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FOCUS ON FUTURES

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Cocoa: another deficit

Cocoa prices have maintained their poise above $2,000 per tonne (Chart 1), and we finally have some concrete data to help us make some sense of it. E.D.&F. Man released its long-awaited look at the 2002-03 cocoa crop year late last week and is forecasting yet another season of deficit.

Man expects Ivorian arrivals to total 1.175 million tonnes, 50,000 tonnes less than the tally for the 2001-02 season. We believed that farmers would plow some of the extra income they pocketed from soaring prices back into fertilizing and other crop-enhancing activities, but that does not seem to be the case.

Despite the persistence of Black Pod disease, farmers in West African neighbor Ghana did a better job of converting increased profits from 2001-02 output into improved crops in 2002-03. Ghanaian output is estimated to jump 90,000 tonnes, or a hefty 26%, to 430,000 tonnes.

Indonesia, which took Ghana's spot as the world's second largest producer last year, will slip back into third place this season, with a drop in output to 410,000 tonnes from 460,000 tonnes.

Despite lower output in the Ivory Coast and Indonesia, the Ghanaian increase and gains in other small producing countries will combine for a 28 million tonne, or 1%, gain in global production to 2.815 million tonnes.

The sharp slide in world grindings of beans, however, is expected to reverse. As a result of weak grindings, which were down 8.4% in 2001-02, inventories of products such as powder and butter have been drawn down significantly, and chocolate manufacturers will be looking to restock. Man estimates that 2002-03 grindings will grow by 4.3%, to 2.925 million tonnes. This will leave a production/consumption deficit of 135,000 tonnes.

Global carryover stocks are forecast to fall from 1.076 million tonnes, or 38.4% of consumption, at the end of 2001-02 to 941,000 tonnes, or 32.17% of consumption at the end of 2002-03.

We remain bewildered by the lack of speculator interest. Even after a buildup from the lows in early August, open interest stands at just 104,997 contracts, compared with over 112,000 in mid-July. What speculative activity there is provides a contrarian's fantasy. This past week's Commitment of Trader's report showed that commodity funds added 2,548 contracts to their short position putting them net short 11,880 contracts. The last time funds were this short cocoa was in early 2001 (Chart 2). At the time, prices were just emerging from the bear market, and the fund managers looked pretty smart. With the market having made yet another new high this afternoon, they're now looking anything but smart.

Naturally, unfavorable weather and political turmoil in West Africa always represent wild cards for the supply side. Nevertheless, we spent a lot of energy over the 2001-02 season watching arrivals to get an idea of the crop size and second guessing Man. It turns out that some of that energy might have been used more efficiently elsewhere.

As early as December 2001, Man forecasted the Ivorian crop at 1.235 million tonnes. Its most recent estimate found in the current report puts the 2001-02 crop at 1.225 million tonnes. Not bad. The numbers get a bit mixed up, because Ivorian arrivals could include smuggled Ghanaian beans. Still, the point is that Man gives us a fairly good idea of what

In this issue

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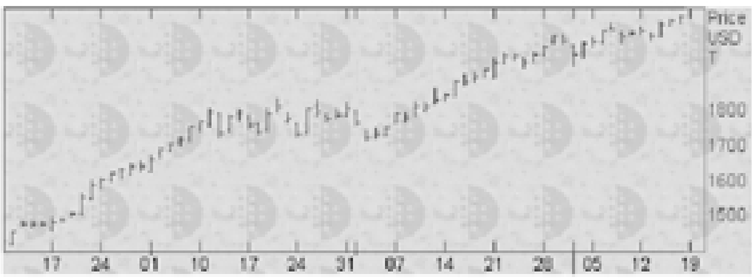
Ivorian production is going to look like, and they do it fairly early in the season.

So after the Man report, we know the supply side is bullish, and the primary wild card shifts to demand. We will not see any grind figures until the third-quarter results are published in mid-October. In the meantime, the spreads, in both New York and London have collapsed, some evidence that the situation is not quite as tight as the price may be indicating.

