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Do cocoa fundamentals support this bull run?

With one month left to the 2013-14 mid-crop season, port arrivals in the Ivory Coast are just shy of 1.7 million tonnes, 300,000 tonnes above last year at this time and about 200,000 tonnes higher than the previous record.

West African cocoa producers have generally turned the corner on flat output. Cameroon, an up-and-coming producer, has been the lone holdout this season. Output is expected at 190,000 tonnes, down about 15% from 2012-13. Cumulatively, West African countries grow about 75% of the world's cocoa beans, and aside from Cameroon, the others are all harvesting bumper or average-size crops.

Ghana, the world's second-largest producer, will not reach the record levels of 900,000 tonnes achieved in the 2010-11 season, but has exceeded early-season expectations. Output is seen at 860,000 tonnes, up 12.5% from a year earlier.

Among other producers, Brazil and Ecuador have seen modest increases, while output in Indonesia and Nigeria are maintaining production levels similar to the past few seasons.

Judging by the supply side, it's certainly difficult to understand the magnitude of the bull run we're witnessing. The demand side, however, is looking quite strong.

The second-quarter grind-reporting season started with a disappointment. The European grind was down 0.7%, year-over-year. But results for the other two key regions – North America and Asia – compensated.

Grinding activity has been slowly shifting to origin countries, so the market half expects poor numbers from the traditional grinding centers in Europe and the US. With a 4.5% increase, the North American grind came in above guesstimates of between 0% and 3%. Chart 1 shows that the market did not react to the North American data, which was released on July 17. Nor did it react to the Asian grind data, released the following day, which was up 5.2%. In the sessions that followed, though, the market took out the top end of a six-week-long trading range and traded up to three-year highs.

The International Cocoa Organization (ICCO) has been forecasting a 100,000-tonne deficit for 2013-14, but most

analysts have trimmed that figure to a 75,000-tonne deficit. In fact, some simple math would seem to indicate that despite the uptick in grindings, the market is either balanced or in surplus.

Previous deficit forecasts were based on the ICCO estimate for a 2.7% growth rate for grindings. Even if the recent positive second-quarter results pull that up to a 4% growth rate, the unexpected strength in Ivorian arrivals overwhelms the increased consumption. ICCO estimates are based on a 1.55-million-tonne output figure for the Ivory Coast, and as indicated above, we're light years ahead of that.

Prices of the products, butter and powder, have remained stagnant. The butter ratio peaked last summer, but remains steady at multi-year highs. But powder is in ample supply, and that is reflected in its price. Chart 2 shows the combined ratio at depressed levels. If grinding profits are marginal, the magnitude of processors' bean purchases will dry up.

Looking forward, although early estimates for the 2014-15 Ivory Coast will surely be along the line of the fantastic performance of the old crop, there are concerns that El Niño could bring dry weather to growing regions.

We were stopped out of our short position, as per our June 9 recommendation. We're still not believers that the supply/demand fundamentals are bullish enough to have warranted the move to these levels – but for now, stand aside.

[By Sholom Sanik, August 1, 2014]

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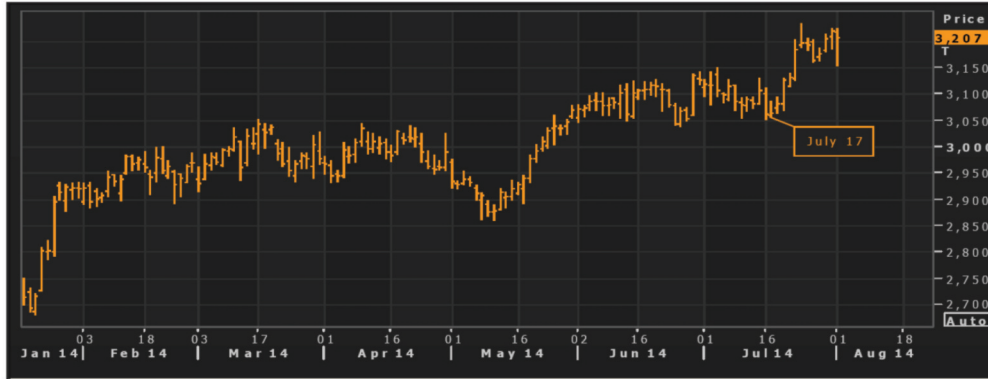
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Chart 1 – September cocoa



