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Cocoa butter spreading thin

Cocoa prices are trading near the bottom of a five-month trading range (Chart 1). The crux of our long-standing bullish argument has been that unlike many commodity markets, high prices have not worked their way through the system to inspire increased production in cocoa. If the demand that disappeared during the global recession returned and continued a normal growth pattern, *bona fide* tightness conditions would result.

Everybody talks about ramping up production, but aside from Cameroon – a relatively small player – none of the major producer/exporter nations have seen steady output growth in recent years. Quite to the contrary, among the three largest producers that comprise about 70% of world production, output has been flat to lower, and there is absolutely no evidence that anything is about to change.

The Ivorian president announced recently that he intends to oversee rising cocoa output, to 2 million tonnes per year, within five years. Over the past decade Ivorian production reached about 1.4 million tonnes several times. With just over a month left to the 2009-10 mid-crop season, total main- and mid-crop port arrivals stand at just over 1.1 million tonnes, down 2.1% from this time last year. Even with optimum weekly arrivals, output is unlikely to match 2008-09 production of 1.22 million tonnes. So Ivorian production has actually been in decline over the past 10 years. With aging plantations, even a return to mid-decade highs is ambitious.

Ghana has been releasing frequent statements about its plans to increase output to 1 million tonnes, but production peaked at 750,000 tonnes earlier this decade, and the country has eked out just 700,000 tonnes over the past three seasons.

Similarly, production in number three producer Indonesia has been stuck between 500,000 and 550,000 tonnes since mid-decade.

On the demand side, second-quarter grind results for non-producing countries released in July were much better than expected. The European grind was 12.7% above the same period in 2009, while the North American grind was up 12.07%. That should mean that consumption is growing at a much better pace than analysts' forecasts for moderate growth of 3% to 5%.

The combination of stagnant growth in production and resurgent demand definitely sounds like a surefire bullish

case. However, as we pointed out earlier, prices have been in a trading range, and the argument that prices have managed to maintain historically high levels is wearing thin. Ever since the dollar topped out in early June, many commodities have begun what may be a fresh bull market, but cocoa has stumbled along its own way.

While the grind has always been used as a substitute for genuine usage statistics, it seems that in the current environment, it is not telling the whole story. Indeed, grind volumes are up over the depressed levels of the recession, but market conditions are such that the pace of the past two quarters is not necessarily sustainable. Not only are butter prices not moving in sync with beans, they are tumbling. Charts 2 and 3 show that butter ratios in both Europe and Asia are at multi-year lows, indicating that butter supplies are ample and that grinders will not increase bean purchases until bean prices have fallen enough to allow for profitable processing.

So despite the fact that meaningful global production/consumption surpluses are highly improbable for a very long time, we're feeling a bit bearish because of the weak butter ratios. For the longer term, we do not see cocoa prices retreating to pre-bull market levels. It is inconceivable that production can grow substantially, given the available infrastructure in producing nations.

Nevertheless, we can see prices becoming vulnerable to

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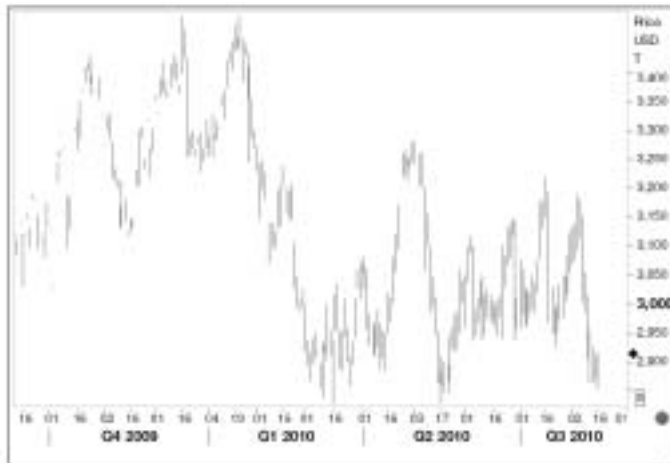
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either a strengthening dollar or daily news reports about the excellent progress of the new 2010-11 Ivorian crop. We know the crop has limited potential, but the headlines can and probably will bring heavy selling pressure to the market. As such,

we are recommending placing good-anytime sell stops at \$2,850 per tonne, basis the nearest trading contract, to protect profits on long positions. And stay tuned.

