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C O F F E E

S I T U A T I O N

R E P O R T

The fundamental factors that ignited coffee's spectacular 300% rise, (basis spot price, Colombian, "Manizales", New York), since mid-July 1975 began with the arctic air that destroyed the better part of the Parana crop on July 17th of that year. There followed: 1) a series of upwardly revised Brazilian - and subsequently other producer nations - export taxes; the latest on January 17th, being from $100.00 to $103.00 per 60 kilogram bag; 2) trade reports that Brazil's 1976-77 crop would be less than 1/3 normal size; 3) subsequent trade reports that Brazil's 1977-78 crop could be as low as 11.5 million bags or 3.5 million bags lower than earlier forecasts; 4) too much rain in Colombia; 5) too little rain in other producing nations; 6) civil war in Angola; 7) speculative buying.

Coffee is now the first commodity since sugar in 1974 to move from the back pages of the business section to front page headlines. That, in itself, is noteworthy! Of course, the controversy that has suddenly blossomed into the public domain is the same as the one that has mesmerized trade experts since prices began their virtually vertical rise; "why?" and "how high?"

The analyst attempting to answer these questions is confronted with two essential problems. Primarily there seems to be, especially in the case of supply data, an absence of a single, reliable source of information. As such, figures often differ depending upon who offers them. The well publicized controversy over the Brazilian crop - harvesting was completed over four months ago - between the USDA which offers as their estimate 9.5 million bags, and the IBC which offers as theirs, 6.4-6.6 million bags, is only one example of many. One quickly comes to understand that not only are there several "reliable" sources, but that each has its own reasons for biasing its reliability. In addition, the traditional method of organizing coffee data often seems confusing.

Taken all together, the trader facing the coffee market for the first time must feel like Theseus staring into the door of the labyrinth.

A maze leads ultimately to a wild beast - in this case a bull - ferocious because he's old. Be advised, his end is drawing near.

1975 - 76

SUPPLY

1. Carry-In	Brazil	20.6*
	Rest of World	13.3
	TOTAL	33.9
2. PRODUCTION	N. America	13,659**
	S. America	35,000
	Africa	18,609
	Asia	5,530
	Oceania	692
	TOTAL	73,490
	TOTAL SUPPLY	107.4

DEMAND

1. Producer Nations		
	N. America	3,482
	S. America	10,503
	Africa	1,331
	Asia	2,295
	Oceania	16
	TOTAL	18,008
2. CONSUMER NATIONS	USA	21,833
	EEC	22,458
	Rest of Europe	9,048
	Others	5,210
	Other N. Hemis.	890
	TOTAL	59,475
	TOTAL DEMAND	77,683
3. CARRY OUT:		29.7

* In millions of 60 kilo bags

** In thousands of 60 kilo bags

1976 - 77

SUPPLY

1. Carry-In		29.7
2. PRODUCTION	N. America	15,525
	S. America	20,175
	Africa	18,997
	Asia	5,925
	Oceania	625
	TOTAL	61,247
	TOTAL SUPPLY	90.9

DEMAND

1. Producer Nations	At Average Prices	$220/lb	$250/lb	$280/lb
	N. America	3,294	2,965	2,636
	S. America	8,623	7,761	6,899
	Africa	1,027	924	822
	Asia	2,249	2,024	1,799
	Oceania	541	487	433
	TOTAL	15,734	14,161	12,589
2. CONSUMER NATIONS	USA	17,466	15,270	13,973
	EEC	16,843	15,046	13,250
	Rest of Europe	6,813	16,086	5,360
	Others	3,908	3,490	3,074
	Other N. Hemis.	623	522	481
	TOTAL	45,653	40,894	36,138
	TOTAL DEMAND	61,387	55,055	48,727
3. CARRY OUT:		29.6	35.9	42.2

SUPPLY

1. If the dispute over stocks in producer nations could be expressed in dramatic form we, the audience, would be watching a farce. How else can one explain Brazil's announcement at the ICO meetings held in London, the last week of January, that it held <u>a full 5 million bags more than it had less than a month before</u>. One can only seek solace in history. In 1954, the year of the last great price rise - the frost occurred in July, 1953 - the IBC steadfastly maintained throughout the entire year that it held 2.0 million bags in stock. Suddenly, beginning in July, it issued a stream of proclamations, and subsequent denials, that its stocks ranged from between 2.7 to 4.5 million bags. (They settled, for all practical purposes at 2.7.)

