FRIEDBERG'S

FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.

Volume 8, No. 8 September 6, 2005

Corn: shrinking crops and expanding demand

It is the eve of the eagerly-awaited release of the USDA's August crop production estimate for the soon-to-be-harvested US 2005-06 corn crop. The July forecast was 10.79 billion bushels (BB), or 274 million tonnes (MT), down from the record 11.81BB (300MT) crop harvested in 2004-05. It hasn't rained very much since the USDA's previous estimate one month ago. There is therefore little doubt that the estimate will be revised lower yet again this month. The corn crop is through its pollination period, and while significant precipitation at this point can improve yields to some degree, it cannot repair all the damage.

Analysts have weighed in with their guesstimates. The average estimate is 10.24BB (260MT), with a high of 10.60BB (269MT) and a low of 9.99BB (252MT). The high estimate is rather conservative and assumes little impact from weeks of dryness. The low estimate assumes a drop in the yield estimate from last month of about 10 bushels per acre (bpa), to 135bpa and 1 million acres shaved off the harvested-acre estimate, to 73.5 million acres.

From the time it became evident that the crop would be facing a season of adverse weather conditions, the good-to-excellent portion of the crop dropped precipitously from 67% to the current reading of 53% – historically, a very low reading. A loss of 1 million acres implies a harvested-to-planted-acre ratio of 90%, which is below the average of the past 5 years (not including 2002-03 when the ratio was 87.8% and when there was an incentive for abandonment because of greater subsidies) and is close to the figure that the most pessimistic forecast is working with. With crop conditions having deteriorated so consistently, it is reasonable to expect the worst-case scenario. Having said that, the USDA does not typically make drastic changes in its estimates until the situation is absolutely clear. If tomorrow's estimate does come in below 10BB (252MT), the market is dramatically undervalued.

While all eyes are on the supply side, the demand side has not received much attention. Old-crop sales have been rather sluggish lately, but falling prices seem to have uncovered some latent demand. This week's commitments report showed that US exporters sold 1.073 million tonnes of old crop and 270,000 tonnes of new crop corn. That was well above both expectations and the average of combined old and new crop sales for the previous 4 weeks of 650,000 tonnes. This brings total commitments for the season up to 47 million tonnes, ahead of the USDA's estimate for total shipments of 46.36 million tonnes. There are only 3 weeks remaining in the marketing year, and with shipments to date of only 41.4 million tonnes, we will not reach the target. The strong showing for exports is a little late, but not insignificant.

Another demand-side issue is ethanol usage. Our last article on corn pointed out that corn-based ethanol consumption had fallen somewhat below the USDA forecast. One would have to think that the motivation to use alternative fuels must be at an all-time high, right along with the all-time high in crude oil prices. The outcome could be similar to the situation with sugar-based ethanol in Brazil, where processing capacity is being pushed to the limit,

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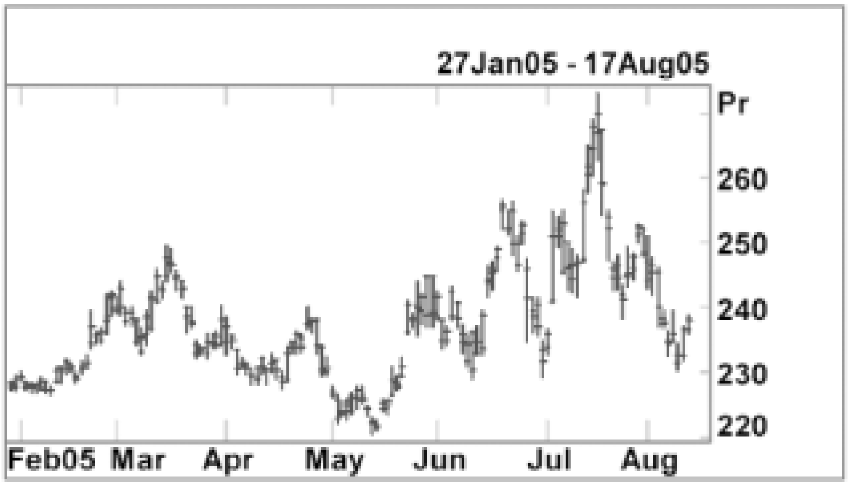
Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: *ssanik@friedberg.ca*).

which has resulted in tightness for the food side of the market. The market for commercially-viable alternative fuels is not nearly as well developed anywhere in the world as it is in Brazil, but the growth rate in the US has been solid, and we can expect that rate to increase with petroleum prices going through the roof.