[August 16, 2010]

Chart 1 – December cocoa



Courtesy Reuters

Chart 2 – European butter ratios



Courtesy Reuters

Chart 3 – Asian butter ratios



Courtesy Reuters

SUGAR

Bear market rally?

Sugar prices have recouped about 35% of steep losses suffered this year (Chart 4). The panic over India's ability to secure enough sugar to meet its domestic needs for 2009-10 drove prices to 30¢ per pound. The final tally for 2009-10 Indian imports is about 5 million tonnes, a formidable amount for a country that has traditionally been self-sufficient. A decision over whether to reintroduce import tariffs is pending, but the need for imports is over and is no longer a bullish factor. The bull run began to crumble when a surprise uptick in yields for the Indian 2009-10 crop pushed

total output to over 18 million tonnes, considerably above the worst of the season's estimates, which at one point reached as low as 14 million tonnes.

Increased sugar area and a normal monsoon season should ensure enough output to meet Indian domestic needs for 2010-11. Early forecasts for the crop were in the 24-million-tonne area, but recent estimates have grown to 25 million tonnes.

Brazilian output is expected to reach over 40 million tonnes, about 4 million tonnes above 2009-10 production.

The major sugar analysts are calling for a 2010-11 3-million-tonne global surplus, up from a 6-million-tonne deficit in 2009-10. The market is eyeing the 20¢-per-pound level. What are we to make of the recent rally?

First, while the Indian market has clearly stabilized, it is not totally out of the woods. The monsoon rains have been adequate, but amounts have varied from above average to below average. In June the rains were slightly below normal, but were higher than average in July. Barring unforeseen circumstances, the crop should at the very least meet domestic usage of 24 million tonnes.

Let's remember, though, in the years preceding the two consecutive drought seasons of 2008-09 and 2009-10, Indian ending stocks were at least 10 million tonnes, which at the time was close to 50% of consumption. That was part of de facto government policy of keeping ample stocks of staples. During the years of drought, stocks fell to about 3.5 million tonnes, or 15% of consumption. Now that we're in recovery mode in 2010-11, even under optimum conditions, ending stocks are expected to grow to about 5.5 million tonnes, which will be somewhere between 20% and 25% of consumption. All of which is fine if the crop is perfect. Even if there is a problem, there still may not be any need for imports in 2010-11. But then stocks get run down to uncomfortable levels again. To restore inventories back to comfortable levels, the crop would have to be extraordinary, which at present does not seem to be the case.

Then there are other issues that have surfaced. The recent floods in Pakistan have reportedly destroyed about 500,000 tonnes of sugarcane plants. Pakistan is a net importer of sugar. In 2009-10 it purchased 1.25 million tonnes abroad, which was greater than the amount needed to meet the annual production/consumption shortfall. Analysts have downplayed the significance of the crop losses suffered in Pakistan

because of this, but it also means that the balance of the growing season has to be perfect – another vulnerable spot.

Russia imports close to 3 million tonnes of sugar annually. The devastating drought was not as well publicized for sugar as it was for wheat, because Russia is a major exporter of wheat, and the impact of its drought will be felt by its regular wheat customers immediately. Russian sugar output in 2009-10 was 4 million tonnes. Estimates for crop losses are erratic and range from between 10% to 20%. That's not as bad as the 25% drop forecast for the wheat crop, but still represents a fair chunk of the output that the Russian market had anticipated would be available for consumption. Analysts say that additional imports of 200,000 tonnes will be necessary. Indeed, if that is the extent of it, the Russian drought will not be a big issue for the overall sugar market. But again, if a more substantial amount is required and Russia needs to tap in to the scarce pool of sugar available for world trade, then it will become an issue and will tighten the market.