The answer to last month's question, "Is there any juice left in cocoa?" is apparently, "yes." Particularly with the possibility that the shorts may be forced to cover at some point. We continue to feel silly. *[September 18, 2002]*

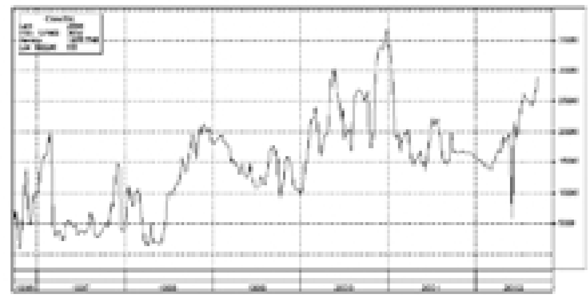
STRATEGY: *Remain sidelined, but stay tuned.*

Chart 1 – December cocoa



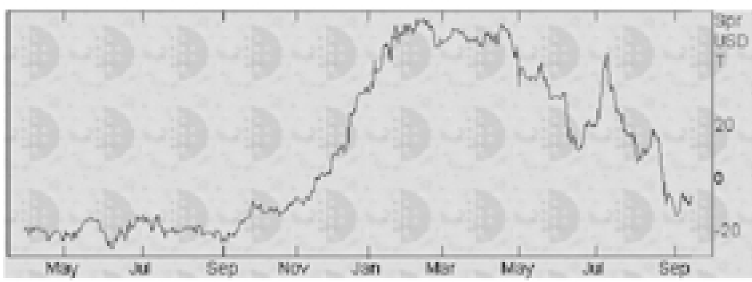
Courtesy Reuters

Chart 2 – Commodity funds net-short position



Courtesy Bloomberg

Chart 3 – NY December/March spread



Courtesy Reuters

COTTON

Global ending stocks continue to shrink

The monthly USDA supply/demand situation report released on September 12 did not carry any particularly dramatic changes from the August report. There were, however, a series of smaller revisions – all favoring the bull camp. The weekly US export report was also constructive for the bull case, with a blockbuster commitment of 365,000 bales, most of which was a single sale to Mexico.

The sale to Mexico is not expected to recur – certainly not at that volume – but it was still news. Normally, 200,000 bales is considered a very robust number for weekly export sales. The two reports should have been enough to support a market that had been slipping in the days leading up to these reports. One wouldn't know it, though. After a brief rally on the morning of the report, the market has been in freefall. Prices have now retreated to mid-June levels, wiping out the summer rally.

US 2002-03 production came in at 18.13 million bales. This was lower than both last month's 18.44 million bales and the low end of analyst's guesstimates of 18.182 million bales. The estimates for annual exports also caught forecasters short at 11.2 million bales, against a pre-report average estimate of 10.92 million bales. As a result, ending stocks came in 300,000 bales lower than last month, at 6.7 million bales against estimates of 7.13 million bales.

On the international scene, the bullish trends of lower

Table 1 – Key producers

Millions of bales	**2002-03**	**2001-02**
United States	18.13	20.3
China	20.50	24.4
India	10.70	12.3
Pakistan	8.2	8.3
Central Asia	7.12	7.35
African Franc Zone	4	4.5
Turkey	4	3.9
Brazil	3.7	3.3
Europe	2.37	2.62
Australia	2.2	3.2

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output and firming consumption continue. Aside from Turkey and Brazil, which are not important exporters, virtually every growing region in the world has been watching their output fall (Table 1). World production was revised to 88.57 million bales, down from 89.41 million bales in August and down sharply from the record crop of 98.06 million bales harvested in 2001-02.

World consumption was lowered slightly from last month's report – by 30,000 bales – but will still be 2.4 million stronger than last year.