So hysterical have things become that when we phoned the USDA for their stocks figure they stated it was unavailable for publication due to extensive reworking they were performing in preparation for forthcoming congressional hearings on the subject.

We do not wish to sound like detectives, whose task it is to determine who tells the truth and who lies, however, considerable research as to reliability has been necessary. Our original carry-in figure for 1975-76 is authorized by trade sources which, historically, have evidenced as high a degree of accuracy as anyone associated with the bean.

North America

2. The USDA reports increased fertilization is assisting output in much of Central America. Weather conditions have been benign. Mexico, from whom the U.S. imports 20% of its coffee, has enjoyed a good harvest as its coffee institute, inspired by current high price levels, has offered effective encouragement to growers. This trend should continue and grow through the 1977-78 crop year.

The recent outbreak of rust in Nicaragua initiated sensational publicity. The facts are these: 1) it will not effect the current crop; 2) although it is small, it is extremely virulent and should be watched closely through 1977-78. It ought to be noted that Colombia has managed to live successfully with inbred rust in certain areas for years.

South America

South American production has decreased by 53%. All of this is well known, hence, for present market purposes, valueless since its been long since discounted.

Trade estimates for Brazil's next crop range from between 13-16 million bags. Most traders are, assumedly, remaining uncommitted at this point as almost a half year remains before harvesting begins in July. Sao Paulo state now has almost 800 million trees, almost as many as before the frost.

In Colombia as in Central America better farm management is being practiced and the rate of proliferation of the higher yielding Catura tree which was introduced just recently is being watched with hopeful eyes.

Africa

The African figure can be expected to increase next crop year, and indeed, may even be revised upward this year as Angola, which has suffered labour difficulties as the main effect of its civil strife, can be expected to return to more normal conditions.

3. Of one thing we can be absolutely certain: <u>thus far, there has been no shortage</u>. If there had been, backwardation, ie. spot selling at premiums to futures contracts, would have set in. This has not happened. Therefore, we must conclude that the spot market has risen solely in anticipation of short supply. This type of price movement in a free market place seemingly belies conventional thinking. A spot commodity cannot anticipate. Its life exists, always in the present. Either it is in short supply, equal to demand, or in abundance, <u>now at this moment</u>.

The reason for this enigma is that the present market place is not functioning freely. Spot prices are, one might say, manipulated by producer-nation governments who are rationing out demand by, as previously mentioned, raising ever higher their export taxes, and minimum export price levels. More than 1/3 of the current price of Santos is composed of export tax. Trade sources report that while export regestries have recently been limited, there has been substantial retail activity between exporters.

In the final analysis how can there have been a shortage? Last year's world exports of 58.29 million bags ranked second only to the record 62.58 million bags exported in 1973.

DEMAND

1. The three columns on the demand side of our table, crop year 1976-77, are based upon our own elasticity curve and are adjusted by per capita GNP using the U.S. as a comparison base. Producer nations have been left unadjusted by per capita GNP because such considerations are, on an average, balanced out by their traditionally strong coffee drinking habits.

2. Ultimately, of course, resistance will originate at the consumer level, and for the following reasons:

a) Because of the cents-off coupon - which should be watched carefully to see at what point and to what degree they become less available - and loss leader method of marketing, consumers are, generally speaking, more price conscious of coffee than they are of other food items.

b) The consumer boycott that began in New York is not an end in itself but a means. The hyperbole that it generated in the media will change price consciousness into price fear. Consumers will begin by stockpiling mini-inventories in their kitchens and end by cutting their consumption substantially.

c) Price increases are passed onto the consumer in accumulated clumps. Each incremental increase during the current bull market, being proportionate to wholesale price jumps, has not been insignificant. And still retail prices have yet to reflect their wholesale counterparts. Trade experts estimate that if they did, housewives would be looking at coffee listed at $5.00 on supermarket shelves.

Looking; not purchasing. Increases of such large degrees and to such high levels are, above all else, too shocking. The trend has already begun. In the 12 months through September 30th, 1976 retail case movement declined by only 2% while in the subsequent 3 months it declined by 7%.

In late August, 1954 the New York Times assessed the role of the American consumer vis a vis the bull market that had just ended thus: "Unofficial estimates of the reduction in coffee consumption in this country when (retail) prices hit $1.40 per pound ran as high as 25%." It is of interest to point out that $1.40, adjusted by the wholesale price index, equals approximately $2.80. However, when one allows for increased income, ie. adjusting by nominal GNP which automatically factors in both growth and inflation, $1.40 equals slightly less than $4.80. This is less than what, as we said, trade experts estimated retail prices would be if they accurately reflected current wholesale prices. Its safe to conclude, therefore, that consumer demand will not tolerate prices much above current levels.

