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Corn: extraordinary crops, yes, but is it enough to meet demand?

The August USDA supply/demand situation report delivered a scathingly bearish outlook for corn prices – or so it seemed at the time. The market tested the lows set earlier this month in the two sessions following the release of the report, but prices held and bounced despite the fresh negative data.

The estimate for 2004-05 global output was increased by 24 million tonnes, to 662.87 million tonnes from the July estimate, a gargantuan leap from last year's 616.91 million tonnes.

US production was raised by 7.32 million tonnes, to 277.46 million tonnes. The street was expecting an increase, but the figure was 3.5 million tonnes above the average of analysts' guesstimates. With timely precipitation and moderate temperatures, growing conditions have been near perfect this year. The estimate for yield was increased to a staggering 148.9 bushels per acre (bpa), 3.9 bushels above last month's estimate. This exceeds 142.2 bpa last year and 129.3 bpa in 2002-03.

Other major producers are having excellent growing seasons as well. EU output will return to normal size after last year's drought-reduced crop slashed output by 20%. But the EU has never been a significant exporter, and with ending stocks of 9.5% of consumption, below global averages, it is not likely to start selling much corn abroad.

The 2004-05 Chinese crop was revised upwards by 5 million tonnes, to 120 million tonnes. Despite this, the USDA maintained its 4-million-tonne estimate for Chinese exports, down from 8 million tonnes last season. This estimate is commensurate with recent developments. On August 23, the Chinese government announced that it was issuing export licences for 3 million tonnes for the second half of 2004, significantly less than the 7 million tonnes that were previously announced. Internal prices are high, and the government would rather keep the corn at home. In any case, prices are not competitive with other exporters. At 29 million tonnes, the estimate for Chinese ending stocks for 2004-05 will fall to only 22% of consumption, compared with 34% last year and 52% at the end of 2002-03. There is little incentive for the government to facilitate export trade.

South American producers Argentina and Brazil both

had poor crops last season and are expected to bounce back. The crops, however, will not be available for many months and should not influence the more intermediate-term trading that we focus on.

Still on the supply side and turning back to the US crop, Bill Gary points out in the August 21 issue of *Price Perceptions* that there have been only four occasions since 1965 in which we had consecutive seasons of record yields. In two of those instances the increases were marginal. While the weather reports in the headlines support the USDA outlook, a closer look at the weekly crop condition reports casts some doubt on the USDA's exuberance in forecasting a 6.7% increase in yields. The good-to-excellent portion of the crop has fallen by 6 percentage points since July 26, to 71%. This is still dramatically better than last year at this time when the good-to-excellent portion was 50% of the crop. But in all probability the USDA's mid-August yield estimate was based on early-August crop conditions and does not fully represent the modest deterioration since.

The explosive increase in global output for 2004-05 will be tempered by growth in consumption. Global production is estimated to grow by 7.5%, to 662.87 million tonnes, and

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

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demand is forecast to grow by only 3.6%, to 669.73 million tonnes. Still, the resulting deficit will draw inventories down again to 85.67 million tonnes, or 12.8% of consumption, compared with 2003-04 ending stocks of 92.53 million tonnes, or 14.3% of consumption. This will be the lowest carryout since 1973-74.

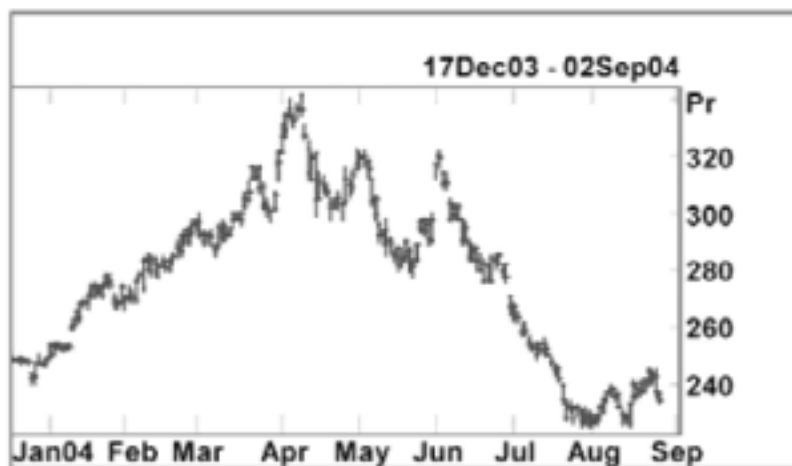
In conclusion, we believe that the fundamental picture, as illustrated, is not nearly as bearish as the tone of press reports suggests. Despite the expected excellent crops, there