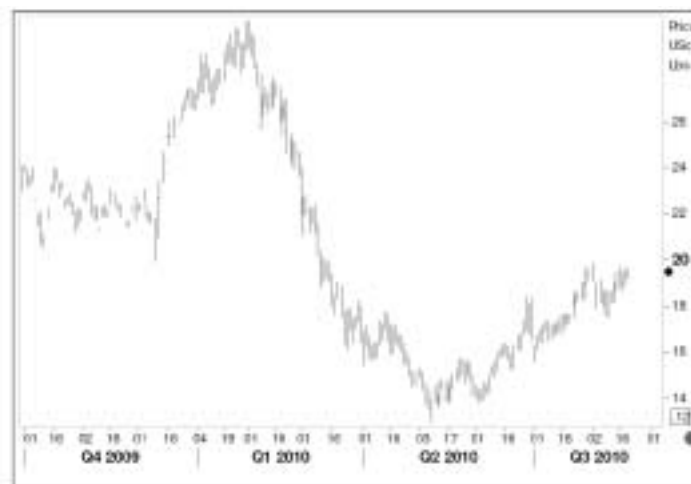
China has been selling sugar from reserves, and although the actual data are a matter of state secret, analysts say that stocks have been run down. There is a very real potential for the government to replenish inventories by increasing imports. Demand has been growing and even an excellent crop leaves a production/consumption deficit.

The various problems among these producing, exporting, and importing countries explains why bulls are not overly impressed by a global 3-million-tonne surplus. The surplus can be gone in a flash.

Nevertheless, we are trading at what in historical terms are still very high prices. It would be prudent to maintain trailing, but liberal, stops on long positions. Use an 18¢ per pound stop, close only, basis the near contract.

[August 20, 2010]

Chart 4 – Nearest contract sugar



Courtesy Reuters

SOYBEANS**More beans please? No problem**

The feature of the USDA's August crop report for soybeans is the estimate for US production. With crops well developed and nearing harvest, this report is the first comprehensive look at yields. The report was chock full of other potential market moving revisions, however, which left the global balance sheet looking considerably different than it did one month ago.

The estimate for the average yield for the US 2010-11 crop was increased by 1.1 bushels per acre, or 2.6%, to 44 bushels per acre. Weather and disease factors were an issue, and the street was certainly not expecting an upside surprise. The average guesstimate for the crop was 3.357 billion bushels, which would have been 12 million bushels above the July estimate, but the actual figure was 88 million bushels higher, at 3.433 billion bushels. The highest guesstimate in this well-watched market was 3.41 billion bushels.

The market came into the report fresh after making nine-month highs. An unexpected upwards revision of that size would normally be worth a sharp selloff, but the market proceeded to test the highs set a week earlier (Chart 5).

Despite the increase in the estimate for the US crop, the demand picture tipped the scales to the bullish side. The USDA made significant revisions to consumption data.

The estimate for US ending stocks for 2010-11 was left unchanged from July, at 360 million bushels. But with upward revisions to consumption for both the current and new marketing year, inventory levels actually fell.

For 2009-10, the estimate for the domestic crush and exports was raised by 5 million and 10 million bushels, respectively, dropping ending stocks to 160 million bushels, or 4.8% of usage. In the spring, that figure was 5.8%.

For 2010-11, domestic consumption was increased by 8 million bushels, and exports were raised by 65 million bushels. The combination of revisions to both marketing years was equal to the pop in the estimate for the crop. But since consumption grew, stocks as a percentage of usage

dropped from 11.36% to 11.1%.

At the global level, the effect of these revisions is that 2010-11 ending stocks will be 25.8% of consumption, down from July's estimate of 27.4%, and below last year's 26.8%.