Courtesy Bloomberg LP

Chart 2 – Combined cocoa butter/powder ratio



CORN

Rebuilding corn inventories

With the US corn harvest just around the corner, it's fair to say that the 2014-15 crop "is made." Although the crop was planted on the least amount of acres since 2010-11, output is slated to reach 14.032 billion bushels, surpassing last season's record crop. Perfect planting and growing weather are expected to result in record yields. As of the most recent weekly crop-progress report, 73% of the crop was in good-to-excellent condition, compared with 59% last year at this time and compared with the five-year average of 55%.

In response, prices have fallen all the way back to their 2010 lows (Chart 3). Will we see further losses?

The August USDA crop report raised the bushel-per-acre (bpa) yield to 167.4, up from last year's 158.8 bpa yield. While that is substantially higher than the five-year average of 151.06, it is not necessarily representative of rapid technological advancement. Back in 2010-11 the bpa yield was 165. In the other years the crop experienced either challenging planting or growing weather.

For that matter, the yield estimate was actually a bit of a disappointment as the average of analysts' guesstimates was 170.5 bpa. Regardless, the market greeted the USDA estimate with a new low in price (Chart 4). Ever since, though, the market has traded sideways, indicating, perhaps, that the selling is done – for the moment anyway.

Another interesting wrinkle in the barrage of otherwise bearish supply-side news, which has not attracted much attention in the headlines, is that acreage may have been overstated. There is more than one US government agency that calculates acreage. Historically, the final numbers do not vary much from the accepted estimates that we see in the planting intentions report, which eventually become official USDA data. This year, however, the discrepancy is particularly large – the figure used in the crop report was the higher one – which leaves room for potential downward revisions to planted area.

Among other large Northern Hemisphere producing countries, China will likely see a 1.5% downward revision

to its crop because of drought. This should not affect global prices, however, because Chinese carryover stocks are ample – about 35% of usage – so they are unlikely to import more than the current estimate of 3 million tonnes.

The Ukraine is a significant exporter. Its crop fared better than originally expected when the conflict with Russia surfaced earlier this year. At 27 million tonnes, the crop is 4 million tonnes below 2013-14 output, still the second-highest crop on record.

Global ending stocks are estimated at 187 million tonnes, or 19.38% of consumption. That is a return to the early-2000s, pre-bull market levels. As such, we could see prices continue to drift lower.

One of the variables that could halt the slide – as mentioned above – is the potential for a downward revision in US acreage.

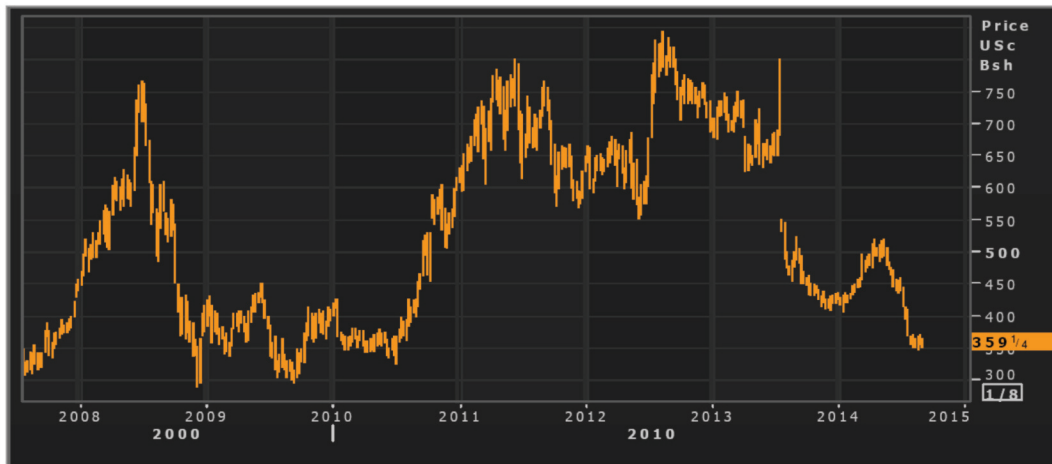
On the demand side, the USDA raised its US export forecast by 600,000 tonnes in the August crop report, to 43.2 mil-

lion tonnes. But that is still a very conservative estimate when compared with last year's sales of 48.8 million tonnes. It is far too early to draw any conclusions from early new-crop sales, which are typically scant in the corn market until the new marketing year begins on September 1. Stronger-than-expected foreign sales would certainly have a stabilizing effect on the market.

