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Global cocoa output unresponsive to high prices

Cocoa is one of the few commodities for which prices have maintained the integrity of the uptrend of the explosive commodity bull market that began in mid decade. At just below $3,000 per tonne, the market continues to trade at prices substantially above average historical levels (Chart 1).

First-quarter grinding results, reported back in April, were the strongest in years, rising 16% and 8% in North America and Europe, respectively. This provided support to the bullish argument that a post-global-recession resurgence in demand was one of the factors that was keeping this market strong (see *Focus on Futures*, May 3). The prospect for follow-through in the second quarter, however, is suspect, because butter ratios remain sluggish. Bean inventories should grow if butter prices don't improve. It would be extremely bullish if second-quarter results – to be released in mid July – surprise to the upside. But the demand side is not necessarily a factor in keeping bean prices where they are.

Rather, we believe, the market is focusing on the longer term supply outlook. For most other agricultural commodity markets, high prices inspire increased output within one growing season. It takes several years for a cocoa tree to bear fruit, but it's actually been several years since prices have been sufficiently strong. It does not seem to have sparked a production expansion.

For many years, Ghanaian government officials have been talking about achieving a 1-million-tonne crop by the end of the decade – this decade, and it's over. Ghana has been producing about 700,000 tonnes in recent years and had an early season 710,000-tonne target for the 2009-10 marketing year. To date, arrivals stand at 580,000 tonnes, down from 623,000 tonnes at this time last year, or about 6.5%. With expectations for a weak mid-crop of only 50,000 tonnes, the government has lowered its forecast to 630,000 tonnes.

The most recent data for the Ivory Coast show port arrivals at 1.018 million tonnes, 2.1% behind last year at this time. At the beginning of the year we were running 15% ahead of the 2008-09 season. There are still three months left to the mid-crop season, and the weather picture is mixed. It's been wet in most regions, which is a mixed blessing. On the one hand moisture is always constructive for the pods still growing. On the other, excessive rain creates a challenge for drying harvested beans and causes crop losses in areas with flooded plantations.

West African nations – which grow 70% of the world's cocoa beans – have obviously not been able to muster the incentive required to expand production. Brazilian output has been growing, but its capacity is limited. The Indonesian government talks about exponential production increases, but like its Ghanaian counterpart's plans, nothing has materialized.

With prices so far above levels of the past several decades there has been enough room for producers to invest comfortably in infrastructure, fertilizer, and pesticides to facilitate increased output – but they did not.

Bears like to blame speculators for keeping this market rich, but it's a bogus claim. Open interest in both New York and London are far below their 2008 peaks (Chart 2 and 3). CFTC data show that funds hold only a modest net-long position (Chart 4).

The International Cocoa Association estimates a 70,000-tonne deficit for 2009-10 and forecasts a balanced market for 2010-11. This outlook is based on a strong fin-

Inside

Sugar: Skeptical of surplus 2
Soybeans: Record crops 4
Corn: USDA's curveball 5

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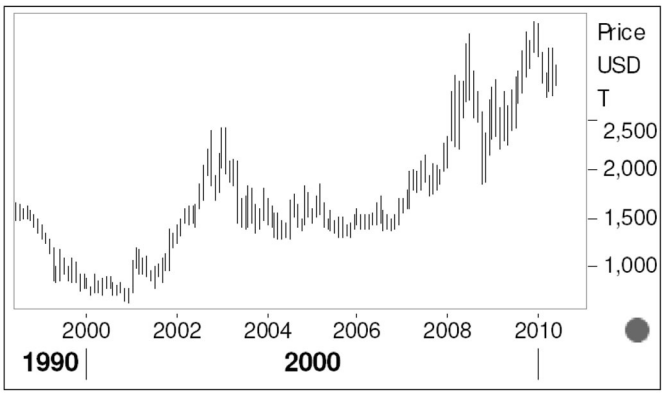
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ish for the West African mid-crops and treating the first quarter grind results as an anomaly. Both of these factors can swing either way.

We continue to believe that the market is vulnerable, and we advise maintaining moderate sized long positions.

