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The copper market in transition

Copper prices peaked at $4.15 per pound this past spring and have since tumbled by about 25%. Just about every raw material on the board participated in the broad bull market in commodities, but copper – as well as the other base metals – stood out in sheer magnitude. The steep ascent from $2 to $4 per pound occurred in a period of just over 2 months. Copper and nickel prices increased seven- and eight-fold respectively since the powerful bull run began in 2001. For the moment, copper is still sporting a $300 handle, but recent developments could be providing an early warning signal that this market has had its day and is in retreat.

Unlike the petroleum market, where geopolitical fear-premiums enhanced bullish fundamentals, copper consumers had to work through a massive deficit that forced them to drive prices through the roof. We are now looking at some hard evidence that the tightness has abated. This leaves current price levels still dramatically above the average cost of production and therefore vulnerable to a nasty tumble.

Considering the extraordinary profitability of mining copper at these prices, we've reasoned all along that we would surely come to a point at which output would overwhelm demand, even in an environment of growing consumption. But growth in Chilean mine output has been sluggish, primarily because of labor strife and significant production problems related to an accident at the massive Chuquicamata mine. September and October output were down 9.8% and 12.3% over the previous year, respectively. The expected boom in copper output has not been canceled, however, only postponed. October saw a recovery, with an increase of 7.4%.

Although output has not lived up to its potential (yet), the International Copper Study Group's (ICSG) data indicate that the supply squeeze is easing. Despite a 3% increase in usage and only 0.02% growth in mine production for the first 8 months of the year, the global balance sheet of refined copper sits at a surplus of 84,000 tonnes. High prices have brought scrap to the market at an accelerated rate and have served to bridge the gap until capacity of utilization at mines returns to normal levels. In the ICSG's study period, capacity ran at 85.8%, compared with 87.6% during the same period in 2005.

ICSG reports are three months behind, but more current data also indicate that the supply situation is indeed loosening up. Although monitoring inventory levels at the three principal warehouse systems is not an exact science, large price moves have been accompanied by equally large changes in stock levels – with some variance in timing – and we are experiencing the first significant collective change in global inventories in some time. While Shanghai stocks have fallen to their lowest level since this past spring, the total of LME, COMEX, and Shanghai has climbed from a low of 140,000 tonnes to the current 215,000 tonnes, which is the highest inventory level since prices peaked (Chart 1).

The other important analyst in this market, Bloomsbury Minerals Economics, confirms the trend. It obviously works with different criteria for establishing balances, because its numbers still show the market in deficit. But the direction is the same. On November 15 it revised its forecast for the global supply/demand refined balance to a deficit of 235,000 tonnes, from a previous estimate of 328,000 tonnes. It is now looking for a surplus of 45,000 tonnes for 2007, compared with its earlier estimate for a deficit of 130,000 tonnes.

Finally, the inter-month spreads at both COMEX and LME have collapsed from a robust backwardation to contago, making this fantastic bull market hardly recognizable as such any longer (Charts 2 and 3). We recommend establishing very conservative short positions.

[November 30, 2006]

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

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Chart 1 – Total global warehouse stocks