In conclusion, the bull market did its job. High prices have inspired production increases. After four seasons of either balanced or deficit production/consumption, the 2014-15 season will mark the second consecutive year of surpluses, leaving the overall outlook in the bearish camp. Still, with such steep losses in prices we do not see any obvious trading opportunities. Should you have been so fortunate as to be short, we would recommend placing buy stops at \$3.85 per bushel, basis December, close only. Otherwise, remain sidelined.

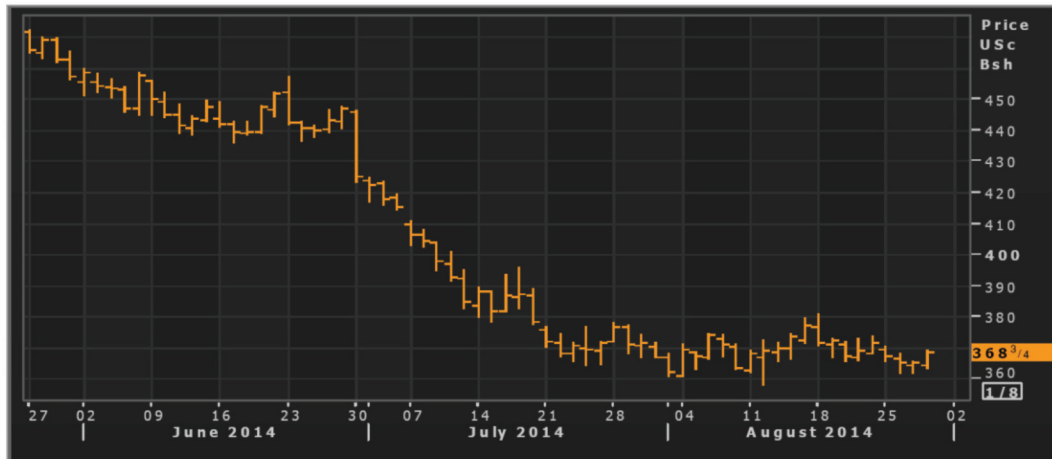
[By Sholom Sanik, August 27, 2014]

Chart 3 – Weekly corn



Courtesy Bloomberg LP

Chart 4 – December corn



Courtesy Bloomberg LP

COPPER

Is Chinese copper demand faltering?

Copper prices bottomed back in March, had a strong bull run, peaked in July, and have been groping for direction ever since (Chart 5). As a group, the base metals have been the strongest commodities for most of the year (Charts 6 through 10), outpacing energy and agriculture. With economies growing in some regions and stable in others, it would seem logical that industrial demand should be robust.

In the June 18 issue of *Focus on Futures* we presented a mostly bearish case. One of the concerns was that Chinese imports would be affected significantly when a scandal was uncovered. Incoming cargoes were being used for collateral to finance deals multiple times. At issue was the fear that banks would balk at financing questionable transactions and that as a result, import volumes would fall. Indeed, Chart 11 shows that imports have been trending downward.

Of course, the copper used to collateralize financial deals is only a part of the equation. China has been consuming over 40% of global annual production and most of that usage is attributed to industrial production. The key barometer is the housing market, where prices have been falling and home building has been slow. As strong as the US economy may be, and even if Europe begins to grow, any resulting increase in copper demand in those regions would be insignificant in terms of the potential drop in Chinese usage.

Having said that, the supply/demand indicators that we monitor continue to indicate a bullish market.

During June and July, global warehouse stocks began

to build, but that was short lived. Chart 12 shows that combined inventories at LME, Shanghai, and COMEX warehouses have begun to slip again.

