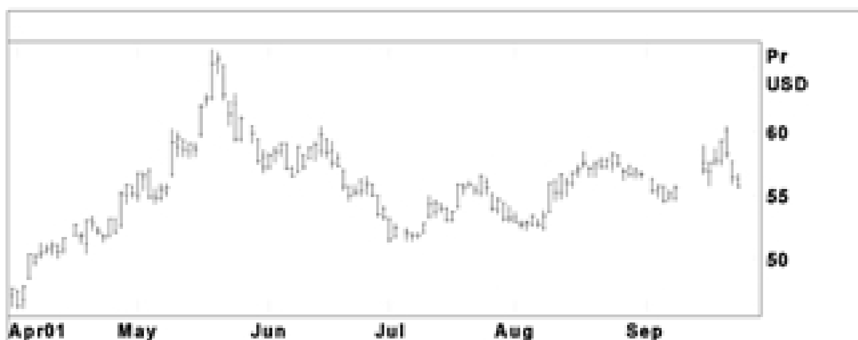


Chart 3 – Philadelphia Gold Stock Index (XAU)



Charts Courtesy *REUTERS*

COCOA

Bucking the trend of falling commodity prices

With the exception of precious metals, prices of just about every commodity on the board fell in the wake of the September 11 terrorist attacks. Grains, oilseeds, meats, base metals, soft commodities, and of course energy products all took a beating. In many cases the markets sliced through the bottom of long standing ranges and sank to multi-year lows. The lone holdout was cocoa (Chart 4).

Its strength was particularly surprising, considering the fact that it is a luxury commodity, especially in emerging economies. One would have expected to see at least some panic buying in the basic-foodstuff commodities that we watch. Grains and oilseeds, for example, have rather tight global supply/demand balances. In addition, importers have become complacent in recent years because they have come to rely on ample supplies and increased mobility in global transportation and have largely moved to just-in-time inventory systems. Cocoa, on the other hand, has notoriously large carryover stocks.

One possible explanation is that Commitment of Trader data show a large short position held by commodity funds. Perhaps they ran for cover. It is a weak argument, though, because its sister soft commodities – coffee and sugar – were carrying equally large spec short positions going into September 11, and they participated in the steep commodity selloff.

E.D.&F Man released its latest report on September 17. The headline statistics focused on a rebound in West African crops and a smaller deficit, which mostly seemed to support the bear camp. In the Ivory Coast, the 2000-01 season was plagued by political instability, and farmers lacked motivation to invest in inputs, because of low prices. Based on fresh export data, Man revised upwards its estimate of 2000-01 output by 40,000 tonnes, to 1.2 million tonnes, which was still 15% lower than 1999-00 output. It expects 2001-02 production to rebound and estimates the crop will be 8% larger at 1.3 million tonnes.

Man also estimates that we will have a global production/consumption deficit of 100,000 tonnes. The optimistic forecasts for a jump of 155,000 tonnes in output for the Ivory Coast and Ghana will leave a deficit considerably smaller than expected. Man's accompanying comments do not paint as bearish a picture as its numbers suggest. Although the crop developed early in the Ivory Coast, which is normally beneficial to yields, it was a bit too early, and the pod setting stage finished prematurely, which will probably allow only for trendline yields. The other issues that affected last year's crop have not vanished. They include uncertainty regarding the political climate and a shaky attempt at establishing a marketing board, both of which will keep farmers from rehabilitating abandoned farms. In addition, Man points out that despite favorable weather conditions over the past two years, yields have been below average, indicating that the 20 year trend of increasing production may be over.

Ghanian production is expected to grow by 14% to 450,000 tonnes. The 55,000-tonne increase is also based on early crop development, which, according to Man, bettered the bumper crop of 1995-96. Cocoa farms, however, were afflicted with black pod disease in the 2000-01 season. The disease has emerged again this year, which makes the optimistic early season estimate tenuous at best.

Grindings are forecast to grow by a modest 1%. We'll have a better idea after third-quarter grinding results are released in mid-October.