has been no improvement in the global balance sheet. The market has fallen by over \$1 per bushel from the highs set in April, in the process wiping out the speculative long position. Commodity funds are now net-short. We believe current market conditions present a low-risk buying opportunity.

[Aug. 27, 2004]

STRATEGY: Remain long December corn as per Flash Update of August 23. Raise stops to 225, close only.

Chart 1 – December corn



Courtesy Reuters

COTTON

The US crop sprints to a record

Since this past spring, when traders got their first sense that 2004-05 Asian crops would be considerably larger than the previous season, prices began a precipitous selloff that would shave prices by close to 25¢ per pound. The US, the world's largest exporter, enjoyed friendly planting and growing conditions, but the crop was expected to be about the same size as last year's. With the release of the August supply/demand situation report, the supply side turned significantly more bearish, with a huge revision to the estimate of the new US crop – clearly a surprise. After briefly setting fresh 22-month lows, the market promptly turned and began a 10¢-per-pound, or 25%, rally in the face of this very bearish news. A sell-the-rumor-buy-the-news classic.

Analysts were significantly off the mark with their guesstimates for this one. The average estimate was for 18.878 million bales, but the figure came in at a record 20.18 million bales, 12% higher than last month's USDA estimate. The estimate was 780,000 bales above even the highest trade estimate. Perfect weather conditions inspired the USDA to raise its estimate for yields by 62 lbs. per acre, or 9.3%, to 727 lbs. from its July estimate. This would be just a tad below last season's record yield of 730 lbs. per acre. As it is, crop-ratings reports supported the USDA's outlook. This week's crop condition

report further underscored the optimism, with the good-to-excellent portion of the crop being increased by 1 percentage point, to 71%, compared with last year's 52% at this point in the season.

Save for minor adjustments, the estimates for other major producers' robust crops were maintained. Global output for 2004-05 will grow to 106.59 million bales, 12.56 million bales, or 13.3%, above last season's production. Consumption is estimated to rise as well, but only by 2 million bales, or 2%. Ending stocks will increase to 39.22 million bales, or 39% of consumption, compared with 33.01 million bales, or 33.5% at the end of the 2003-04 marketing year.

At 115,000 bales, this past week's US export commitments were rather lame, but were also somewhat anomalous. New crop sales averaged 230,000 bales in the previous four weeks. Commitments for 2004-05 stand at 4.86 million bales, compared with 3.21 million bales at this time last season. The pace seems to be encouraging enough for the USDA to have revised its August estimate for US exports upwards by 700,000 bales, to 12 million bales. This despite the USDA's assumption we pointed to in last month's issue that Chinese import needs will be smaller than last season because of the much bigger crop it expects to harvest.

The huge counter-trend rally began to fade last week, but was saved by nervousness about potential damage from the powerful hurricanes coming off the Atlantic that have already caused devastation in Florida and the Carolinas. On August 30, the market closed locked limit up across the board. Wetness can damage cotton plants with open bolls.

