

# FRIEDBERG'S

## FOCUS ON FUTURES

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## The struggle to maintain a balance between Brazilian sugar and ethanol

The sugar bear had a brief respite this past fall when poor harvest weather in Brazil threatened the quality and quantity of the crop. After trading down to multi-year lows in early September, prices rallied 10% through mid-October. Weather conditions improved, and prices came right back down to test the 19¢-per-pound level. Several months ago, weather conditions were so poor that analysts put the Brazilian crop – and by extension exports – significantly behind the previous year. Now that the harvest of the Center-South region is complete, crop and export estimates are actually ahead of the 2011-12 season.

Most other output developments have been to the bullish side, though.

Still in Brazil, 90% of the crop is grown in the South Center. The balance is grown in the north, and those regions experienced extreme drought during the growing season. In some areas, as much as 30% of the crop was lost. On average, the losses are expected to be up to 15% of output for the region, or 1.5% of total Brazilian output. It's not an overwhelming amount, but enough to mitigate some of the effect of the extraordinary recovery of the South Center.

The 2012-13 Indian crop suffered from a below-average monsoon. As we guessed in previous articles on sugar (see *Focus on Futures*, August 31), estimates that put this year's output on par with the previous year's results of 26 million tonnes were impossible to achieve. Indeed, current estimates have fallen to as low as 23 million tonnes, which is dangerously close to domestic consumption levels. That would cast some doubt on the wisdom of the liberalized export policy. Ending stocks for the recently completed 2011-12 marketing year will be about 6 million tonnes, which is adequate, but makes it imperative for the coming 2013-14 crop to have a proper monsoon season.

Thailand had record output for two consecutive years of about 10 million tonnes in 2010-11 and 2011-12. It was a sudden jump of about 40% over the average of 7 million tonnes that the country had produced in previous years. The pattern was expected to continue into 2012-13, but precipitation was insufficient, and as a result, output will be close to 1

million tonnes below early season forecasts. Thai exports will still be over 7 million tonnes, but about 1 million tonnes less than in 2011-12.

Several years ago, as much as 65% of all cane grown in Brazil was dedicated to ethanol production. As sugar prices exploded towards 30¢ per pound and beyond, profitability shifted towards sugar production. At present only 51% of the crop is being turned into ethanol. That is sure to change.

First, the government is expected to raise the minimum ethanol-to-petroleum ratio from the 20% to 25% range sometime in the new year. More importantly, though, the end of the ethanol-subsidy era in the US and a disastrous US corn crop this past summer have sparked a wave of US imports of Brazilian ethanol.

Several months ago, 2012-13 Brazilian ethanol exports were estimated at 2.2 billion liters, up from 1.9 billion in 2011-12. Roughly 75% of exports are destined for the US, but that ratio is likely to grow. The export estimate is being revised upwards, with some analysts putting the figure at 2.55 billion liters. And there is ample evidence that these estimates are conservative. September exports were 452 million liters, up from 174 million liters a year earlier. In October exports reached 492 million liters, compared with 247 mil-

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lion liters in October 2011. Expect these developments to tighten up Brazilian ethanol supplies and to accommodate a considerably higher ethanol-to-sugar output ratio.

On November 15 the International Sugar Organization raised its estimate for the 2012-13 global sugar surplus to 6.18 million tonnes, up from a previous forecast of 5.86 million tonnes. While we can't disagree with this forecast under current conditions, we believe that Brazilian sugar supplies –

the single most important fundamental for the global sugar market – will not be as plentiful heading into the coming months.

We've struggled with a long position in sugar, which we view as still being a long, drawn out bull market. Maintain the 18.5¢-per pound stop, basis the nearest contract, we recommended on August 31.

[November 27, 2012]

Chart 1 – March sugar



Courtesy Reuters

## **SOYBEAN OIL**

### **Strong demand for soybean oil seen in US exports**

Despite the severe drought in the Northern Hemisphere this past summer, the global supply of vegetable oils is actually expected to grow in the 2012-13 marketing year. However, the recent unusual activity in the US export market underscores the fact that the market for the various major oil types does not necessarily overlap. US export volumes of soybean oil have been explosive. A comment in a recent report by the German oilseeds analyst *Oil World* summarized the situation well: “This illustrates that the substitutability of the individual oils is having its limits.”

Consider these statistics. Since the beginning of the marketing year, which began on October 1, US exporters have sold 590,000 tonnes of soybean oil, compared with only 140,000 tonnes at this time last year. In historical terms, these sales levels are not without precedent. In 2009, commitments at this point of the season were 716,000 tonnes, and in 2010 they were even higher, at 796,000 tonnes. This year's sales are still worthy of attention, though. At this time of year

in the previous 10 years – including the extraordinary sales seen in 2009 and 2010 – commitments averaged only 312,000 tonnes by the beginning of December.