We maintain our bullish bias.

[August 11, 2005]

Chart 1 – December corn



Courtesy Reuters

WHEAT

Tumbling prices do not reflect fundamentals

With the Northern Hemisphere winter wheat harvest complete and the spring wheat crops more than half-way there, we're getting a better idea of what global 2005-06 output will look like. In this month's supply/demand situation report, the USDA lowered its estimate by 2.23 million tonnes, to 610.33 million tonnes.

Downward revisions in the US, Argentina, the EU, and the FSU were partially offset by a 2-million-tonne upward revision to the Chinese crop.

The issue of whether last year's 624-million-tonne bumper crop and the resulting production/consumption surplus – the first in 5 years – would turn out to be a one-time event seems close to being settled. The 2004-05 season finished with a surplus of 17 million tonnes, which lifted ending stocks to 148.36 million tonnes, or 24.4% of consumption. According to the August USDA report, we're back to the era of deficits, with demand outstripping supply by close to 7 million tonnes. If crop conditions and consumption estimates remain close to current forecasts, 2005-06 ending stocks will drop back to 141.45 million tonnes, or 23% of consumption. This represents a continuation of the decline in world inventories, which averaged 35% of consumption in the late 1990s and early part of this decade.

The downward revision for the US crop came from the winter wheat side; the estimate for the spring wheat crop actually rose slightly. But spring wheat crop conditions have been deteriorating. The good-to-excellent portion of the crop fell a rather substantial 3 percentage points in this week's crop progress report, to 64%, so we're likely to see estimates for the spring wheat crop fall again in September.

Demand has perked up. The USDA estimates that 2005-06 US exports will be much weaker than last season, and indeed, the marketing year got off to a slow start. But the pace has picked up. Average commitments for the past 4 weeks totaled 650,000 tonnes, compared with only 510,000 tonnes in the previous 4-week period. This prompted the USDA to increase its estimate for annual sales for 2005-06 by 680,000 tonnes, to 26.54 million tonnes. That will still be well shy of 2004-05 sales, which reached 28.92 million tonnes, but if demand keeps up, we will continue to close the gap.

With the global balance sheet tightening steadily back to levels that were considered quite bullish at various junctures over the past several years, why is the market so weak? Spring wheat represents only 25% of the total US crop, and in any case recent weather seems to have been detrimental, according to the latest crop progress report.

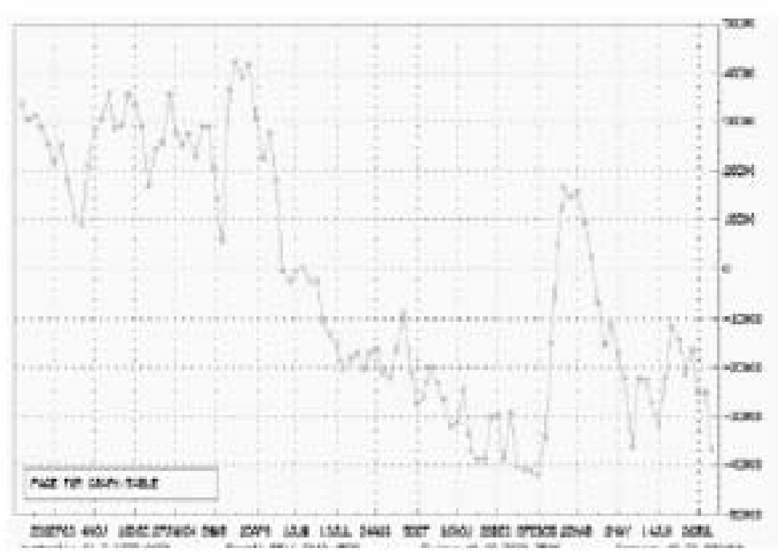
The three primary US agricultural markets – wheat, corn, and soybeans – share some dynamics in terms of climatic conditions, but at the same time, each has unique growing-season characteristics that govern when rain or drought matter most. Nevertheless, sympathy pains travel from one trading pit to the other, and there is strong evidence that this is the case now. Corn and soybean crops benefited from recent milder and wetter weather in the Midwest, or so it is believed.