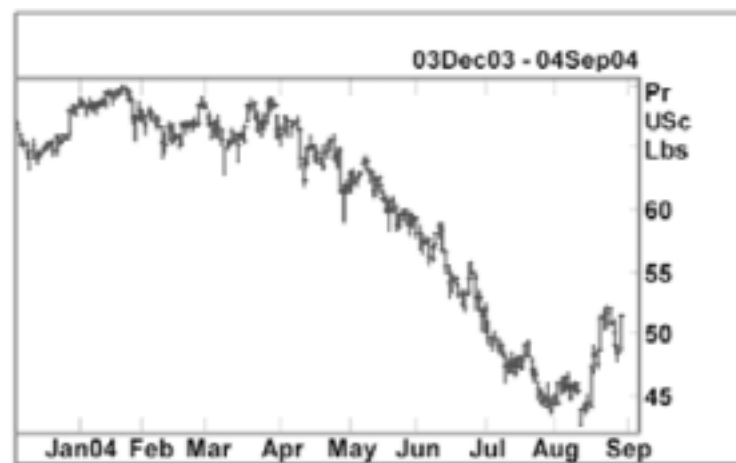
Commodity funds – which have maintained a short position through the drop from the 65¢-per-pound level – have begun to cover their short position. The current Commitment of Traders report shows that in the most recent reporting period, funds reduced their net-short position by 7,310 contracts, to 23,424 contracts, from a high of 31,162 contracts two weeks ago. If indeed the mindset of the group has reversed, regardless of its motivation, i.e., technical or fundamental, we can expect a tidal wave of short covering to ensue.

To summarize the developments noted above, the supply side is not quite in the bag, but is fairly close to it. The effect of a sudden weather disturbance to the almost mature US crop is an unknown at the moment, but was certainly taken fairly seriously by traders in its initial brush with cotton-growing states. While the USDA is upbeat about demand for US cotton, it is still quite a challenge to build a bullish case when we look at the near-overwhelming size of foreign crops, particularly in China.

The balance of evidence, as illustrated, is bearish. It would be prudent, however, to allow the market a chance to digest the fresh weather news. The solid limit-up performance seemed to indicate the possibility of significant crop damage, so for the moment we remain sidelined. *[Aug. 31, 2004]*

STRATEGY: *Remain sidelined.*

Chart 2 – December cotton



Courtesy Reuters

SUGAR

Indian output alters the landscape

In recent years, following the sugar market meant following developments in the sugar industry in Brazil – by far the largest producer and the third biggest consumer after India and China. While Brazilian dominance will continue, a new dynamic has emerged that until recently was a sleeper issue.

Until the end of the 2002-03 season, India was self sufficient in sugar. It typically grew a few million tonnes more than it consumed and exported very little, thus building the world's largest single-country inventory of sugar. That self sufficiency, however, began to unravel during the 2003-04 season when the primary growing regions experienced drought. After years of 20-million-tonne-plus crops, output fell sharply. Analysts who cover the market are divided over how big the 2003-04 crop will be, with estimates ranging from 13.5 million to 16.5 million tonnes, with the more recent estimates coming in at the lower end of that range.

The outlook for 2004-05 production is not much brighter

because sugar cane area is expected to fall by 20% from 2002-03, to 3.72 million hectares, from 4.63 million hectares. Unless more hectares are devoted to sugar over the course of the growing season, even optimum yields would produce a crop of only 15 million tonnes.

All the major Indian statistics – production, consumption, and therefore ending stocks – tend to vary considerably from analyst to analyst, but even the most conservative estimate sees domestic usage of 18 million tonnes. After two years of 3- to 5-million-tonne production/consumption deficits, the once mighty stockpile of 10 million tonnes is either wiped out or very close to it. Some estimates put domestic consumption at 20 million tonnes. Press reports talk about imports of 1 to 2 million tonnes. Given the above rough arithmetic, we believe that the Indians might need to buy a whole lot more than that.

Over the past few months, wet weather in Brazil threat-

ened to curb 2003-04 yields. We're through that now, and the crop turned out just fine. The USDA estimates Brazilian output at yet another record, 25.5 million tonnes, a 2-million-tonne increase over 2002-03. And despite this, forecasts for the global supply/demand balance have begun to reflect the Indian situation.