The USDA had been forecasting surprisingly low US final sales for 2012-13. Until now, the estimate for the whole season was below year-to-date commitments. In the December crop report, the estimate finally caught up to reality, to some degree. The estimate was revised up by more than 50%, to 820,000 tonnes. That compares with final sales of 660,000 tonnes for 2011-12, but is considerably below 2010-11 sales of 1.47 million tonnes. Average final sales for the previous 10 years was 932,000 tonnes. We believe it is unlikely that sales will not exceed the 10-year average, given that sales to date are already double the 10-year average.

After suffering through a scorching drought this past summer, the 2012-13 US soybean crop harvested in the fall turned out much better than anybody believed it could. The November USDA crop report raised its estimate for the crop

to 80.86 million tonnes, which is 10% above the lowest estimate of the season.

Soybean output from both Brazil and Argentina is expected to stage a dramatic recovery from last year's severely weather-compromised crops – up 35% for Argentina and 22% for Brazil.

The issue is that soybean oil supplies have been run down. Even with the better-than-anticipated crop in the US and the record crops coming out of South America, the market for oil is tight. The USDA estimate for 2012-13 global ending stocks – even after including the large bean crop harvested and to be harvested in the spring – is 3 million tonnes, or 6.9% of consumption, a record low. That is down from 9.1% in 2011-12 and an average of 9% of usage in the 10 previous marketing years.

Chart 3 shows the soybean/soybean oil price ratio. It illustrates quite clearly what's been happening. Up until this past summer, oil supplies were plentiful, so prices were depressed *vis-à-vis* bean prices. Now that demand seems to have been revitalized, prices have begun to strengthen.

We've definitely become bullish on this market. What makes this a particularly attractive long is that it is hardly a crowded trade. Open interest is at the lower end of the range of the past two years (Chart 4). Even more appealing is that the funds are short (Chart 5). If we're right about our read of the fundamentals, the ensuing short-covering rally alone makes for an interesting trade.

Buy March soybean oil. Place initial stops at 49.5¢ per pound, close only.

[December 12, 2012]

Chart 2 – March soybean oil



Courtesy Reuters

Chart 3 – Soybean/soybean oil ratio



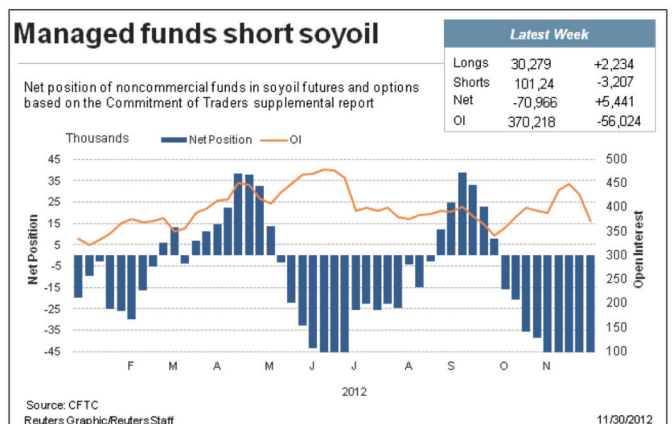
Courtesy Reuters

Chart 4 – Soybean oil open interest



Courtesy Reuters

Chart 5 – Commodity funds net short position



Courtesy Reuters

**COTTON****Production set to plunge**

Cotton prices have firmed up towards the high end of the recent, relatively tight range. In an environment in which many of the commodity bull markets – such as some of the grains and softs – may be unraveling, cotton has been a standout. And on the surface, its resilience is counterintuitive.

The December 11 monthly USDA crop report was actually friendly for cotton prices. Ending stocks for 2011-12 were revised down by 450,000 bales. A small increase in the 2012-13 production estimate was overshadowed by an even larger increase in consumption. As a result, the estimate for 2012-13 ending stocks was revised downwards by 630,000 bales, to 79.64 million bales, or 74.8% of usage, down from last month's estimate of 75.49%. However, that figure still represents burdensome inventories. We are still much higher than last year's 67% of usage and dramatically above the 10-year average of 51%.

Market participants have had the opportunity to digest all the information regarding the size and quality of the new crops, which must last through to Autumn 2013. In addition, they've had a chance to contemplate the monstrous global stockpiles. And yet the market has built a base that stretches back to early summer and seems to defy the implications of the supply/demand fundamentals.