Table 2 – Ending Stocks of Key Producers

Millions of bales	**02-03 Sept.**	**02-03 Aug.**	**01-02**
United States	6.7	7	7.6
Central Asia	1.65	1.72	1.94
African Franc Zone	1.14	1.22	1.48
Australia	1.68	1.78	2.26
Europe	1.74	1.74	1.98

Global carryover stocks are estimated to be 39.16 million bales, or 40.5% of consumption, at the end of 2002-03 season, a downward revision from last month's 41.1% of consumption. On the surface, we don't seem anywhere near the brink of tightness with these inventory levels. But it's all relative. The 2001-02 season ended with stocks of 46.84 million bales (49.6% of consumption), so we are dropping 7.68 million bales of inventories in just one season. 2000-01 ending stocks were 42.7 million bales, or 46.4% of consumption.

We are clearly running below average inventory levels. The lowest carryover in the 1990s was at the end of the 1993-94 season when stocks fell to 30.8% of consumption. That season was the foundation of a rally that eventually saw cotton prices soar to over $1 per pound. Table 2 illustrates that ending stocks in all principal exporting regions have fallen from last year.

So why does the market look like it's falling off a cliff? The USDA is assuming that the US is going to have a repeat performance in both domestic consumption and exports. Of course, this will hinge strongly on the performance of the economy both here and abroad. Early results from the export side are not terribly encouraging. Export commitments this marketing year are running at 4.37 million bales, 1.36 million bales behind the same time last season.

Traders who drove open interest up over 16,000 contracts this summer may be a bit disappointed with lagging exports and are now in a liquidating mode. Even after open interest shed 9,000 contracts from the peak as prices have come off, speculators still own a lopsided portion of the long position. As of this past week's CFTC report, commodity funds are net long 15,726 contracts, and small speculators are net-long 5,617 contracts. We believe these positions are now in the early stages of liquidation. As such, the market will remain under pressure for the moment.

As with many other agricultural commodities that had poor crops this summer, it is fairly clear that the supply side has gratified bulls. The demand side is the variable and should be monitored carefully. We believe, as illustrated, that the fundamentals have shifted to the bull side. Assuming evidence emerges that the USDA is not too enthusiastic about consumption, we will be looking at these sharp dips as buying opportunities. *[September 19, 2002]*

CURRENT STRATEGY: *In the interim we went long December cotton as per* Flash Update *of Oct. 2, but we were promptly stopped out as per* Flash Update *of Oct. 4. Stay tuned.*

SUGAR

What's so sweet about sugar?

Although the fundamentals remain decidedly bearish, sugar prices have rallied 2¢ per pound since late June. It is quite a challenge to conjure up even a moderately bullish case for this commodity. It is far easier to explain why prices dropped from 11¢ per pound to 5¢ per pound over the past 2 years (Chart 4).

In the 2000-01 crop year, principal producer/exporters Brazil, Australia, Western Europe, and Thailand had poor crops, which resulted in the rally to 11¢ per pound. World production fell 4.7% from the previous season, while consumption continued to grow at the trendline rate of 2% per annum. But output bounced back in 2001-02, increasing 2.5%, leaving a production/consumption surplus of 1.5 million tonnes.

The current, 2002-03 season has seen substantial increases for most of the major producers. The International Sugar Organization (ISO) released its first estimate of the 2002-03 season. It puts global output at 139.89 million tonnes, up 2.89 million tonnes, or 2% from last the 2001-02 season. The ISO pegs consumption at 136.24 million tonnes, 2.64 million tonnes, or 1.9%, higher than last year, which will result in a production/consumption surplus of 3.657.

Brazilian production is estimated at close to 23 million tonnes, up more than 2.5 million tonnes, or 13% better than last year. Australia, which exports 80% of its crop, will see output increase by 700,000 tonnes, or 15%. And Western Europe will be up by 1.3 million tonnes, or 8%. Only Thailand will have a smaller crop than last season, but only by 5% and still substantially above its dismal 2000- 01 crop.