CONCLUSION

Not surprisingly, we conclude this bull will be its own matador. The question remains: when will the suicide take place?

Backwardation is the key. What will ultimately occur, and when, can, to a certain degree, be ascertained by looking back once again to 1953-54.

End of Month, (except as noted), Spot & Six Month Forward Futures Prices, 1953-54. *

	Spot	Futures	Differential
June, '53	54.80¢	53.25¢	1.55¢
July	61.80	60.04	1.76
August	61.20	57.74	3.46
September	62.00	57.39	4.61
October	61.00	56.55	4.45
November	57.75	57.40	.35
December	64-5/8	65.98	-1.35
January, '54	71-1/2	71.05	.45
February	82.00	80.75	1.25
March	92.75	91.75	1.00
April	88.25	87.35	.90
May	86.75	85.50	1.25
June	88.50	84.90	3.60
July	86.00	83.24	2.76
August 10	86.00	81.55	4.45
August 12	86.00	80.70	5.30
August 13	86.00	78.70	7.30
August 31	61.20	57.74	3.46

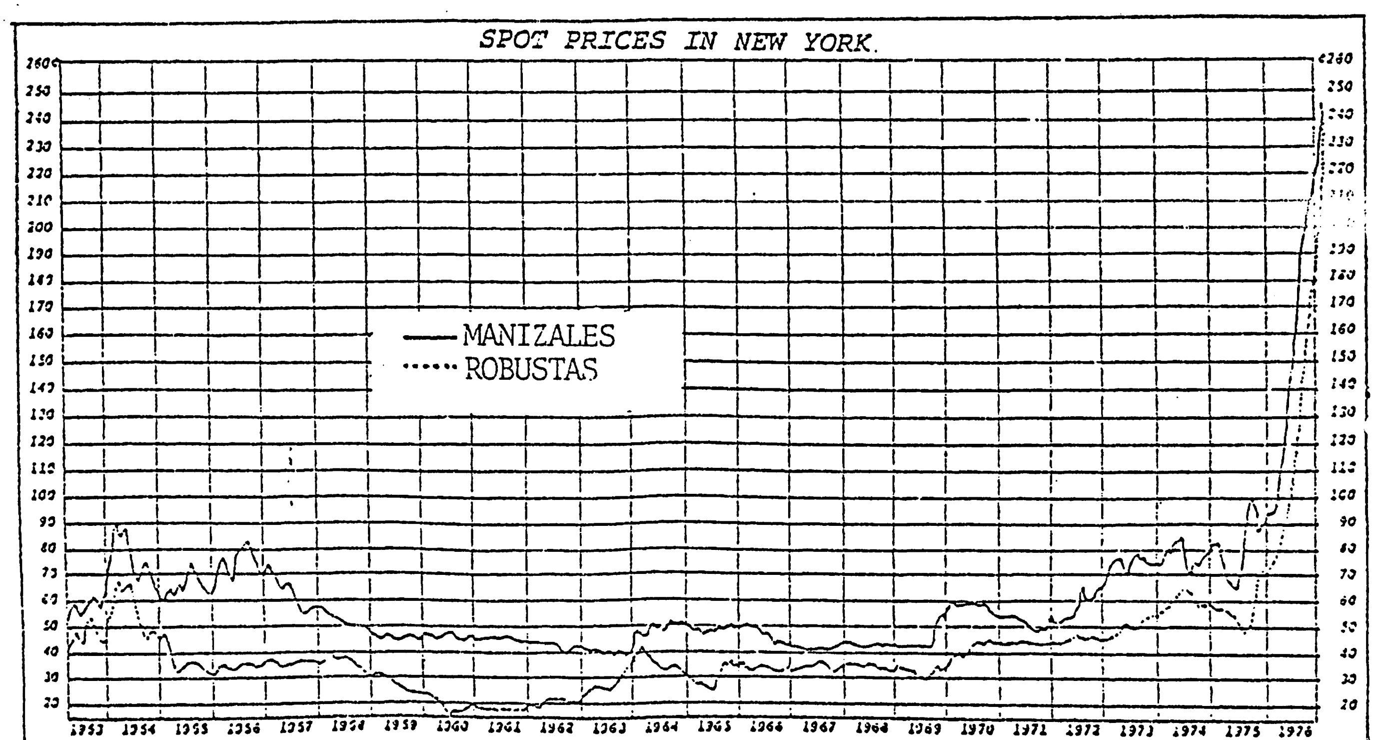
*Daily Limit until April: 2¢. After April: 1¢.