US exports have been steady, but not overwhelming. Average weekly commitments since the beginning of November have been 338,000 bales, which is above average for this time of year. Total year-to-date commitments, however, stand at 7.8 million bales, down about 20% from last year at this time. Last year there were a few weeks of extraordinary sales, and then the market sputtered, with little new-sales activity for the balance of the marketing year.

According to official statistics – which is the same data used for the USDA balance sheet – the Chinese have ample stocks. So it's a bit puzzling why they have been buying cotton abroad. The strength of US exports hinges almost exclusively on Chinese purchases. It remains to be seen if their enigmatic buying will continue. Demand is a wildcard.

As we discussed in the October 25 issue of *Focus on Futures*, cotton prices may remain high in historical terms, but they are actually very unattractive for farmers, for two reasons. First, current prices can't be compared with the pre-2008 period, because production costs have skyrocketed. At current prices, profit margins are very slim. More significantly, while grain prices have come off their highs, it is still more profitable to plant corn, soybeans, and wheat.

There is talk that in some regions farmers will plant 50% fewer acres to cotton than they did last season. Some analysts are forecasting that total US cotton area will fall by close to 30% from last year's 12.36 million acres, which would be a 30-year low.

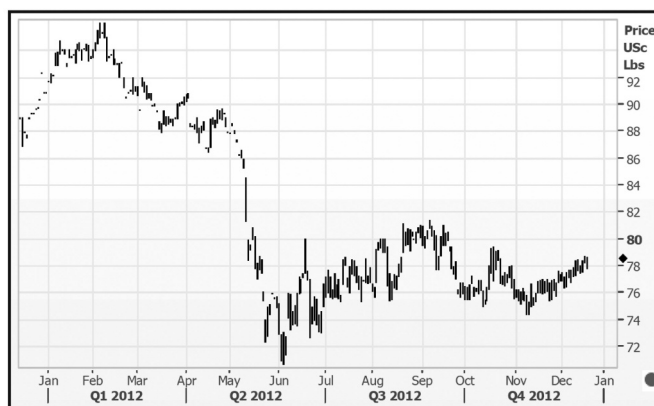
Furthermore, even if the gap between cotton prices and alternative crops narrows over the next couple of months, there is a point at which the window for cotton planting closes. Corn and soybean plantings require investment in seed, and for regions where corn and soybeans are planted early, that investment is usually made by early February. At that point, farmers will not return to cotton. The longer cotton prices remain confined to the present range, the greater the probability of a dramatic fall in acreage. These economic realities are likely to prevail among other cotton-growing nations.

As we mentioned, it's hard to know whether demand can snap back to 2010-11 levels. If it does not, we still don't think prices will fall much further, because the shift from overproduction to underproduction is expected to happen in just one season. If demand surprises, look for much higher prices.

We advised rolling long positions in the December 2012 contract all the way to new-crop December 2013. The near months could be more vulnerable to an abrupt halt in Chinese buying. Next year's crop months will be more reflective of the much smaller output we expect to see.

Maintain sell stops at 72.5¢ per pound, basis December 2013, close only. [December 29, 2012]

Chart 6 – March cotton



Courtesy Reuters

**COPPER**

**Are bullish statistics misleading?**

Copper prices finished 2012 on a strong note and sprinted to multi-month highs to ring in the New Year (Chart 7). Aside from piggybacking on the stock market rally, the strength in copper prices has been underpinned by what seem to be some bullish supply and demand fundamentals.

Expectations for growth of 2012 Chilean production ran high, even as recently as several months ago. Early estimates put output up by as much as 10% over 2011. Between June and August, monthly production figures averaged 7.7% growth. It seemed as though some of the chronic problems such as labor strife and weather were not hampering operations and that the optimistic estimates were achievable. With data current through the end of November, year-over-year production is up only 2.85%, however, which leaves the promise of explosive growth in Chilean output in doubt.

While no region has experienced runaway growth, economic data are showing moderate recovery, at least enough to keep demand in industrial commodities steady. According to the International Copper Study Group's (ICSG) most recent report, which covers the period between January and September 2012, global usage for refined copper grew 5.5% over the same period in 2011. Production of refined copper grew during this period as well, but by only 1.7%, ostensibly creating a drawdown in global supplies.

ICSG estimates that up to the end of the third quarter of 2012, the global market is running a huge production/consumption deficit of refined copper to the tune of 594,000 tonnes, compared with a deficit of only 74,000 tonnes at the same time in 2011.

Global warehouse stock levels tell a bit of a different story, though. Although not necessarily a completely reliable indicator – because it's hard to know how much of

warehouse inventory has already been sold forward – it should be somewhat disconcerting to bulls to see stocks rising at all three major exchange warehouse systems. Chart 8 shows combined LME, Shanghai, and COMEX stocks have increased since this past summer by over 40% to the highest level in almost a year.