Any bull market speculation in sugar – particularly when supply doesn't seem to be an issue – must include the possibility of China as an importer. We strike out here too. China is expected to grow a record crop this season of 9 million tonnes, slightly above its previous record crop of 1998-99.

India will have a smaller crop this year, but it does not play a significant role in world trade in any case. Even with

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its burdensome ending stocks of 10 million tonnes and the steps it has taken to clear bureaucratic roadblocks to exporting its surplus, the low-quality sugar available for export is sold only to neighboring countries. It poses no competitive threat to producers of higher-quality sugar that is sold to traditional importing countries.

Over the past week, Hurricane Issadore – currently moving in from the Atlantic and across Florida and Cuba –reminded traders of last year's hurricane season. A significant chunk of Cuba's crop was lost to that storm, and prices rallied sharply. At the time, we too were long sugar and thought that the loss of a few hundred thousand tonnes of sugar was enough to impact the bigger picture (see *Focus on Futures*, November 26, 2001). There are, however, two important distinctions between the current environment and last year's.

First, the fundamentals were better. Analysts were still talking about global production/consumption deficits back then. But the 2001-02 crops turned out better than early forecasts, and no one really expected the prospects for the 2002-03 crops to look quite as favorable as they do now.

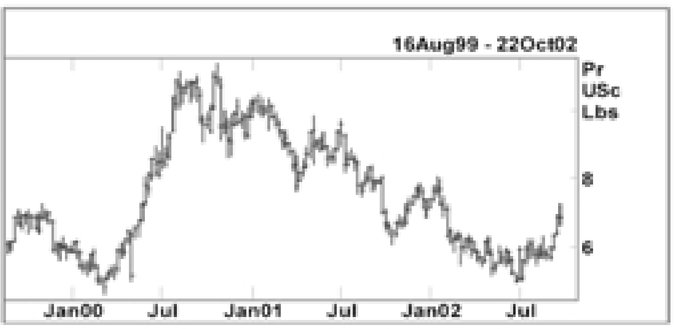
Second, back then, both fund and small speculators were short and were scrambling to cover. This year, speculators, particularly the small-spec group, have gone berserk with their enthusiasm for the long side of sugar. Open interest has jumped 75,000 contracts since early July (Chart 5). Commodity funds are now net-long 31,750 contracts, while small speculators are net-long 46,163 contracts (Charts 6 and 7).

This leads us to believe that the source of the bull run is not rooted in anything fundamentally bullish and will run its course sooner or later. A return to the sub-5¢-per pound level is a good possibility. We are considering the short side.

[September 20, 2002]

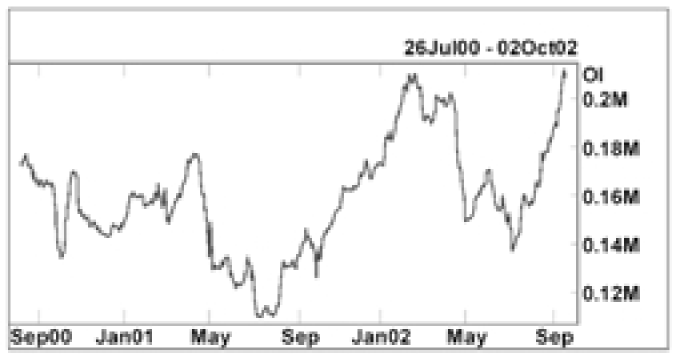
STRATEGY: *Remain sidelined, but stay tuned.*