The most important part of the Man report, which best explains cocoa's recent strength, is the fact that despite the improved crops, global ending stocks are no longer as overwhelming as they've been in the past 5 years. Ending stocks for 2001-02 are forecast to fall by 102,000 tonnes from last year, to 992,000 tonnes, or 32.6% of grindings, substantially below the 40%-plus numbers we've become accustomed to in this market.

Given that the conditions that caused the lower production in West Africa have not changed that much, it is not a great stretch to question Man's robust Ivorian and Ghanian output estimate. If it is off by even 50,000 or 60,000 tonnes between the two countries, we're looking at ending stocks of close to 30% of consumption.

The trading pits of the Cocoa Coffee and Sugar Exchange were housed in one of the buildings in the World Trade Center complex and had to be abandoned. The exchange has moved to temporary facilities and is open for only one and a half hours a day. Volume is light and trading patterns are somewhat erratic. We remain friendly to the long side and look for an opportunity to enter. *[September 26, 2001]*

STRATEGY: *Stay tuned.*

Chart 4 – December cocoa

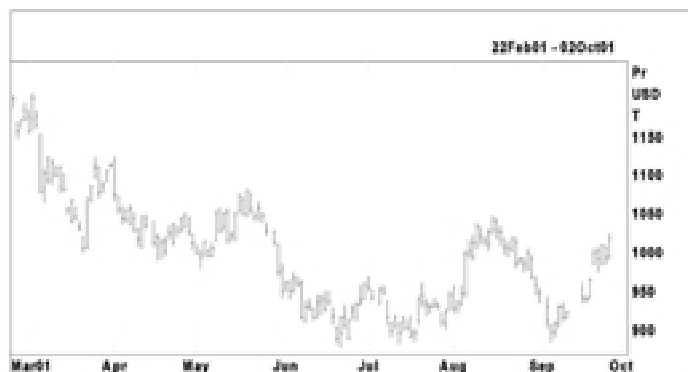


Chart Courtesy *REUTERS*

SUGAR

Sugar, lots of it

Last year's bull run in sugar saw prices more than double after they hit a pitiful 4.5¢ per pound. With October sugar trading at 6.5¢ per pound, the market has now shed almost half of those gains. Is the whole thing unraveling?

While global demand continues to rise at trendline growth rates of about 1.5% per annum, the strength was fueled exclusively by the supply side. The major exporting countries – Australia, Brazil, and the EU – had miserable crops in the 2000-01 crop year, which pushed the global production/ consumption balance into deficit for the first time since the 1993-94 season. Early in the season the deficit was thought to be as high as 5 million tonnes, but in its most recent report – on September 14 – the International Sugar Organization (ISO) pegged the 2000-01 shortfall at only 1 million tonnes. With weak economic conditions prevailing in most regions, and a rather bleak outlook for the future, it is difficult to imagine that the consumption side will provide much support to this market.

The ISO forecasts another season of global deficit at 1.5 million tonnes for 2001-02. It estimates production at 132.5 million tonnes, an increase of 1.7% and a 2.1% rise in consumption to 134 million tonnes.

Brazil

Brazilian output in 2000-01 reached only 17 million tonnes compared with 20 million tonnes in 1999-00. In the July 2 issue of *Focus on Futures*, we concluded with regard to the 2001-02 crop that "the size of Brazilian exportable surplus will be the key to the future of this market." While we may have been correct about that, we certainly underestimated the potential of the Brazilian crop. At that time the reports we were receiving about the 2001-02 crop would have seen a best-case-scenario crop of less than 18 million tonnes. Until mid-summer the market traded off the belief that Brazil would not snap back to 1999-00 output levels. Now it seems that those pessimistic estimates were premature, and we probably will have a crop of over 19 million tonnes. Although we don't even have a preliminary estimate of the 2002-03 Brazilian crop that will be harvested this coming spring, analysts expect it to return to the 20 million tonne level.