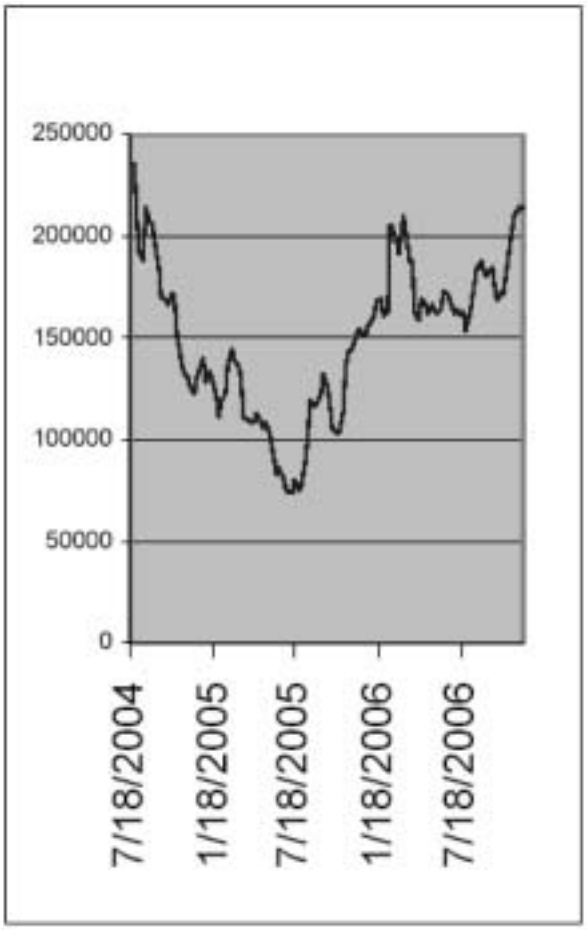


Chart 2 – December/March COMEX spread

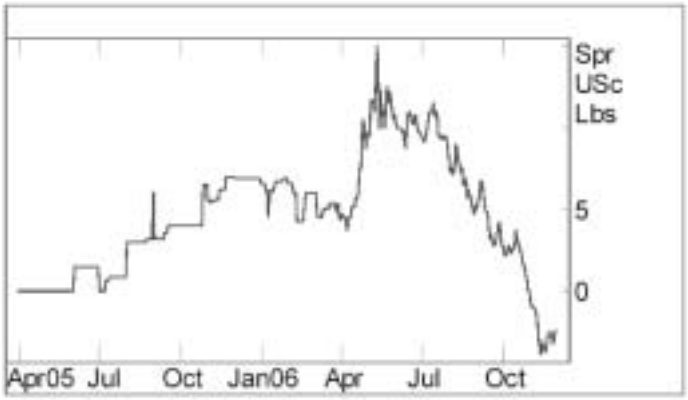


Chart courtesy Reuters

Chart 3 – Cash/3-months LME spread

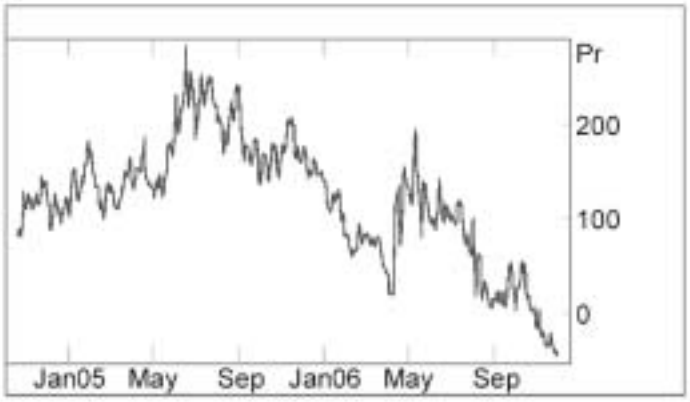


Chart courtesy Reuters

WHEAT

Where are the buyers?

The bull market in wheat has been in pause mode since early October. There is nothing unusual about a market consolidating a large move in price, but this condition, known as "consolidation," is vague and typically serves as a sophisticated-sounding explanation for an otherwise inexplicable halt in a market trend. We, too, often cite "consolidation," but in this particular case we believe we understand the background for the market's hesitation.

First, the USDA surprised the market somewhat by revising the 2006-07 Australian crop down by only 500,000 tonnes from its October estimate, to 10.5 million tonnes. The official Australian estimate of the crop stands at 9.5 million tonnes. It may not seem like that much of a difference with a global crop of 615 million tonnes. But what happens down under will have a ripple effect on other important wheat exporters.

The USDA expects Australian exports to fall by 4.5 million tonnes from the previous season, to 10.5 million this season, which of course means that it would be exporting its entire crop. Exporters insist that contracts to "core" customers will be met, which means two things: 1) After depleting the crop, exporters will dip into meager inventories to keep longstanding customers happy, thereby drawing down stocks to dangerously low levels. To illustrate, consider that at the end of the 2004-05 and 2005-06 seasons, Australian carryover stocks were 40% and 34% of consumption, respectively. This coming season, its stocks will fall to either 14%, according to the USDA estimate, or 8%, according to the Australian estimate; 2) Those who are not "core" customers still need to eat (they or their animals) and will – sooner or later – show up at the door of US exporters, which, as we'll soon see, has not happened to date.