Chart 4 – Nearest contract sugar



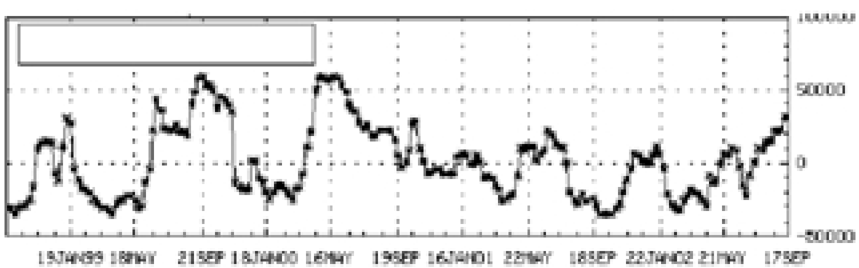
Courtesy Reuters

Chart 5 – NY sugar open interest



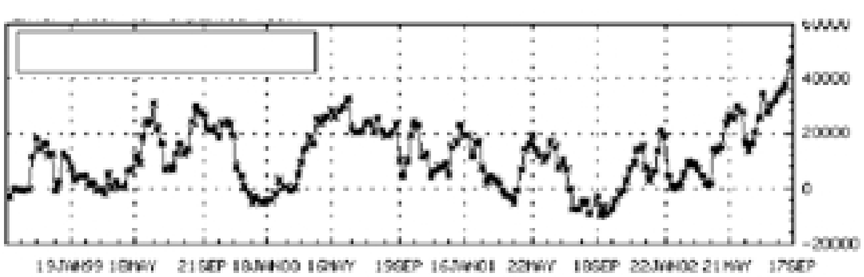
Courtesy Reuters

Chart 6 – Commodity funds net-long position



Courtesy Bloomberg

Chart 7 – Small speculators net-long position



Courtesy Bloomberg

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WHEAT

The bull pauses

On September 12 the USDA released its monthly supply/demand situation report. December wheat spiked to $4.40 per bushel – a level not seen since May 1998. The euphoria over the bullish report did not last very long, though. The market closed up 12¢ per bushel, at $4.22, but sharply off the high. Prices have been ticking down ever since. Is the bull run over, or are we are experiencing a correction/consolidation?

This has been a supply-side bull market. The 2002-03 growing season in the US, Canada, and Australia – whose exports comprised 55% of global exports in the 2001-02 season – was a disaster. There have been several developments since the release of the monthly USDA report that solidifies the bull case.

In 2001-02, key exporter Australia produced 24 million tonnes of wheat. The USDA lowered its 2002-03 production estimate to 15 million tonnes from the August estimate of 20 million tonnes. But it did not cut deep enough. On September 23, The Australian Bureau for Agricultural and Resource Economics maintained its August forecast at 13.45 million tonnes.

Canada's stature as the world's second-largest exporter is in jeopardy. In 2000-01 Canada produced a bumper crop of 26.8 million tonnes. Weather problems last year caused a sharp drop in output, to 20.6 million tonnes. This year, according to the Statistics Canada estimate adopted by the USDA in its September report, Canadian farmers will harvest only 15.44 million tonnes.

The availability of milling quality wheat from the Canadian harvest may be even more scant than these numbers indicate. As of last week, about 50% of the harvest had been completed, but only 9% was given the top rating (No.1 Canadian Western), down from 13% the previous week, but more importantly, down from the 10-year average of 52%!

Finally, this morning, the USDA rounded out the increasingly bullish picture with two reports on the US.

The quarterly stocks report confirmed that inventories of wheat have been drawn down significantly. On September 1, stocks stood at 1.74 billion bushels, down 415 million bushels, or 19%, from September 1, 2001, and below the average trade estimate of 1.76 billion bushels.

The estimate for the all-wheat crop was lowered by 62 million bushels (1.7 million tonnes) from the September 9 report, to 1.625 billion bushels. Again, this was below the average analysts' estimate of 1.663 billion bushels.

Plugging these revised statistics into the USDA's September report will show an even tighter global stock picture. For the US and Australia, we can safely use the government reports cited to subtract 3.2 million tonnes from the USDA's world output estimate of 572.56 million tonnes. There haven't been any specific revisions to the Canadian reports, but conditions have deteriorated in the past several weeks, so we will assume just a modest reduction of 500,000 tonnes.