In his August 9 estimate, French broker Jonathan Kingsman revised his forecast for the global deficit up, from 3.4 million tonnes to 6.39 million tonnes. On August 12, sugar merchant Czarnikow released its first estimate for the 2004-05 crop year. It said that we would move from a balanced market at the end of 2003-04 to a 4.85-million-tonne deficit at the end of the current season.

Ending stocks as a percentage of consumption will fall from about 45% of consumption to something below 40%.

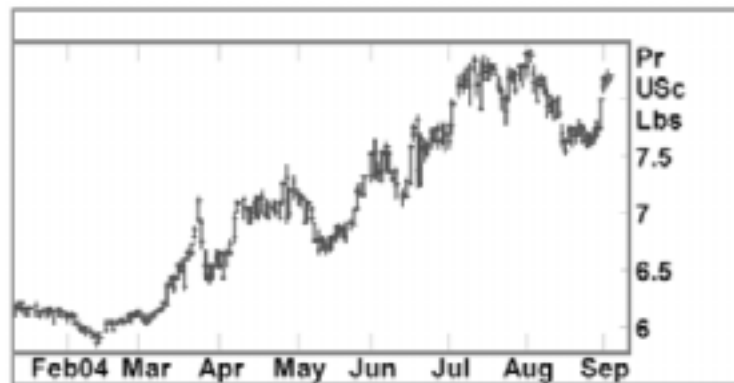
The other developing story is the increase in ethanol consumption. Crude oil didn't quite make it through \$50 per barrel, but it still remains very expensive in historical terms. Consumers, large and small, have a strong motivation to be shopping for alternative energy sources. This motivation will probably still exist even if there were a \$5- to \$10-per-barrel drop in crude prices.

Thailand, for example, a major exporter for the Asian arena, has taken the search for alternative fuel sources very seriously. Although its ethanol processing facilities are not complete, it is estimated that by 2007, there will be enough ethanol in production for sugar exports to fall by 1 million tonnes, or 20% of total exports. The Philippines, which returned to the export market last season after a long absence, has announced that it will be keeping its excess sugar at home for ethanol production. And, Brazil, of course has already made ethanol a near-staple item at the pumps. About half of all the sugar grown is distilled into ethanol.

We're definitely bullish. One of our hesitations has been the rather large contango that has developed between the October and March contracts, particularly in light of the fact that there has been a shipping backup at Brazilian ports. We are looking at the potential for a longer-term upwards adjustment in sugar prices, however, and are coming closer to looking away from the obvious near-term plentiful supplies indicated by the nearby contango. In fact, from March on out, the market is inverted. [Sept. 3, 2004]