So the USDA's relatively moderate revision to its estimate of the Australian crop left traders wondering whether the

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USDA was being typically conservative and is content to lower estimates as the crop nears the completion of the harvest. Or whether the Australian estimate indeed went a bit too far.

The other problem with the seemingly perfect bullish picture is puzzlement over sluggish US exports. Early season forecasts for 2006-07 US exports were slashed by 3 million tonnes from last season. Australia accounted for 14% of world trade in 2005-06, and one would think that its lost business would shift to the US, at least to some degree. Since it became obvious that Australian crops were in trouble, the USDA has increased its estimate for US exports by *only* 700,000 tonnes, to 25.17 million tonnes. And rightly so. The pace of US export commitments has been satisfactory for a normal season, but this is no normal season. Global output has fallen by 32 million tonnes, or 5.2%, from last season.

US export commitment data show that we are significantly behind even the USDA's already pessimistic estimate for annual exports. As of this past week, commitments were 14.86 million tonnes, 17% behind last year at this time, while the USDA estimate for the whole season shows a decline of only 8.5%.

It is quite possible – although we have no evidence to substantiate this – that foreign buyers have been balking at these prices, believing that the market got ahead of itself and that there will be opportunities down the road. Were this the case, bulls have nothing to fret about; the buying will come and probably at a more frenzied pace.

In any case, even if we don't see improved US sales, we've run ending stocks down so low that we would need evidence of a substantial increase in Northern Hemisphere winter wheat acreage to change the outlook. At present, global ending stocks are estimated at 19.33% of consumption, the lowest inventory on record. If US exports do not pick up and we subtract the roughly 3 million tonnes from global usage that would be implied by the pace of export commitments, it would bring global stocks up to 20% of consumption, still the lowest on record.

We advise maintaining moderate long positions, which can withstand setbacks. A close below $4.6 per bushel on the spot month should be the maximum tolerance level.

[December 4, 2006]

Chart 4 – March wheat

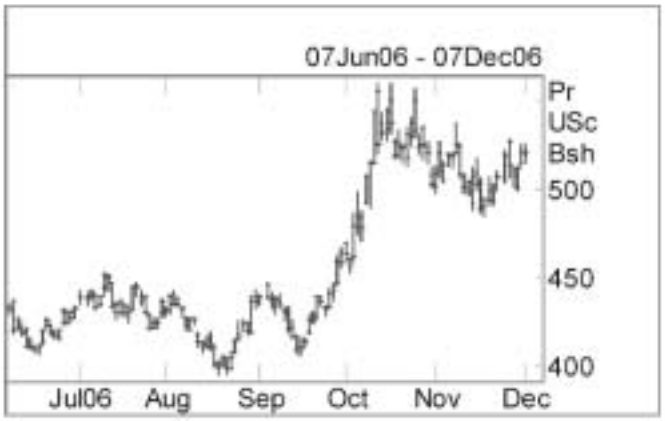


Chart courtesy Reuters

COCOA

Softer West African crops and growing demand set stage for rally

We've left the cocoa market alone for a bit. The last time we visited the subject on August 30 we concluded that we were "cautious buyers." The market has been trading below the level of the massive July collapse, but prices have been building a base. One would have thought that the well warranted plunge would have seen some follow-through selling, but several attempts to penetrate the long-held $1,400-per-tonne support level have failed.

After moving from early season forecasts that called for a global production/consumption deficit for the outgoing 2005-06 season of as much as 200,000 tonnes to the current estimates for a surplus of 80,000 tonnes (ICCO), we should have seen more downside progress.