As illustrated, the effect on wheat was at best minimal. While prices of the three markets seem to be heading in the same direction, a careful examination of the structure of the open interest reveals that the behavior of commercial traders is very different in the wheat market.

Commodity funds are heavily long corn and soybeans but carry a substantial short position for wheat. A glance at Chart 2 shows that the current fund net-short position in wheat is close to a historical extreme, which means that the commercial side of the market has happily obliged, accumulating long positions as the market ticked down.

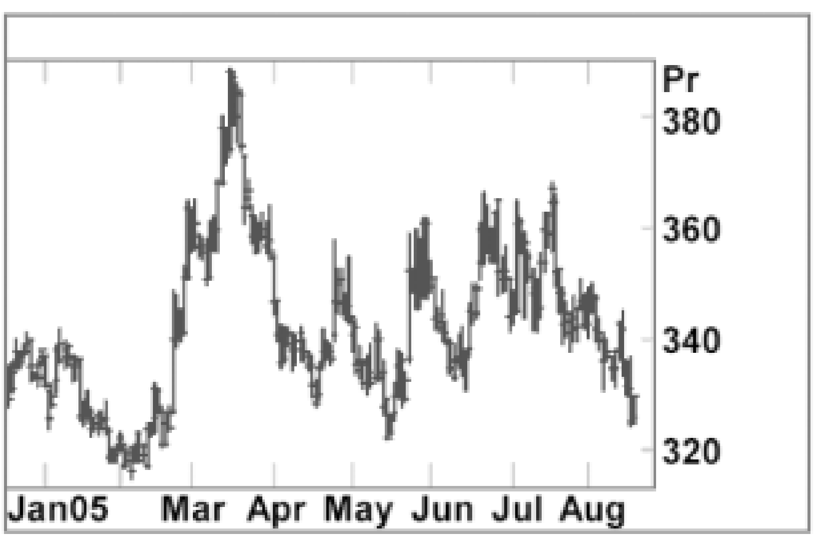
We remain bullish and advise mimicking commercial traders. *[August 17, 2005]*

Chart 2 – Net short position of large speculators



Courtesy Bloomberg

Chart 3 – December wheat



Courtesy Reuters

COCOA

Can the Ivory Coast return to a bumper crop?

September cocoa traded down to $1,316 per tonne earlier this month, the lowest price we've seen in the spot contract since last summer (Chart 4). The new marketing year in West Africa begins in October, and early expectations are for a recovery from a rather bleak 2004-05 season. As of August 26, combined main- and mid-crop bean arrivals at the two Ivorian ports totaled 1.16 million tonnes, down 12.4% from the previous season.

On August 25, the International Cocoa Organization (ICCO) revised its estimate for the 2004-05 global production/consumption balance to show a deficit of 106,000 tonnes, up from its May estimate of 44,000 tonnes.

For the new season, however, the ICCO is looking for West African production to return to normal and forecast a global production/consumption surplus of 100,000 tonnes. This estimate is based on favorable weather conditions in the early going of the 2005-06 season.

Nigeria, once the world's second largest producer, has been in the cocoa headlines lately. The government issued statements indicating expectations for much larger crops in the new season, as well as estimates for 2004-05 output that were substantially larger than those of European analysts. Industry estimates are in the 200,000-tonne-plus area, whereas the government was talking about 400,000 tonnes for 2004-05 and forecasting output of 500,000 tonnes for 2005-06. These fantastic estimates, however, were dismissed by market participants. While such numbers would surely make a difference to the global balance, the market ignored the news, and prices have actually drifted higher since the Nigerian story hit the wires.

The idea of a West African country targeting bigger crops shouldn't be dismissed out of hand, though. Five or six years ago, Ghana announced plans for going head-to-head with the Ivory Coast, and it has indeed increased output by about 50% since the beginning of the decade, while Ivorian crop size has basically remained in the same range. But it is very clear that at this time, the Nigerian claims are at best futuristic and should not be construed as bearish in the short term.