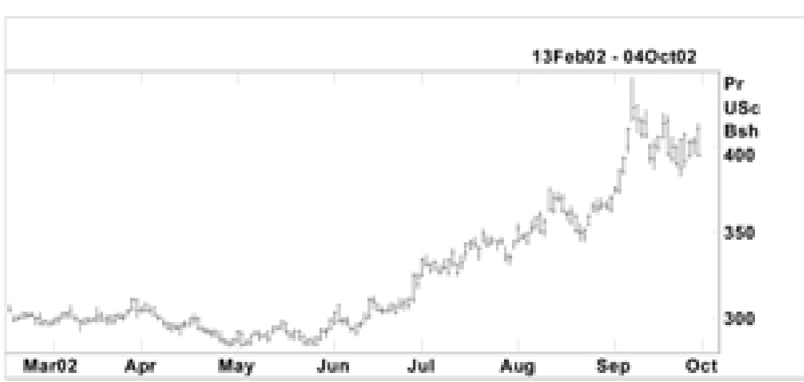
Global output would fall to 568.86 million tonnes and reduce the September estimate for 2002-03 ending stocks to 131.75 million tonnes. With usage estimated at 598.60 million tonnes, this would lower inventories to 22% of consumption, down from 22.6% in the September report and dramatically below last season's 27.5% of consumption.

These supply issues are well known to market participants. What is not known to anyone is how buyers will behave at these prices. The most recent weekly US export report was actually very strong, at 910,000 million tonnes and above the typical weekly tally. To date, export commitments of 11.6 million tonnes for the marketing year are running ahead of last year's pace of 10.8 million tonnes. It is difficult to say whether we can continue putting up numbers like that.

In conclusion, we feel confident that if the demand side merely meets expectations, we will have another strong upswing that will handily take out the current $4.40-per-bushel peak. *[September 30, 2002]*

STRATEGY: *Remain long December wheat. Maintain stops at 360, close only.*

Chart 8
December wheat



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HOTLINE UPDATE

Monday, September 16, 2002:
Good morning for Monday September 16, 9:05 am. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December corn, with our stop at 243; long December wheat, with our stop at 325; long December gold, with our stop at 300; long November soybeans, with our stop at 499; and short December mini S&P, with our stop at 970. All stops are close only.

Friday, September 20, 2002:
Good afternoon for Friday September 20, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December corn, with our stop revised to 260; long December wheat, with our stop revised to 360; long December gold, with our stop revised to 305; long November soybeans, with our stop revised to 557; and short December mini S&P, with our stop revised to 930. All stops are close only.

***Flash Update* – Monday, September 23, 2002:**
Good afternoon for Monday, September 23, 2:20 pm. This is a Flash Update. We have liquidated our long December corn position at 254 1/2.

***Flash Update* – Tuesday, September 24, 2002:**
Good morning for Tuesday, September 24, 9:50 pm. This is a Flash Update. We have liquidated our long November soybean position at 553 1/2.

Friday, September 27, 2002:
Good afternoon for Friday September 27, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December wheat, with our stop at 360; long December gold, with our stop at 305; and short December mini S&P, with our stop at 930. All stops are close only.

***Flash Update* – Wednesday, October 2, 2002:**
Good afternoon for Wednesday, October 2, 1:30 pm. This is a Flash Update. We have purchased December cotton at 45.77, placing our initial stop at 42.80, close only.

***Flash Update* – Friday, October 4, 2002:**
Good afternoon for Friday, October 4, 3:00 pm. This is a Flash Update. We have liquidated our long December cotton position at 42.43.

Friday, October 4, 2002:
Good afternoon for Friday October 4, 3:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December wheat, with our stop at 360; long December gold, with our stop at 305; and short December mini S&P, with our stop at 930. All stops are close only.

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