

FRIEDBERG'S

FOCUS ON FUTURES

Friedberg Commodity Management Inc.



Volume 6, No. 9 September 22, 2003

COTTON

Still a record crop in China, but weather does enough damage to reignite the bull

For most of this past summer, cotton prices looked like they had it. China was slated for a bumper crop, which seemed to be showing up early in the US marketing year, with new sales beginning to tail off from their torrid pace in 2002-03. Things have changed, though.

On September 10 – the day preceding the release of the USDA's monthly report – China's Agriculture Ministry lowered its forecast for the country's 2003-04 cotton crop to between 23 and 24 million bales. This compares with the USDA's August estimate of 27 million bales. The crop losses were the result of excessive precipitation in the principal growing regions along the Yangtze and Yellow Rivers. The market rallied 2.5¢ per pound on this news.

The following morning, in its September report, the USDA lowered its estimate by 1.5 million bales, to 25.5 million bales, acknowledging that early estimates for the Chinese crop were indeed overblown. The USDA report sent cotton prices soaring to a limit-bid close, and October cotton settled at its highest spot close since December 2000. This item was the most bullish aspect of the report, but the balance of the report contained other factors that will contribute to evertightening inventories.

The USDA maintained its August estimate for Chinese consumption, indicating that there continues to be virtually no expectation for a SARS-related effect on usage. In fact, these demand figures represent strong growth in usage. Domestic consumption is pegged at 30.2 million bales, compared with 28.9 million bales in 2002-03 and 26 million bales in 2001-02.

The USDA revised its estimate for 2003-04 US exports upwards by 200,000 bales, to 12 million bales. That was somewhat surprising to us because weekly export commitments have been relatively slow, averaging 92,000 bales over the past 4 weeks. Last year, commitments averaged 162,000 bales in the same 4-week period. Total commitments for the marketing year stand at 3.326 million bales, compared with 4.185 million bales last year at this time.

This past season saw a similar scenario in which the USDA kept increasing its estimate for annual exports in its monthly supply/demand situation report, despite the fact that the pace of weekly exports did not seem commensurate with the USDA's forecast for the year. Analysts were skeptical, but as the year progressed, exports did catch up, and the 11.9-million-bale forecast was vindicated. At this point in the season, the USDA relies heavily on historical trends which can obviously change. Still, with shipments having met the USDA's forecast for 2002-03, there is little evidence that the pace of consumption will not continue. While US and European economies are steady, economic activity in China and Japan is far stronger.

We've heard quite a bit lately about how inadvisable it is to compare current inventory levels for this or any commodity with historical levels. Technology has advanced shipping time and efficiency, leaving importers – even in remote regions – complacent enough to maintain smaller inventories. What may have been a very bullish stocks-to-consumption

Inside

Copper: The global deficit grows	2
Gold: Due for a setback?	3
Corn: Better-than-expected crops send prices tumbling	4
Hotline Update	6

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

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

Get Focus by e-mail

Focus on Futures is available by e-mail as an Adobe PDF file. If you prefer to receive your copy of *Focus on Futures* by e-mail, please send us a message at focus@friedberg.ca with your full name, e-mail address, and street address.

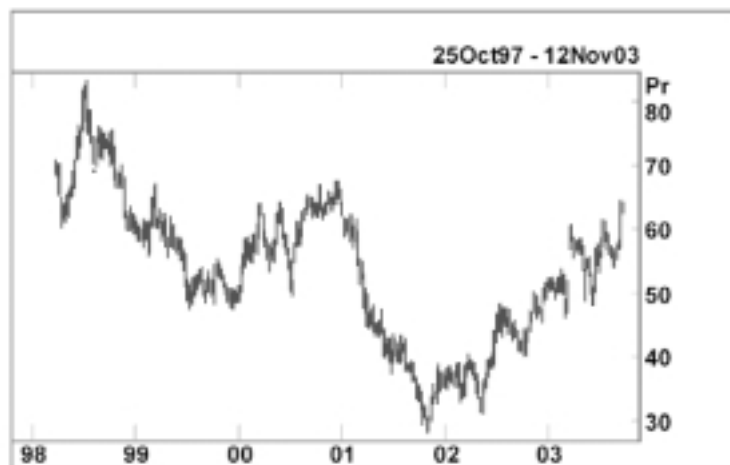
ratio 10 years ago may represent ample supplies in 2003. Still, the rapid decline of cotton stocks over the past year is extraordinary. Global ending stocks for 2003-04 are estimated at 32.22 million bales, or 32.6% of consumption, compared with last month's 34.6% of consumption, 38% for 2002-03, and 50% in 2001-02.