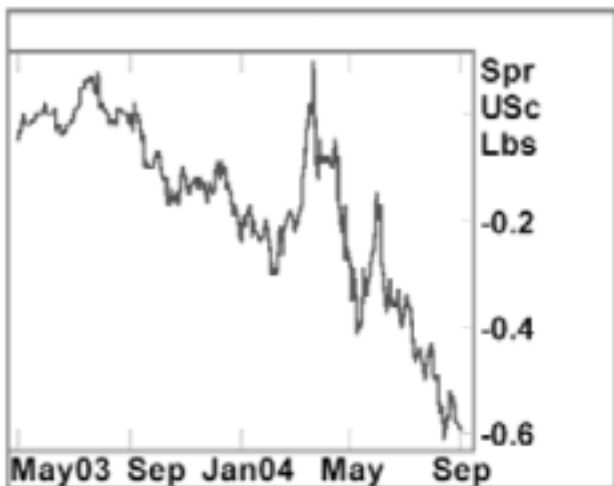
STRATEGY: *Stay tuned.*

Chart 3 – October sugar



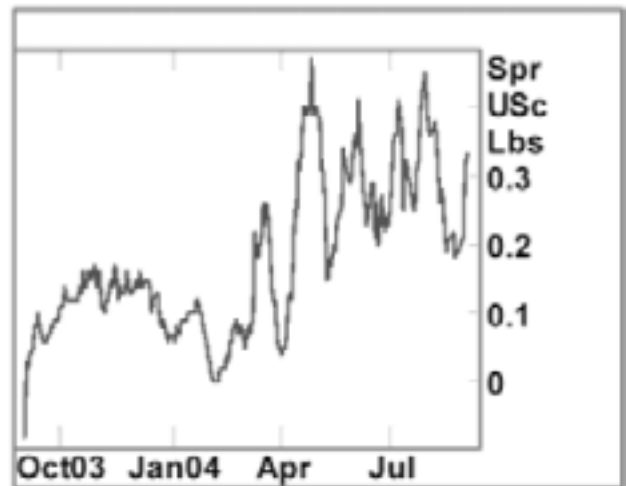
Courtesy Reuters

Chart 4 – October/March spread



Courtesy Reuters

Chart 5 – March/July spread



Courtesy Reuters

SOYBEANS**Supply side looks good, demand side is questionable**

Soybeans rallied to \$10 per bushel this past spring, while traders watched US supplies run down to dangerously low levels. With the old-crop marketing year over, the USDA's near-final figures show US ending stocks for 2003-04 at 2.87 million tonnes, or 4.2% of consumption. This was the lowest carryout in modern history. The subsequent collapse in prices is no great enigma and came in two steps. Once huge South American supplies became available throughout the summer, a sharp downward adjustment in price was inevitable, despite the strong demand from Asia. Then, that demand dried up as well when the Chinese government began to institute measures to cool off a steaming economy. Bean crushers ran into financial difficulty and were having trouble financing imports. The whole process that facilitated the bull market unraveled.

Now that we've seen a \$4-per-bushel drop in price, where do we go from here? The August USDA supply/demand situation report was mixed. The estimate for the US crop was lower than expected, but the overall global picture shows that we should have ample supplies for 2004-05.

The US crop was revised downwards from the July report by 1.72 million tonnes, to 78.29 million tonnes, against analysts' average guesstimate of 80.6 million tonnes. So the US side of the report was certainly a surprise. The revised estimate is commensurate with recent developments. The trend in crop ratings has been slipping. The good-to-excellent portion of the crop fell from 73% on August 9 to the most current reading of 64%. Crop ratings obviously become more pertinent as we enter harvest season.

The recent rally off the \$5.50-per-bushel level began on the day of the release of the USDA August report (Chart 6). The rally was further supported by fears that the rather cool summer we experienced in North America could be a preamble to an early autumn, which would bring unseasonable cold temperatures while the crop is still growing.

While there is no precedent in modern history for a freeze in the soybean crop, the market has established a fear premium. Weather forecasts for cooler temperatures pushed prices up to six-week highs earlier this week. But meteorologists are now calling for warmer weather through the Labor Day weekend and into next week, so the threat has been diminished, but has not disappeared completely.

The USDA has already lowered yields to 39.1 bushels per acre (bpa) in its mid-monthly report, down from 39.9 bpa, to reflect the cooler weather, and the harvest is far from complete.

The USDA increased its estimate for 2003-04 global carryover stocks by 2.7 million tonnes from last month, which reflects the unexpected slowdown in Chinese purchases towards the end of the 2003-04 marketing year. Carried forward to the new marketing year and combined with a lowered consumption estimate to counter the downward revision to US output, these adjustments resulted in 3.2-million-tonne

increase in the estimate for 2004-05 ending stocks, to 50.2 million tonnes, or 24% of consumption. This compares with last year's 18.9% of consumption.

It is still very early for forecasting South American crops, which are just heading into their planting season. But based on acreage intentions, those crops will be huge. The USDA left Brazilian and Argentinean estimates unchanged from July. The Brazilian crop is estimated at 66 million tonnes, up a whopping 25% from 2003-04, while the estimate for Argentinean output is 39 million tonnes, 15% higher than this past season.