Data from the demand side have been strong. Second-quarter grind statistics showed that European consumption rose 7.5% while US demand grew 4.4%. After factoring in flat consumption growth in previous quarters, these figures are in line with E.D. & F. Man's June estimate for 2004-05 global grinding activity to grow at a rate of 3.4%.

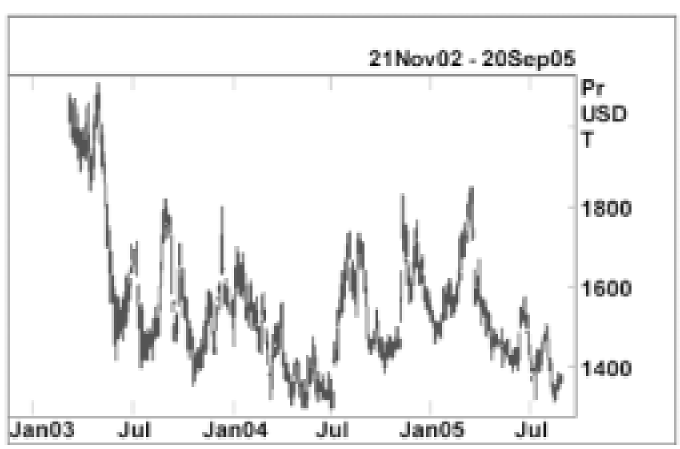
Butter ratios have snapped back and are being quoted at about 3.15 times the London spot prices in both Europe and Asia, after having slipped to about 2.8 earlier this year. Powder remains the drag it has been all along, with warehouses reportedly bulging with the less desired of the two end products. Butter and powder are quoted as a package; hence, processing margins are obviously not attractive enough for grinders to be purchasing enough beans to tighten the market.

With global ending stocks still hovering at over 40% of consumption, even after a season of poor crops and inventory drawdowns, it is difficult to establish a convincing bullish case. Nevertheless, it should be noted that the most recent downleg was precipitated by anticipation of a return to 2003-04 Ivorian output levels because of excellent weather conditions. It is far too early to make any such assumptions. Last year, meteorological services reported ample and beneficial moisture levels throughout August and September, and the first hint of dryness did not appear until early October. When arrivals began to slow, it was attributed to civil strife, but it soon became clear that the crop would be sub-standard. The market proceeded to make several trips to the $1,700-per-tonne level and beyond.

We are at the bottom of a multi-year range that has seen wild swings from top to bottom. The fundamentals have not changed very much, and if anything, they have shifted slightly to the bullish side, even though it is not obvious on the balance sheet. First, we've seen an uptick in grind statistics, and second, the Ivory Coast may be entering a period of declining output. We continue to favor the long side.

[August 30, 2005]

Chart 4 – Weekly nearest contract cocoa



Courtesy Reuters

COTTON

Another bumper US crop?

Readers who heeded the advice we dispensed in the July 25 issue of *Focus on Futures* to trade cotton from the long side are somewhat lighter of pocket today. The fresh recent low in December cotton is certainly supported by some bearish developments in the fundamentals.

The street had been underestimating the size of the 2005-06 US crop. To understand why, consider the following. It was difficult to imagine duplicating or even coming close to the performance of the 2004-05 crop, which yielded 23.25 million bales, a record by 2.95 bales, or 14.5% above the previous record set in 2001-02. Every aspect of the 2004-05 planting, growing, and harvesting seasons was as near to perfect as we've ever seen. In fact, it was an accident of sorts. It is not as if farmers planted more acres. The final planted acreage figure was 13.66 million acres, well below the average of the previous 5 years of 14.72 million acres. That's when Mother Nature took over. Weather conditions were so ideal that the ratio of harvested to planted acres was 95.6%, compared with the average of the previous 5 years of 87.94%. The record yield of 855 pounds per acre compares with an average of 668 pounds per acre in the previous 5 seasons.

As the 2005-06 growing season progressed, however, crop surveys became more meaningful, and production estimates that previously relied largely on trendline patterns began to shift to hard data. The weekly crop condition report shows the good-to-excellent portion of the crop at 65%, up 2 percentage points from a week earlier, and continuing to rise steadily since mid-July. We're still shy of last year's 71% good-to-excellent rating at this point of the season, but the gap has narrowed.