Australia

Australia produced about 4.6 million tonnes in the 2001-02 season, its second year in a row of poor crops. This compares with an average of 5.3 million tonnes in the previous 5 seasons. These numbers seem small when compared with Brazil's. But the Australian situation is almost as important, because it typically exports over 70% of its output, and its exports account for over 10% of world trade.

The smaller crops combined to reduce the amount of sugar available for export the past 2 years by about 1.5 million tonnes. However, here too as in Brazil, analysts are talking about a bounce back to bumper crop conditions for the 2002-03, with early estimates of above average output.

EU

The EU had a dismal sugar crop in the 2001-02 season. Statistics released on September 14 revised downwards the European Commission estimate of the EU beet crop to 14.92 million tonnes from its July estimate of 15.3 million tonnes. Still, just last week F.O. Licht maintained that ample supplies are available for the export market.

India

India has huge stocks of sugar, but it has not been much of an exporter, so its burdensome stocks have not caused much pressure on prices. In the past couple of seasons existing legislation has been altered to free up some inventories for the export market. The amount it has exported per annum, perhaps 1 to 1.5 million tonnes, has been relatively small.

On September 27 the USDA attaché in India raised its estimate of Indian output for 2000-01 to a record 20.4 million tonnes and lowered its estimate for domestic consumption to 17.5 million tonnes. Ending stocks will climb to 12.4 million tonnes, also a record. The forecast for the 2001-02 marketing year is more balanced, with production of 18.4 million tonnes and consumption of 18 million tonnes. The country continues to produce huge crops, and it is difficult not to be concerned that more sugar will find its way to the market.

The ISO estimates that 2001-02 global ending stocks will be 58.5 million tonnes, or 44% of consumption. Although this will represent a drop of 2 percentage points from the previous season, it is still a lot of sugar and puts the 2.5¢ per pound drop of this past summer into understandable perspective.

We must caution, though, that Commitment of Trader data show an extremely lopsided spec short position by both commodity funds and small speculators. Together they are short 40,186 contracts, very fertile ground for a massive short- covering rally. In addition, sentiment indicators stand at the same low reading of this past spring, after which the market rallied 2¢ per pound.

The fundamentals have turned decidedly bearish, primarily because of the abundance of Brazilian sugar and the growing fear that India could unleash more supplies at any time. Still, prices have already gone past the point where farmers in countries with no government-subsidy protection cannot earn a profit, which in part set the stage for the bull run last year. As always, China is a wild card. It consistently produces less than is required for domestic consumption, and its inventories are believed to be low. We stand aside, but will consider sniffing out a short-covering rally. *[September 30, 2001]*

STRATEGY: *Stay tuned.*

HOTLINE UPDATE

Friday, September 7, 2001:
Good afternoon for Friday, September 7, 4:15 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long December gold, with our stop at 255; short September mini S&P, with our stop at 1230; and long December corn, with our stop revised to 219. All stops are close only.

Friday, September 14, 2001:
Good afternoon for Friday, September 14, 4:35 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December gold, with our stop at 255, short September mini S&P, with our stop at 1230, and long December corn, with our stop revised to 219. All stops are close only.

Flash Update: **Monday, September 17, 2001:**
Good morning for Monday, September 17, 11:26 am. This is a Flash Update. We have covered our short September mini S&P position at 1225.25.

Flash Update: **Wednesday, September 19, 2001:**
Good morning for Wednesday, September 19, 8:55 am. This is a Flash Update. We have liquidated our long December corn position at 219.

Friday, September 21, 2001:
Good afternoon for Friday, September 21, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December gold with our stop at 255. All stops are close only.

Flash Update: **Tuesday, September 25, 2001:**
Good morning for Tuesday September 25, 9:15 am. This is a Flash Update. We have purchased December 10-year Notes at 107-29/32, placing our initial stop at 106-14/32 close only.

Friday, September 28, 2001:
Good afternoon for Friday, September 28, 5:00 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long December gold, with our stop revised to 279.50, and long December 10-Year notes, with our stop revised to 107-10/32. All stops are close only.

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