On the production side, early forecasts for 2014 Chilean production called for output growth of 5% over 2013. That estimate has been eroding, first to 4% growth and more recently to 3%. Average year-over-year monthly production has been sporadic. There have been strong gains in some months, but others have shown flat to negative growth. Through the end of July, average monthly output is growing at only 2.07%.

Finally, you can bend statistics many ways, and with the uncertainty surrounding the stocks held at bonded warehouses in China, this is certainly the case in the copper market. But developments on the global balance sheet have been extraordinary, at least according to the International Copper Study Group (ICSG). In its August 20 update it showed an unexpected production/consumption deficit for May, which brought the year-to-date refined balance to a 466,000-tonne deficit. That compares with a 251,000-tonne surplus at this time last year. As recently as April, the ICSG estimated that 2014 would end with a 405,000-tonne *surplus*.

Despite the fact that the balance of evidence would seem to suggest that the market is tightening, the risk of a downturn in the Chinese economy – and the drop in imports that would almost surely follow – leaves us with no coherent trading strategy. Remain sidelined.

[By Sholom Sanik, August 29, 2014]

Chart 5 – December COMEX copper



Courtesy Bloomberg LP

Chart 6 – LME nickel



Courtesy Bloomberg LP

Chart 7 – LME weekly zinc



Courtesy Bloomberg LP

Chart 8 – LME weekly aluminum



Courtesy Bloomberg LP

Chart 9 – LME weekly tin



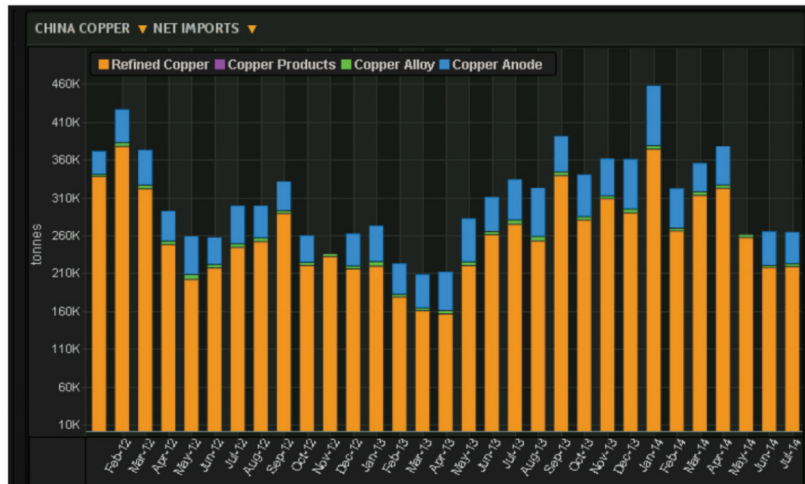
Courtesy Bloomberg LP

Chart 10 – LME weekly lead



Courtesy Bloomberg LP

Chart 11 – Chinese copper imports



Courtesy Bloomberg LP

Chart 12 – Combined global warehouse stocks



SUGAR

Bitter sweets

Sugar prices have taken a dive and are a stone's throw from the 14.70¢-per-pound lows set back in January (Chart 13).

The 2013-14 Indian crushing season got off to a late start because mill owners balked at paying hefty premiums for cane. Sugar prices were falling at a much faster pace than cane, and the millers were losing money. Eventually, the government stepped in by providing subsidies to the mills. Production was falling behind, but as the season progressed, the millers caught up and churned out a very respectable 25.3 million tonnes. With domestic consumption of about 23 million tonnes, the resulting surplus padded Indian inventories. Ending stocks for the marketing year, which concludes on September 30, are estimated at 7.5 million tonnes.

As we embark on the 2014-15 marketing year, the struggle between the farmers and the millers is playing out again. Millers have threatened that they will not begin processing cane if the gap between cane and sugar prices is as wide as it is now. With prices tumbling, it is hard to believe that a potential supply problem could be developing in the world's second-largest sugar-producing nation.

However, just since June, the spread between spot October and March has fallen by over a full cent (Chart 14), indicating that while there is ample sugar to meet the world's needs over the next several months, the bounty may have a limited life.