Over the past six weeks there has been an explosive rush by foreign buyers to book US new-crop soybean purchases – or at least it felt that way. Weekly new-crop commitments averaged 1.44 million tonnes during this period, well above normal weekly levels. Importing countries are always very active at this time of year, and while we're ahead of new-crop commitments at this time last year, the difference is not that extraordinary.

The initial bullish reaction to the August crop report fizzled, and in the following two weeks the market traded all the way down to pre-report levels. And that's because despite the improved demand outlook, we're still in a very well supplied market.

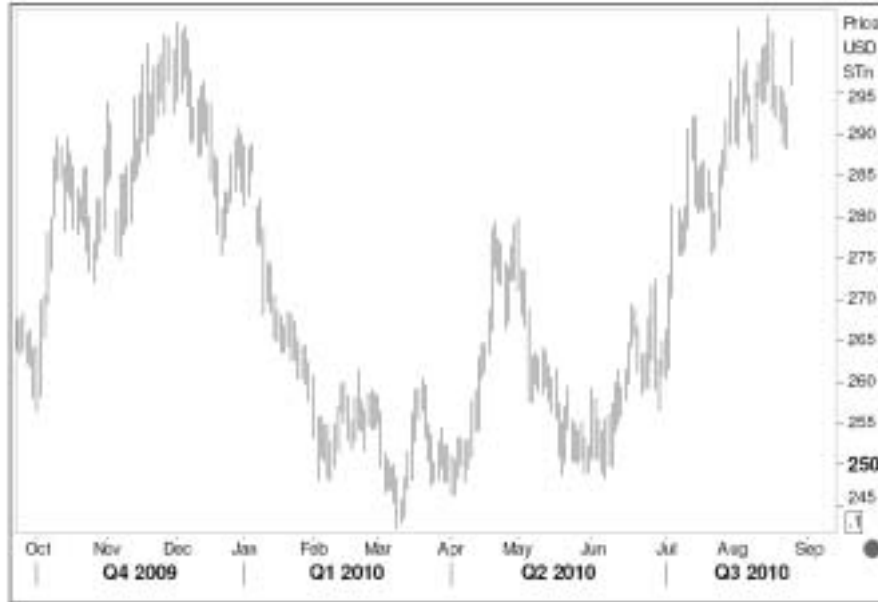
Unlike some other rallying commodity markets, the ending stock position has been replenished, and even after the bullish August crop report, there is no comparison to the inventory levels that created the bull market of two years ago. At the end of 2008-09, global ending stocks stood at 19.9%, dramatically below the current downwardly-revised level of 25.8%.

Even if exports continue to run at above historical norms, the US crop is abundant and will supply the market until the South American crops are harvested next spring.

Soybean prices have risen to a point that stimulated production, and we do not see them trading substantially higher. The bull market in commodities has resumed its lull, however, so we believe there is a danger in being short anything. Nevertheless, if there is a candidate for a short among commodities that have run with the pack and will soon become tired, this is it. Be certain to use a stop close above the high, basis the nearest contract.

[August 27, 2010]

Chart 5 – November soybeans



Courtesy Reuters

COTTON

Recovery in cotton output, but still not enough

Most analysts are bullish on cotton – it's hard not to be – but we detect a lot of skepticism. You hear a lot about the improbability of surpassing 2008 price levels (Chart 6). We beg to differ as we watch the balance sheet tighten with each set of revisions.

Producers responded to the post-recession surge in demand with larger crops. As we will illustrate, however, it was not enough. In the August crop report, the USDA once again raised the estimate for US 2010-11 output. The new estimate was 18.53 million bales, up 230,000 bales from July, and close to 2 million bales above early-summer estimates. US production will be up dramatically from the past two seasons, when the harvest reached multi-decade lows of 12.19 million bales in 2009-10 and 12.82 million bales in 2008-09.