The August USDA supply/demand situation report confirmed the improved outlook for 2005-06 US output. The estimate was increased by a substantial 1.49 million bales from its July estimate, to 21.29 million bales. That was the most significant fundamental development that caused prices to slide.

Overall though, with the combination of a 750,000-bale downward revision to Southern Hemisphere crops and an uptick in the estimate for global consumption, the balance sheet has not changed all that much. The estimate for 2005-06 global ending stocks was revised up by 860,000 bales, to 49.81 million bales, or 44.5% of consumption. This is up from the July estimate of 43.9%, but still below a global stocks-to-use ratio of 47.08% at the end of 2004-05.

A fresh factor to emerge, and which initially did not seem to worry the market a great deal – judging by tumbling prices – is possible damage inflicted to the cotton crop in the Mississippi Delta by hurricane Katrina. In the first few sessions after the storm hit, traders seemed to be focusing on a build-up of supplies of cotton and other US agricultural products that needed to be shipped nationwide and around the globe, but would be held up because of the damage caused to the shipping infrastructure along the Mississippi River. This, it was reasoned, would pressure US prices because importers would be hesitant to book orders and be forced to scramble to find alternate suppliers. By Thursday afternoon, however, the cotton and other markets rallied as market participants stopped worrying about a supply backup, assuming that the flow of goods would resume along the Mississippi in time to accommodate the harvest. We believe that the important issue here is to determine whether there has been any significant loss of output.

On the demand side, US export commitments are running ahead of last year, but it is too early to draw any conclusions. We should bear in mind how strong US exports were late last season and how surprising it was that China was as eager a buyer as it was, considering the huge crop it was working off.

Finally, and perhaps the indicator to watch most carefully, is the behavior of commodity funds. They are heavily short this market. If they can't break the market to the downside and fundamentals turn a bit more bullish, we will witness a very substantial short-covering rally. We are not as enthusiastic about the long side as we were in July because of the possibility of a better-than-expected US crop. Nevertheless, there are a number of uncertainties, as illustrated, and we would recommend maintaining a long position protected by a close-only stop below recent lows. *[September 1, 2005]*

Chart 5 – December cotton

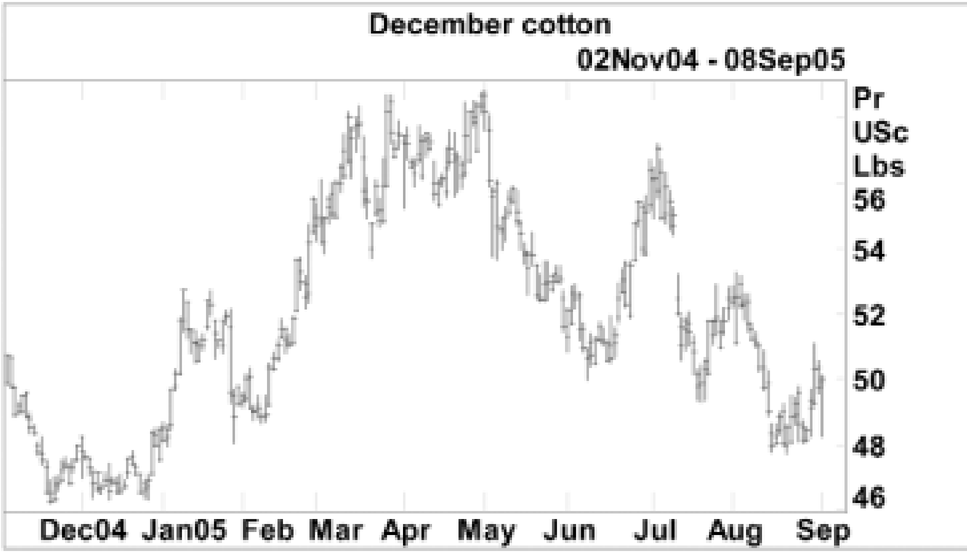


Chart courtesy of Reuters

Friedberg's Focus on Futures is published by Friedberg Mercantile Group Ltd., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3.

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:

In Canada
Friedberg Mercantile Group Ltd.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

For U.S. Persons
Friedberg Mercantile Group, Inc.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario, Canada M5J 2T3
1-800-461-2700