The drop in the estimate for the Chinese crop has altered the landscape for this market considerably, and opens up the possibility for stocks in major exporting countries to be depleted. As it is, US ending stocks have been revised down

to 3.8 million bales, or 20.4% of consumption, a level last seen at the end of the 1997-98 season. Chinese importers will not seek to replace the entire 2 to 3 million bales lost to weather, but they are likely to increase imports by several hundred thousand bales, further tightening supplies. We missed the boat for this leg. We consider the above developments bullish and hope to capitalize when and if the opportunity is presented. *[September 13, 2003]*

STRATEGY: *Stay closely tuned.*

Chart 1 – Weekly cotton, nearest contract



Courtesy Reuters

COPPER

The global deficit grows despite continued production increases

Just a few months ago we were talking about a balanced copper market for 2003. Even among market participants with a bullish bias on the economy – and by extension, towards copper prices – one didn't hear much talk of deficits. After two years of hefty global surpluses – 731,000 tonnes in 2001 and 241,000 tonnes in 2002 – the dynamics of this market would need to shift dramatically to create any significant drawdown in inventories.

Both of the predominant bearish influences – the early-decade global economic slump and rising production in Chile – ended about one year ago, allowing the market to begin its ascent from the 60¢-per-pound bear-market depths. The latter factor was facilitated in a somewhat superficial manner – a concerted effort by mining companies to curtail output. As soon as prices began to rise, however, that bearish factor went out the window, and production began to rise again.

According to the International Copper Study Group's (ICSG) September report, global mine production in the first half of 2003 totaled 6.789 million tonnes, 174,000 tonnes, or 2.6%, higher than the same period in 2002. Expansions at

Chilean mines are now in full swing. Consider more recent statistics that have become available since the release of the ICSG data. Chile's Escondida, the world's largest copper mine, produced 73,132 tonnes in August, a 30% increase over August 2002. July output was 85,516 tonnes, a 66% yearover-year increase. Through the end of August, production at Escondida was up 37.9% over the first 8 months of 2002.

On August 28, BHP Billiton Ltd/Plc, Escondida's majority owner, announced that it was going to idle 200,000 tonnes of production per annum to allow it to monitor the market for more favorable conditions, which of course means strong enough demand to absorb increased global production. The market has since rallied by as much as 4¢-per-pound, to two-and-a-half year highs.

Even as mine production grew, prices rose because the demand side was doing its job, growing at an even faster rate than mine output. Through the end of June, global consumption of refined copper grew by 340,000 tonnes, or 4.5%, to 7.841 million tonnes. Recoveries in the major consuming

regions are humming along, particularly in Asia. Once the world's largest consumer of copper, the US has been displaced by China for top spot. Usage of refined copper in the US fell in the first 6 months of 2003, to 1.145 million tonnes, down 60,000 tonnes, or 5% from the same period last year. Usage in China has jumped by 242,000 tonnes, or 21%, to 1.405 million tonnes over last year.

The progress of the Japanese recovery can be seen in copper consumption as well. In 2000, usage was 1.347 million tonnes, followed by contractions in consumption to 1.146 and 1.158 million tonnes in 2001 and 2002 respectively. Through June, usage stands at 603,000 tonnes, a 7.5% increase over the same period last year. Consumption in the EU has seen a slight increase.

In itself, following warehouse stock movements at the three principal exchanges does not provide any conclusive evidence, because there is little transparency in terms of knowing whether the metal moving out is actually being consumed and being taken out of the system or whether it is just being moved around. In any case, drawdowns are certainly not bearish. At the LME, stocks have fallen by about 400,000

tonnes over the past year. During the same period, NYMEX inventories dropped about 100,000 tonnes. Shanghai stocks have bounced by about 50,000 tonnes off their lows, but still remain 130,000 tonnes below the peak reached last spring.