With another round of government intervention, the millers in India may muddle through again. The broader issue, however, involves not only cane prices but also the rising cost of production in general. One analysis from an Indian farm industry group claims that labor, fuel, and fertilizer input costs have risen by 50% over the past five years.

The estimates for 2014-15 Brazilian output vary widely, from 31 million tonnes to 36 million tonnes. By taking a rough average of 33.5 million tonnes, output will be roughly the same as in 2013-14. Drought is an ongoing problem, which has kept Brazilian cane

crops at roughly the same level over the past few seasons.

The problem with high cane prices and rising production costs is similar in Brazil, but it would seem that the industry in Brazil is in a better financial position. That doesn't mean that they are profitable, only that the problem is being pushed forward. Ultimately, it is hard to see any growth in an industry that is losing money. To boot, there is talk that the Brazilian government is considering raising the minimum ethanol blend for motor vehicles from the current 25% to 27.5%. We expect that the ratio of ethanol to sugar output will rise from its present level of about 54/46 to levels that we've seen in previous years of, say, 60/40. That would lower the exportable surplus of sugar by several million tonnes.

Global demand is growing at about 2.5% per annum, but production growth is stagnant. We have moved from a 10-million-tonne global production/consumption surplus in 2012-13 to a 3-to-4-million-tonne surplus in 2013-14. Forecasts for the upcoming 2014-15 season range from a 500,000-tonne deficit (Czarnikow) to a 1.3-million-tonne surplus (International Sugar Organization).

Another drag on the market has been Thailand's surplus stocks, which it is trying to move.

We were stopped out of our long October futures positions, and our call options are eroding. Commodity funds are firmly in control and greet every attempt at a rally with further selling. The net-short speculative position is almost as large as it was back in January (Chart 15). All factors considered, it is hard for us to believe that being short sugar at 15¢ per pound will prove to be a sound trading strategy. Of course, with October going off the board, the problem of trying to find a bargain lies in paying up for the huge contango, as illustrated above. We maintain our recommendation of buying long-term call options. July 21.00 calls are currently trading at about 30 points.

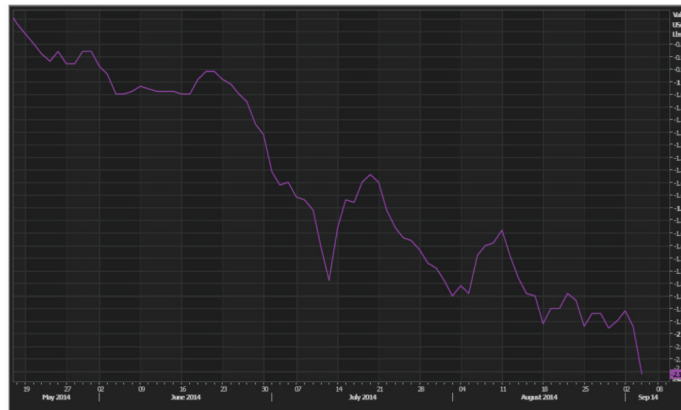
[By Sholom Sanik, September 5, 2014]

Chart 13 – Nearest contract ICE sugar



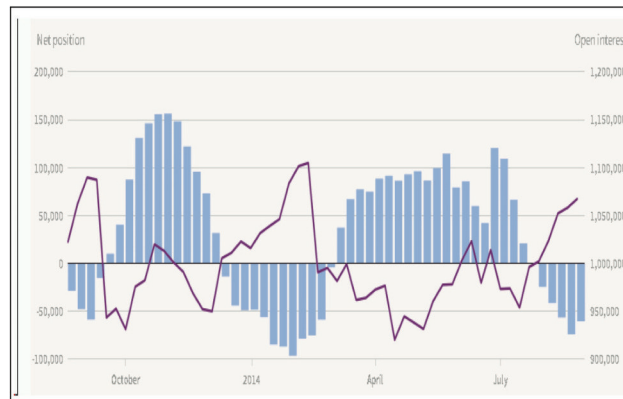
Courtesy Bloomberg LP

Chart 14 – October-March ICE sugar spread



Courtesy Bloomberg LP

Chart 15 – Speculators ICE sugar net-short position



Courtesy Reuters

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