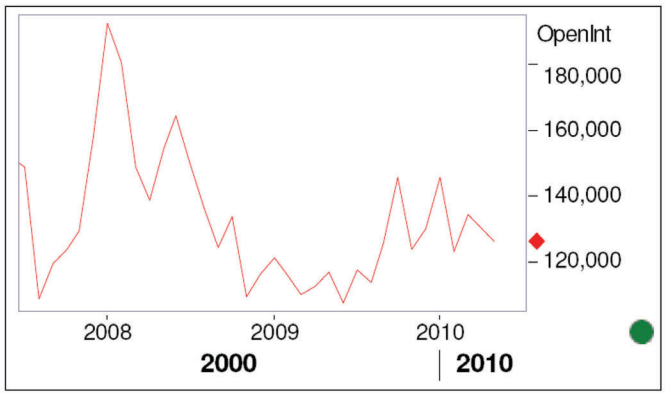
[June 18, 2010]

Chart 1 – Nearest contract NY cocoa



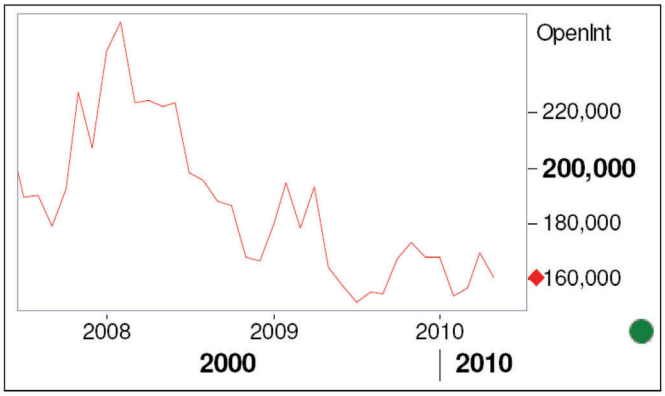
Courtesy Reuters

Chart 2 – NY open interest



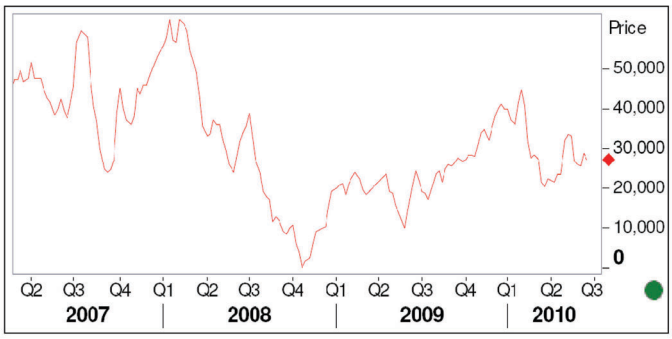
Courtesy Reuters

Chart 3 – London open interest



Courtesy Reuters

Chart 4 – Non-commercial net-long position



Courtesy Reuters

SUGAR

No room for any monsoon glitches

The steep slide in sugar prices came to an abrupt halt at 13¢ per pound in early May. The market has since worked its way back over the 16¢-per-pound level. Followers of our April 29 recommendation to "...nibble at the long side" felt some pain for awhile, but should now all be sitting comfortably with a modestly profitable position.

Given the bearish revisions to the 2009-10 balance sheet and the surplus estimates for the upcoming 2010-11 season, the rally would seem to be counterintuitive.

Based on recent upwards revisions to Indian output, the global balance sheet for 2009-10 will show a deficit of about 7 million tonnes, a far cry from deficit estimates that reached as high as 15 million tonnes only a few months ago. For 2010-11, early forecasts are calling for a global surplus of between 2.5 million and 5 million tonnes.

Once again, everything hinges on India. The first important event that the market is focusing on is a pending decision on whether to reestablish the import tariffs that were lifted to ease soaring domestic prices and a massive production/consumption deficit of between 4 million and 5 million tonnes in the 2009-10 marketing year. Lifting the tariffs facilitated imports of 5.5 million tonnes of raw and white sugar, leaving current estimates for ending stocks at about 5 million tonnes, which is about half of historical levels. Market expectations are for the tariffs to be imposed.

Sugar area in the key growing regions is up sharply for

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2010-11, and assuming the monsoon does not disappoint again, the crop is expected to reach 24 million tonnes, up from 18.7 million tonnes in 2009-10. About 60% of farmland in India relies strictly on the monsoon rains. The monsoon arrived earlier this month, but was four or five days behind schedule. In April the state run India Meteorological Department forecast that monsoon coverage would be 98% of the long-term average, but after reviewing more recent patterns has upgraded that forecast to 102% of the 50-year average.