The surge in demand has thus overwhelmed the uptick in output and leaves the market with a 271,000-tonne deficit through the end of June. At this point last year, the market was showing a surplus of 219,000 tonnes.

It will be interesting to monitor Chilean output to see whether mining companies can resist producing at these attractive prices, which they haven't seen in some time. If they stick to their stated intentions of not allowing output to run away and Asian demand continues at its current pace, the market should continue higher.

Although we identified the primary bullish issues months ago (see our June 26 issue), our skepticism regarding the general global economic outlook kept us from buying this market. We like the long side, and we will be looking for an entry point. *[September 19, 2003]*

STRATEGY: *Stay tuned.*

GOLD

Is gold overbought and due for a setback?

Gold prices are approaching the \$388.50-per-ounce peak they touched briefly this past February. Although there are many factors influencing this bull run, the weakness of the US dollar clearly has been one of the primary factors. The dollar has fallen some 20% since the beginning of 2002. For the most part, gold prices have tracked the dollar (Chart 2). There are those, however, who argue that gold's fundamentals are strong enough and will take on a life of their own even if the dollar were to turn higher. That view gained some credibility recently. When the dollar experienced a substantial, counter-trend rally of about 8%, gold followed suit, dropping back below \$350 per ounce. But gold has now all but completed its recovery back to just a whisker shy of its 2002 highs, while the dollar is still a fair way from its lows. In recent days, the dollar has taken quite a beating, but gold prices had already visited these environs as early as 10 days ago.

Judging by the size of the open interest at COMEX, gold bugs and other groups of gold investors are definitely feeling exuberant. But we don't think that they are necessarily acting irrationally, in response to any short-term, panicky attitude towards financial markets or geopolitical crisis. Typically, when there is trouble brewing somewhere in the world, fear premiums have the same effects on the same markets. A brief scan of those markets shows no such fears: Stocks in the US, Europe, and Japan have been shaking off their bear-market appearances rather handsomely of late. By way of contrast, we can look back to this past February, when gold was trading at current levels, to find that the Dow Jones was hovering

at 7,500, more than 20% below its current level. In addition, credit spreads have narrowed to their lowest level in years, indicating that financial markets are calm. Investors may very well be diversifying their portfolios to include gold, but in a rational manner. If in fact the complacency indicated in a strong stock market and the confidence shown in corporate debt turns out to be misguided, gold could only benefit.

This establishes some evidence that the appetite displayed by investors in gold is not being motivated by the more traditional, short-lived reasons that we've seen in the past. Instead, we are witnessing a longer-term dissatisfaction with traditional asset classes caused in no small part by the unhappy ending of the tech-bubble bull market in equities.

As traders, though, with a more intermediate-term time horizon, necessitated by the highly leveraged futures markets that we employ, there is some explaining to do. As mentioned above, open interest has skyrocketed to record levels. Were this the case in any other futures markets, we would monitor the open interest level daily and beat a hasty retreat from a long position at the first sign that a liquidation of the weaker hands was imminent. Indeed, sell signals have been identified for the current gold market. We believe, however, that the dynamics of the gold market are in transition and therefore deserve a different read.

Typically, producers of any commodity can sell into rallies and sit with large paper losses because as producers they can deliver the commodity and at worst they sold too early. But they will not be foreclosed on by their broker or banker.

The speculator does not have this luxury. The puzzle in the current gold market is the identity of the commercial shorts.

In the past, mining companies and central banks would end all rallies quickly enough. But the nature of activity by mining companies and central banks have changed dramatically. Central bank selling has become transparent since the signing of the Washington accord and no longer inspires the fear and hesitancy among gold investors the way it did in the heyday of the mid-1990s. The accord expires next year and is likely to be renewed.

Hedging by mining companies, however, is not only no longer a bearish factor, the de-hedging process has become a bullish factor, at least until the companies committed to be hedge free complete the repurchase of forward sales. The statistics are very clear on this matter. According to a report published by Gold Fields Mineral Services in August, de-hedging in the first 2 quarters of 2003 totaled 329 tonnes, compared with 423 tonnes for all of 2002.