On September 2, the Brazilian agriculture ministry released its estimate for the 2004-05 Brazilian crop, forecasting output of 60 million tonnes. That's quite a difference from the USDA's estimate.

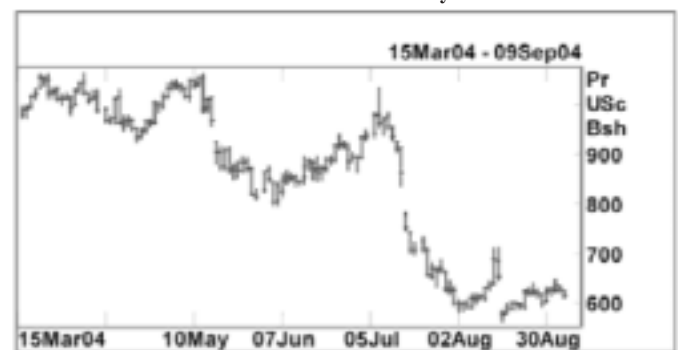
Even if some of the early, exciting supply-side expectations were trimmed, the demand side must perform or this rally will fade, and we will head back to the \$4- to \$4.50-per-bushel range. So far, US exports for the new marketing year have been ho-hum. Average US export new-crop commitments are off to a poor start. This week US exporters sold 192,000 tonnes, compared with last week's sales of 527,000 tonnes. Last week's tally was an anomaly, though. The 4-week average has been 296,000 tonnes, well below the average weekly pace required to meet the USDA's optimistic annual target of 28.03 million tonnes. Last year's exports were 24.22 million tonnes. New crop commitments stand at 5.36 million tonnes, compared with new-crop sales of 7.4 million tonnes at this time last year.

Factors that can change the situation exist on both the supply and demand sides. The US weather remains a legitimate threat, and it is too early to pass judgment on South American crops. China's feed needs have not disappeared, which makes a careful watch of export patterns vital. Given current forecasts, however, we have to believe that the rally will fade.

[Sept. 7, 2004]

STRATEGY: *Stay tuned.*

Chart 6 – Nearest contract soybeans



Courtesy Reuters

HOTLINE UPDATE

Friday, August 6, 2004:

Good afternoon for Friday, August 6, 4:00 pm. The following is a recap of our latest recommendations and stop levels. We are currently long December gold at 391.80, with our stop at 379.50. All stops are close only.

Friday, August 13, 2004:

Good afternoon for Friday, August 13, 5:00 pm. The following is a recap of our latest recommendations and stop levels. We are currently long December gold at 391.80, with our stop at 379.50. All stops are close only.

Friday, August 20, 2004

Good afternoon for Friday, August 20, 4:40 pm. The following is a recap of our latest recommendations and stop levels. We are currently long December gold at 391.80, with our stop at 379.50. All stops are close only.

Flash Update – Monday, August 23, 2004:

Good morning for Monday, August 23, 11:20 am. This is a Flash Update. We have purchased December corn at 240, placing our initial stop at 220, close only.

Flash Update – Friday, August 27, 2004:

Good afternoon for Friday, August 27, 12:10 pm. This is a Flash Update. We have liquidated our long December gold position at 403.70.

Friday, August 27, 2004

Good afternoon for Friday, August 27, 4:50 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels:

On August 23 we purchased December corn at 240; on August 27 we liquidated our long December gold position at 403.70.

We are currently long December corn at 240, with our stop revised to 225. All stops are close only.

Flash Update – Thursday, September 2, 2004:

Good afternoon for Thursday, September 2, 2:55 pm. This is a Flash Update. We have sold short December copper at 124.90, placing our initial stop at 132, close only.

Friday, September 3, 2004:

Good afternoon for Friday, September 3, 4:45 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels:

On September 2 we sold short December copper at 124.90.

We are currently long December corn at 240, with our stop revised to 225, and short December copper at 124.90, with our initial stop at 132. All stops are close only.

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