Regardless of the bumper crop, US ending stocks are set to fall. Domestic mill consumption is expected to remain stagnant at 3.40 million bales, the same as 2009-10, and still down from 3.59 million bales in 2008-09. But there has been a torrent of export sales. Commitments for the 2010-11 marketing year, which began on August 1, stand at 6.6 million bales, more than double the commit-

ment at this time last year of only 2.8 million bales. The USDA increased its estimate for 2010-11 in the August 12 crop report by 700,000 bales over the July estimate, to 15 million bales. That would lower ending stocks to 3.2 million bales, or 17.39% of consumption, a huge drop from the July estimate of 19.77%. That compares with 20% last year and 38% in 2008-09.

Most other producing nations saw an increase in output as well, but the US is by far the world's largest exporter, and the growth of the pool of exportable surpluses of these other nations is questionable.

Indian production, for example, was revised upwards by 1 million bales from the July estimate, to a record 26 million bales. That's a jump from 23.5 million bales in 2009-10. And yet cotton available for export will fall because of growth in domestic consumption. Domestic prices have been rising, and the government will control export flows much the same way it has successfully done with sugar this past season. Although the USDA still estimates Indian exports unchanged from last season, at 6.5 million bales, a recent government statement said that exports would fall by 40%, to only 4 million bales.

The USDA cut Pakistani output by 700,000 bales from the July estimate, to 9.5 million bales, because of the massive flooding that destroyed cotton and other crops. Some analysts believe that the estimate was liberal and does not account for the full extent of the devastating natural disaster. They believe that at least an additional 500,000 bales were lost.

China has been on a buying spree with year-to-date purchases of 1.9 million bales, compared with only 285,000 bales at this time last year. The USDA has pared down the estimate for Chinese ending stocks by close to 2 million bales in the August crop report, but with the government selling cotton out of its reserves all season long,

that figure is probably still too high.

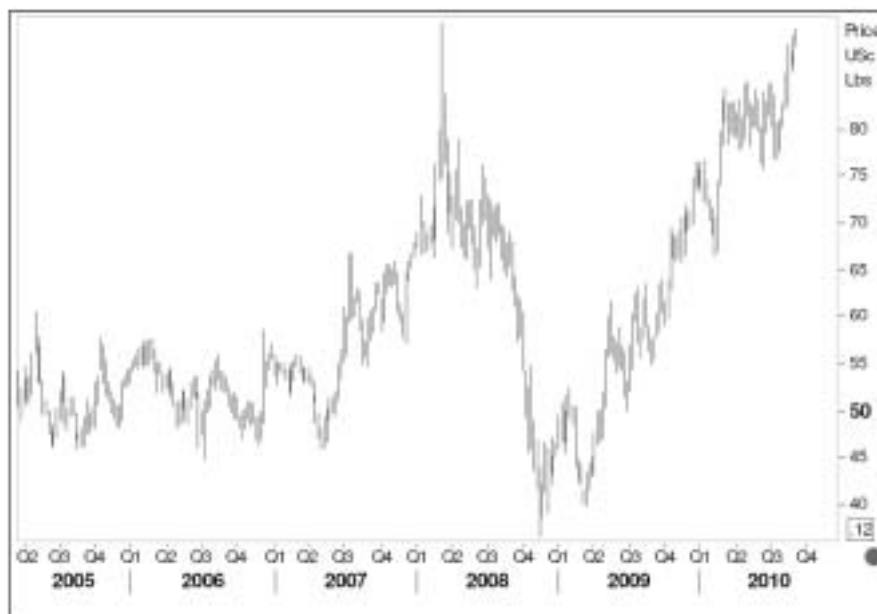
Global ending stocks for 2010-11 are forecast to fall to 45.61 million bales, or 37.7% of usage, down from the 41.6% July estimate. The large increase in US production was a necessity, but accomplished nothing in the way of stabilizing the tight supply situation.

So there is absolutely no comparison between the rally in 2008 and the current bull run. In the years leading up to the 2008 market, global ending stocks never sank below 50% of usage. We are now at inventory levels that have not been seen since the mid-1990s, which ultimately took the market up to \$1.15 per pound.

Remain long.

[September 1, 2010]

Chart 6 – Weekly nearest contract cotton



Courtesy Reuters

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