It is unlikely that mining companies have begun to hedge because the vast majority of them are large public companies

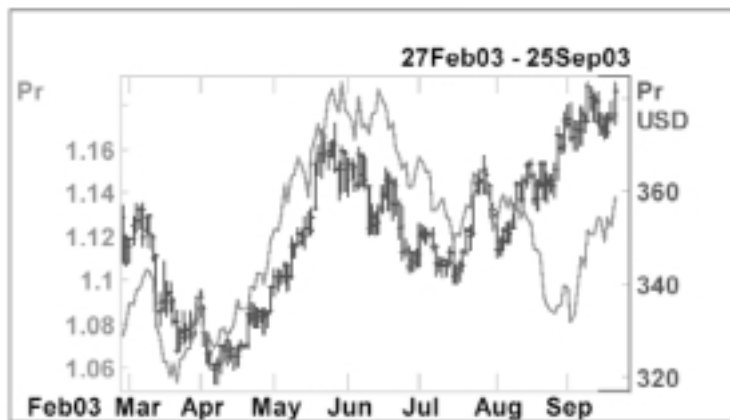
that have made it very clear to shareholders that they have adopted hedge-free or close-to-hedge-free policies.

So who are the commercials with the mammoth short positions that can sit with painful paper losses and deliver if they have to? We speculate that many of the so-called commercials, designated by the exchange as such, may be commercials, but are not natural selling hedgers, and cannot deliver the gold that they have contracted to sell. With a rising market, the pressure is on the shorts and analysis of open interest readings must be revamped for this particular situation. The "commercial shorts" may very well be speculators who will need to cover one day and have no advantage.

We've tightened up our stop to \$370 per ounce, because if our theory is wrong, a liquidation would be powerful given the overwhelming size of the open interest. In the meantime, the market is poised to take out the highs and sprint past the \$400-per-ounce level. *[September 21, 2003]*

STRATEGY: Remain long December gold as per Flash Update of Aug. 7. Raise stops to 370, close only.

Chart 2 – Gold (bar), euro (line)



Courtesy Reuters

CORN

Less damage than expected to the US corn crop sends prices tumbling

The September USDA supply/demand situation report was a disappointment for corn bulls. The key item everyone was eagerly awaiting was the new estimate for 2003-04 US production. After an early forecast for a record crop, hot and dry weather reduced yields throughout July and August. The good-to-excellent portion of the crop dropped from a high of 75% on June 30 to the current estimate of 44%.

In the days leading up to the release of the monthly report, the average guesstimate for the crop stood at 249.5 million tonnes (9.829 billion bushels), down 6 million tonnes (235 million bushels) from the USDA's August report. The

report came in at 252.6 million tonnes (9.994 billion bushels), very close to the high end of the guesstimate range and catching traders and analysts off guard. The street's estimates were pricing in a \$2.4- to \$2.5-per-bushel range. An adjustment had to be made and the market promptly shed 25¢ per bushel (Chart 3). Where do we go from here?

The US was not the only place in the world that experienced challenging growing conditions this summer, and as such, the supply side of the balance sheet certainly remains a vulnerable factor. Drought conditions were rather severe across Europe – Eastern and Western. The

USDA slashed EU output by 2.5 million tonnes from last month's report, to 32 million tonnes. Estimates for Eastern European output were lowered by 2.3 million tonnes to 22.8 million tonnes. Although neither region is counted on for exports of any significance, both are potential importers, particularly the EU.

All told, global ending stocks continue to fall. The USDA lowered its estimate for global ending stocks from last month by 4.3 million tonnes to 74.29 million tonnes, although the change in stocks-to-usage is not very significant because global consumption was revised downwards by 3 million tonnes. We now stand at 11.8% of consumption, compared with 12.4% last month and 15.5% at the end of 2002-03.

It would seem from the market's reaction to the better-than-expected performance of the US crop that the only issues on the table are on the supply side. We've been harping away over the past few months about Asian demand. The USDA didn't make any changes to the 2003-04 Chinese output or consumption data, but did lower last year's ending stocks by 1 million tonnes, which brings this year's carryover stocks down to 25.2 million tonnes, just below 20% of consumption. The Chinese ending stock picture has been subject to some fairly wide swings over the past few years, but assuming the USDA has got it right this time around, the drop in ending stocks has been rather dramatic. Last year's carryover stocks were a revised 34.5% of consumption, already down sharply from 2001-02 ending stocks of 51.4% of usage. China, having turned from importer to exporter over the past several seasons, may see a diminishing role as an exporter.