The principal issue in 2005-06 was the size of the Ivorian crop. After production fell in 2004-05, to 1.27 million tonnes, there were high hopes for the 2005-06 crop. Arrivals ran consistently above year-earlier tallies, and the situation looked promising. Towards the end of the main-crop, however, arrivals tapered off, and global deficit forecasts were increased. As late as February, E.D. & F. Man was still estimating the Ivorian crop at below 1.2 million tonnes. Then, the mid-crop exceeded all expectations and ended up at a record-by-far 400,000 tonnes, with a total crop of just under 1.4 million tonnes, which explains the sharp plunge in July.

As we head into the new 2006-07 marketing year, arrivals stand at 287,000 tonnes, compared with 353,000 tonnes last year at this time. Just as we saw the numbers taper off sharply as the season progressed last year, there have been plenty of seasons where things have picked up steam after slow-going early on. In the short term, we have dry weather, and the crops need some moisture before the

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real dry season sets in a few weeks from now. Inconclusive at this time.

Neighboring Ghana, the world's second largest cocoa grower, harvested a record 740,000 tonnes in 2005-06. The local cocoa ministry, normally a vocal supporter of its country's cocoa-growing prowess, estimates that the new crop will fall to 600,000 tonnes, but only because of expectations of a cyclical off year that normally follows a bumper harvest.

Nigeria has been talking about tripling its cocoa output from the current average of 200,000 tonnes, but in the meantime, the new season got off to a poor start because of poor fertilizer coverage and insufficient precipitation. The ambitious plans for the future are not realistic.

Overall demand has been quite good. Third-quarter grindings for the US were the strongest in some time, growing by 4.45% over the third quarter of 2005. EU grindings for the same period grew by 4.6%. This followed second-quarter grindings that increased by 6.9%. We should keep in mind that origin grinding facilities continue to add capacity, and if US and European grindings continue to grow regardless, we can safely assume that consumption is growing at a healthy clip.

In addition, spot butter ratios have increased for the first time in memory, jumping to 2.7 times the London spot price, after languishing at 2.4 for the longest time.

The market's survival after moving from forecasts for a large deficit to a decent surplus in the space of several months is remarkable. Monitoring market action for a commodity such as cocoa – with its dearth of meaningful data – is crucial. Our hunch is that the formation of a base above the $1,400-per-tonne level indicates that 2006-07 global output is headed for a disappointment, especially since it comes against a backdrop of a steady growth in consumption.

We're not great advocates of buying breakouts, but this case merits an exception, because we seem to be resolving a tight, five-month range with what we believe to be a budding bullish case. This market should be traded from the long side. *[December 4, 2006]*

Chart 5 – March cocoa

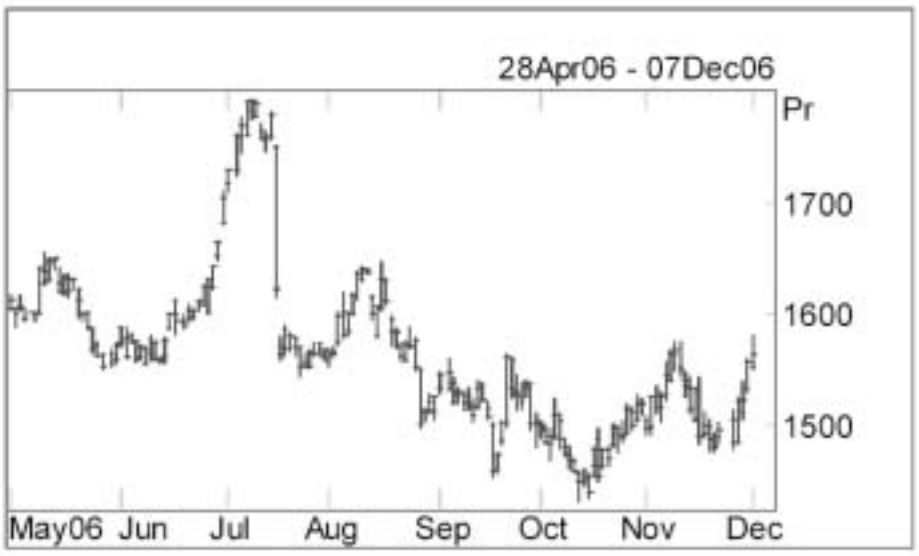


Chart courtesy Reuters

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