The harvest in Brazil is humming along fine. Sugar production is expected to increase by more than 10%, to over 40 million tonnes. As expected, the ratio of cane crushed for ethanol over sugar production has fallen from an early season high of 57.3/42.7 to 55.6/44.4. Original forecasts for 2010-11 were for a ratio of 57/43 in favor of ethanol. We expect that forecast to be met, because the government raised the mandated ethanol/petroleum blend ratio on May 1, from 20%, back to 25%.

The increase in Brazilian output – not so ironically – is about the amount India would need to import to bring its year-end inventories back to traditional levels of the 10 million tonnes required to meet the needs of the world's largest sugar consumer. Thus, even if India were to decide to allow imports, it would not be drawing down global inventories such as was the case in 2009-10. So why have prices been firming?

At 13¢ per pound the market was discounting a perfect monsoon. When the monsoon arrived late, the market attached a premium to that complacency. Thus far, the rally has held even after the rains caught up. The monsoon must last through September.

Another issue that the market has largely ignored is growing Chinese output. After two consecutive weather-related poor crops, 2010-11 output is expected to bounce by 20%, to about 13 million tonnes. The problem is that Chinese demand has been growing and is expected to increase to 15 million tonnes from 14 million tonnes. Official inventories are listed at about 1.5 million tonnes, but the government sold a fair amount of sugar from state-controlled stocks over the past two years, and there is no way of knowing whether there is enough in store for that to be repeated. The street estimates that China will have to import about 1 million tonnes in the 2010-11 marketing year, but depending on the success of the harvest, that figure could rise.

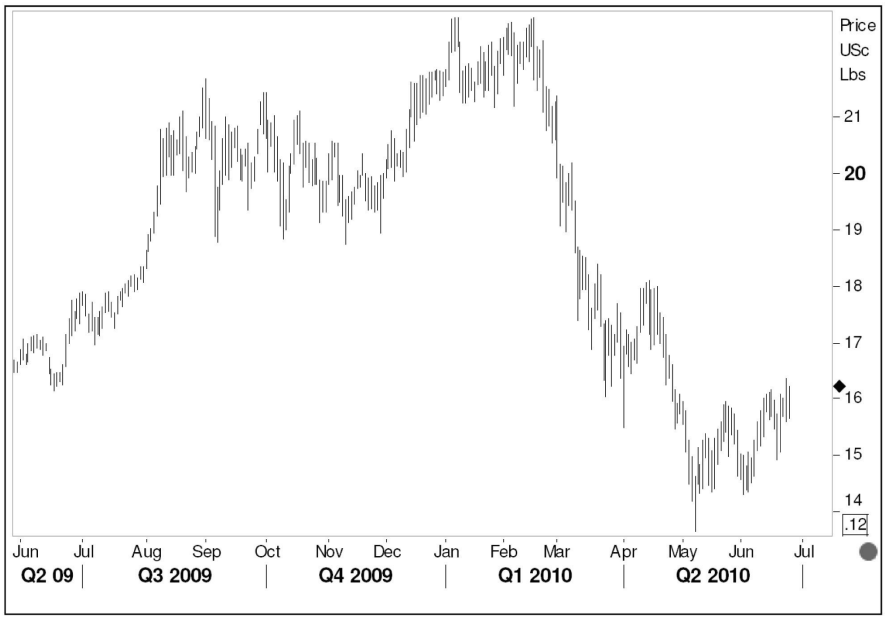
Exportable surpluses among exporting nations are slim. Thailand is the world's second-largest exporter. Thai farmers tried to grow more cane to take advantage of soaring world prices, but dry weather kept 2009-10 output at about 7 million tonnes, the same level as the previous season. Exportable surplus for the recently ended crushing season was 4.7 million tonnes, down from 5.1 million tonnes a year earlier.

Similarly, Australia was expected to see higher output this year, but cyclone damage reduced the increase to a negligible 80,000 tonnes. And with growth in domestic usage, the estimate for exports is 3.28 million tonnes, compared with 3.25 million tonnes in 2009-10.

Despite the outlook for a global surplus in 2010-11, we're skeptical about a comfortable surplus. Remain long.

[June 25, 2010]

Chart 5 – October sugar



Courtesy Reuters

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SOYBEANS

Record soybean crops everywhere

The grain and oilseed markets experienced a rally in mid-June, inspired mostly by very wet weather across the Canadian prairies, which delayed planting progress. Soybean prices tagged along for the ride. Reduced rapeseed acreage and damage to planted crops threatened to reduce Canadian canola output by close to 10%, which would draw ending stocks down to their lowest level in years. While it made for catchy headlines, the net effect to the overall vegetable-oil market was negligible, and even less so to the soybean-driven protein-meal market. Indeed, the 60¢-per-bushel pop in soybean prices faded, and prices traded back into the pre-rally range.