Aside from the US, this leaves Argentina as the only other exporter of any significance and makes what happens in the US all the more important. Exports are not running away, but are moving well in the early going of the marketing year. Commitments stand at 8.08 million tonnes, compared with 6.64 million tonnes at this juncture of last season. Based on the dramatically smaller availability of feed wheat this year and our guess that China will shy away from the export mar-

ket, it is quite likely that at 45.7 million tonnes the USDA has underestimated US exports.

Typically, a summer drought brings out the speculative community, and open interest builds. When the USDA brings everyone down to earth by informing us that the crop has not burnt to the ground, we expect the ensuing liquidation to push prices down. This year, things were different. Commodity funds were short, and their short-covering in the face what seemed to be bullish news was a key ingredient in the rally to \$2.5 per bushel. As it turns out, they covered before the report's release and went into the report net-long. Open interest has now fallen to its lowest level in quite some time. There may be more liquidation ahead, but the baggage is not burdensome in historical terms, and we believe the market's action in the coming weeks will be a reflection of the true supply/demand fundamentals.

In conclusion, the fact that the US crop survived the summer drought in better shape than most expected is definitely a negative. The crop – while still subject to more accurate estimates as the harvest comes in – is not a bullish factor any longer. But bull markets are made of demand and the market is tight enough to make any increase consumption push prices higher. We're cautious here, with a tight stop, but maintain a bullish bias. *[September 21, 2003]*

STRATEGY: Remain long December corn. Raise stops to 2.20, close only.

CORRECTION: In our August 28 issue, we reported that new crop export commitments were running below the same time last year by 332,000 tonnes. That was incorrect. In fact, the opposite was true. Commitments were *ahead* by 1.4 million tonnes. While the paragraph containing the miscalculation erroneously drew the conclusion that early season sales were sluggish, the bullish tone of the arguments presented in that article as a whole were not affected. We apologize for any confusion this error may have caused. – S.S.

Chart 3 – December corn



Courtesy Reuters

HOTLINE UPDATE

Friday, August 29, 2003:

Good afternoon for Friday, August 29, 4:55 pm. The following is a recap of our latest recommendations and stop levels: We are currently long December corn at 213.5, with our stop at 209, and long December gold at 354, with our stop at 357. All stops are close only.

Flash Update – Tuesday, September 9, 2003:

Good morning for Tuesday, September 9, 10:40 am. This is a Flash Update. We have purchased December wheat at 361, placing our initial stop at 345, close only.

Flash Update – Friday, September 12, 2003:

Good afternoon for Friday, September 12, 12:25 pm. This is a Flash Update. We have liquidated our long December wheat position at 350.

Friday, September 12, 2003:

Good afternoon for Friday, September 12, 5:20 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On September 9, we purchased December wheat at 361; on September 12, we liquidated our December wheat position at 350; we are currently long December corn at 213.5, with our stop revised to 220; and long December gold at 354, with our stop revised to 364. All stops are close only.

Friday, September 19, 2003:

Good afternoon for Friday, September 19, 4:40 pm. The following is a recap of our latest recommendations and stop levels: We are currently long December corn at 213.5 with our stop at 220; and long December gold at 354, with our stop revised to 370. 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 © 2003 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
 Suite 250, BCE Place
 181 Bay Street
 Toronto, Ontario, Canada
 M5J 2T3
 416-364-1171

All enquiries concerning trading accounts should be directed to:

<p>In Canada Friedberg Mercantile Group Ltd. Suite 250, BCE Place 181 Bay Street Toronto, Ontario M5J 2T3 416-350-2903 Attn: Sholom Sanik</p>	<p>For U.S. Persons Friedberg Mercantile Group, Inc. Suite 250, BCE Place 181 Bay Street Toronto, Ontario, Canada M5J 2T3 1-800-461-2700</p>
--	--

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.