The bull market began in July, already in a state of backwardation as a result of the residual effects of the Korean war. Backwardation widened initially and then contracted beginning in November, and even inverted into a contango during December as Brazil raised her export levels and buyers believed the market would still go higher. Brazil continued to raise her minimum level until mid June when it announced, effective July 1st, it would raise them for what would be the last time, to 87¢ per 60 kilo. bag. However, by July backwardation had widened and Brazil was forced to begin purchasing all coffee which private exporters could not sell above that price. Through July backwardation continued to widen so that by August importers no longer purchased spot supplies at all but clearly intended to wait. This put pressure on the spot price. Brazil could no longer sell her coffee. The market collapsed and the export requirement was lowered to 61.20¢ by the end of the month.

Our feeling is that the end will come at around the same time it did in 1953-54; sometime around late July or early August, after the threat of another frost passes. Between now and then prices will move even higher as roasters can be expected to stockpile to insure themselves against a possible longshoreman's strike in New York. (Their contract is due for renewal in September.) The effects of this will be to further aggravate demand thus causing stocks to increase at the rate indicated in the table on page 2. To reiterate briefly, should wholesale prices average present levels - 2.40/lb. - stocks will increase 8.7% despite the admittedly precipitous decline in Brazilian production.

Once the top is reached prices could decline to 80¢ within eighteen months.

STRATEGIES



1. Wait until the <u>May-July</u> period, (once backwardation sets in), to sell short. <u>We favour</u> sale of the September contract in London.

As the chart on page 6 indicates, Robustas coffee, the deliverable grade in London, normally trades at a discount to Manizales, the deliverable grade in New York. One notices the spread tends to contract during periods of rising prices and widen during periods of declining prices. The degree of contraction during the present bull market can be seen more clearly by referring to the table comparing the values of the nearest futures contracts on the two exchanges over the last 7-1/2 months.

Date	Ldn. Price	Spot Rate	Ldn. Price	N.Y. Price	Diff. ¢ per lb.	% Diff: Ldn. vs N.Y.
Feb 15	£3,182	1.70225	¢ 245.69	¢ 243.92	-1.77	100.73
Jan 31	2,801	1.71425	217.80	222.35	4.55	97.95
Dec 31	2,794	1.70200	214.68	228.55	12.87	94.37
Nov 30	2,345	1.66750	175.16	187.00	11.84	93.67
Oct 29	2,125	1.66175	156.15	178.50	22.32	87.40
Sep 29	1,769	1.77450	133.80	166.15	32.35	80.50
Aug 31	1,555	1.78425	125.16	165.00	39.84	75.85

The spread has contracted to the point of inversion. Essentially, what has happened is that, in the current buying hysteria, roasters felt they were enjoying an edge by purchasing what is traditionally a cheaper grade coffee. Their abandonment of discretion has made the supply of Robustas an even bigger question mark in the eyes of roasters than it usually is.

If the supply status of Robustas <u>is</u> a question - and it shouldn't be - the answer is obvious. There was no freeze in Africa. It was in Brazil. The depletion of stocks will be of Brazilian stocks in particular and of Arabicas, ie. New York deliverable grades in general.

Taking this latter fact into consideration along with the traditional relationship between the two coffees as outlined above, provides our reasoning for shorting London.