Regardless of the broader recovery in copper demand indicated by the ICSG data, this market's consumption fortunes are tied to China. The most recent import data show that Chinese imports of refined copper rose 13.5% from October, but were down 27.7% year-over-year (Chart 9).

It is hard to justify copper at \$3.50 to \$4.00 per pound – or even at lower prices – without the influence of Chinese imports. The average cost of production – even after including copper from mines with lower ore grades in Chile, which is more expensive to extract – is still far below current prices. If this commodity lived by the rules of many other commodities, prices would have to plummet to catch up.

Peru is the world's third-largest copper miner and currently produces 1.3 million tonnes, or 8% of the world total. Newmont Mining is pouring a massive amount of capital into the Peruvian mining sector. There are hurdles to overcome, primarily in addressing environmental concerns. However, if plans proceed as expected, output could double over the next two years. Even if the deficit number were accurate, an influx of such magnitude would handily erase any shortfall.

Chart 10 shows that funds are net long, but not overwhelmingly. A continuation of the rally in the stock market can easily carry copper prices above the \$3.85-per-pound highs seen this past fall – and beyond.

Remain short. Maintain stops recommended on October 17 at \$3.85, basis the nearest contract, close only.

*[January 8, 2013]*

Chart 7 – March copper



Courtesy Reuters

Chart 8 – Global warehouse stocks

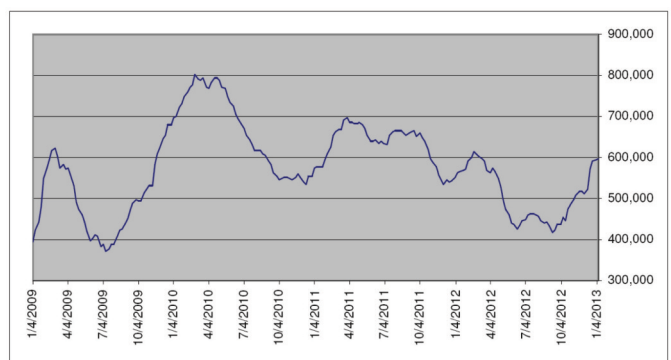
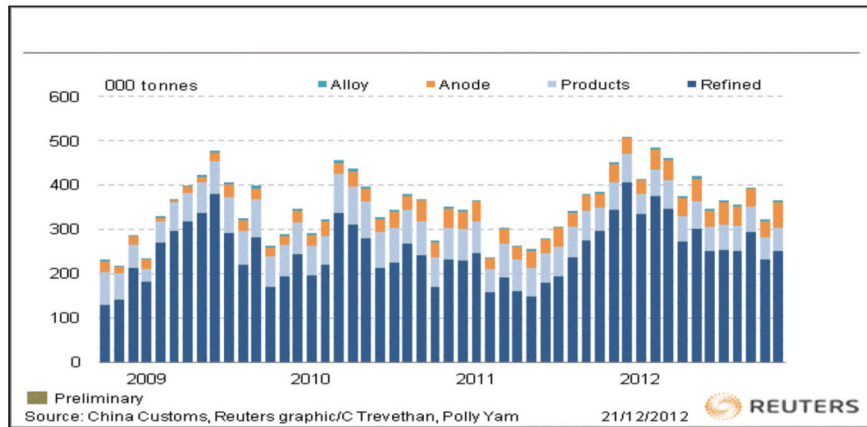
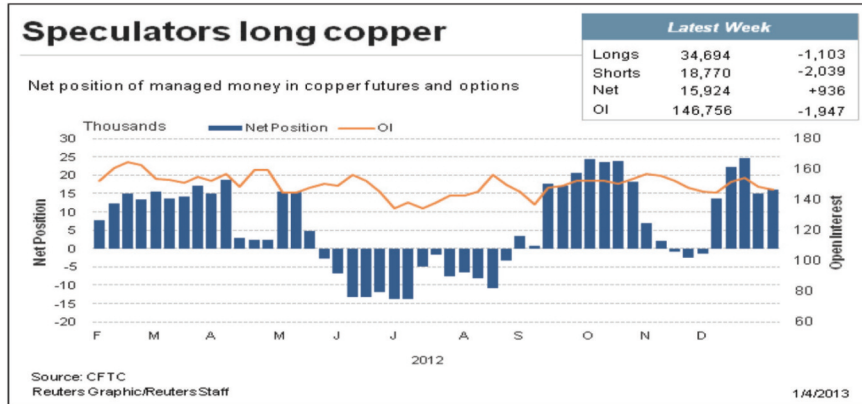


Chart 9 – Chinese copper imports



Courtesy Reuters

Chart 10 – Net traders' position



Courtesy Reuters

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