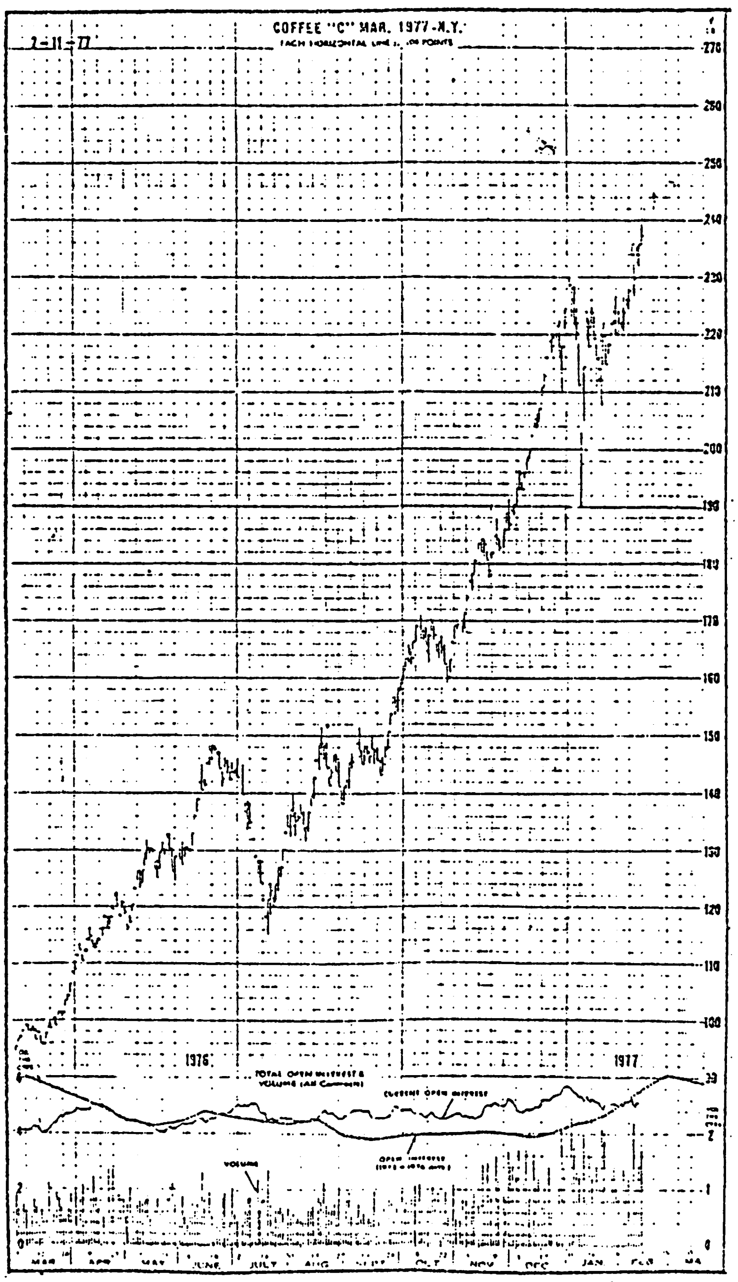
(Once the top is reached we will consider adopting a spread position - short London/long New York - and advise you keep in contact with us for counselling.)

Assuming a short position in London implies heding the British Pound as an insurance measure. At present levels five London Coffee contracts have a value approximately equal to three British Pound contracts on the IMM, (£79,550 versus £75,000).

2. Purchase March '78 Put Options on a Ⱡ100 scale up during the next few months, (cf. enclosed bulletin on option trading). March '78 Puts are presently trading in the Ⱡ520-Ⱡ525 range which is equivalent to approximately $4,400.

3. Buy March '78 Call Options <u>now</u> and short against them on every upside move of Ⱡ100. Calls cost approximately the same as Puts.

4. Sometime in the May-July period those with inventories should grant call options thereby insuring their inventories by taking in very substantial premiums. Again, please refer to the enclosed bulletin on option trading.



Coffee is traded in both London and New York. The New York, 'C' contract trades in units of 37,500 pounds in approximately 250 bags. Prices are quoted in dollars and cents with a minimum fluctuation 1/100 cent equal to $3.75. Trading is typically conducted for delivery during March, May, July, September and December. The maximum permissable move from the preceding day's settlement price is three cents except in the spot month when the limit is removed.

Trades on the London Coffee Terminal Associations are conducted in contracts of five long tons. Prices are quoted in pound sterling per long ton. The market trades on a morning call followed by free trading and a mid-day call. In the afternoon there is a P.M. call followed by another period of free trading and a closing call.

	MARGIN	MAINTENANCE	COMMISSIONS (round turn)
London	£ 1,600	£1,600	£ 26.00
New York	$12,000	$9,500	$100.00

Note: unlike New York, London does not credit a profitable trade until the position is liquidated. It does, however debit an unprofitable one so that margin is required as the market moves adversely.

All statements expressed herein, while not guaranteed, are based on information considered reliable and are believed by us to be accurate.

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The authors wish to express their thanks to George Murphy of Paton & Co., N.Y. and Wm. Scandrett of Hayter & Scandrett, Toronto, for providing them with valuable information which they were unable to obtain elsewhere.