Weather in the US Midwest, Delta, and southeast soybean regions has not been perfect during the planting and early growing season. Overall, though, the results are not problematic. The most recent crop progress report shows that 97% of the crop has been planted, in line with the five-year average. The good-to-excellent portion of the crop fell two percentage points from the previous week, to 67%. That's just below last year at this time, when the top category was 68%.

The June 30 USDA acreage update showed that US farmers planted 78.868 million acres of soybeans. That was 768,000 acres above the March planting intentions report, and more significantly, 685,000 above the average of analysts' guesstimates. Using the modest yield estimate of 42.9 bushels-per-acre and the harvested-to-planted ratio of 98.7% contained in the June 10 crop report, US output would surpass last year's record production to reach 3.340 billion bushels.

The quarterly stock report was released concurrently showing June 1 soybean stocks at 571 million bushels, 24 million bushels below analysts' guesstimates.

The net effect of the two reports for the 2010-11 balance sheet is minimal. The estimate for ending stocks would increase by about 5 million tonnes, to 365 million tonnes. Initially, the market rallied – perhaps in sympathy with a bullish corn report – but once traders had a chance to judge the implications of another record US crop, prices turned lower to settle at a two-week low (Chart 6).

The USDA raised its estimate for 2009-10 Brazilian production by 1 million tonnes in the June crop report, to 69 million tonnes. The harvest has been complete for a few weeks, so it's unlikely that output estimates will change very much. The Argentinean estimate was unchanged from May. Both countries grew record crops for a combined total of 123 million tonnes, or 47% of global output.

With the US accounting for 35% of global output, it does underscore how vulnerable the market is to weather issues that could seriously compromise output in any one region.

Nevertheless, although it is very early for complacency regarding the US crop, it is fair to say that, with constantly improving technology, crops are getting hardier by the year, and the inevitable weather scares should not steer us from the big picture. Last year we had the potential for serious weather damage with late-planted crops exposing beans to possible early autumn frosts. From early-summer through late-November, new-crop prices rose by as much as $2 per bushel. Strong exports were a major force in the rally, but there was a lot of unwarranted attention paid to the condition of the crop.

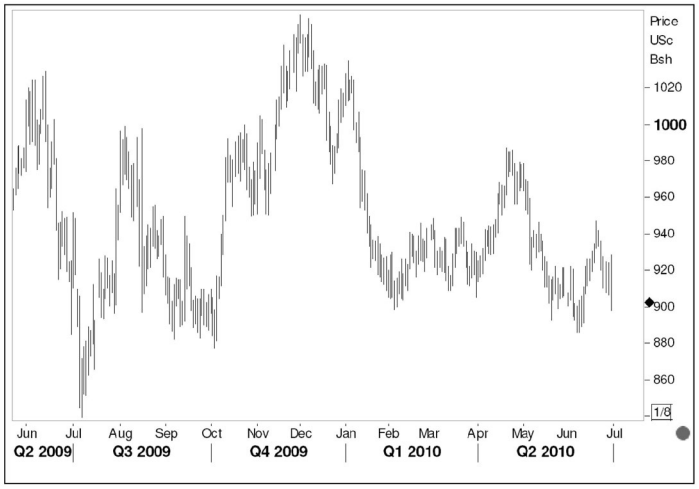
Global ending stocks for 2009-10 are estimated at a record 27.8% of consumption. US exports have dwindled, with old-crop new sales averaging only 181,000 tonnes over the past four weeks. The shipment pace, however, is on target to meet the USDA estimate, and there is not very much else that can change this late in the marketing year.

Early estimates for the 2010-11 balance sheet are for a drawdown in global inventories, mainly because smaller crops are forecast for South America, which is based on stated planting intentions. Stocks will still remain near record levels, at 27.17% of consumption.

The world is awash in soybeans. Remain short.

[July 1, 2010]

Chart 6 – November soybeans



Courtesy Reuters

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CORN

The USDA throws bears a curve ball

In the days leading up to the June 30 USDA acreage estimates and quarterly stocks reports, corn prices plunged by over 40¢ per bushel. After breaking below long-held support early in June, only to reverse and create what appeared to be a bear trap, (bearish) technical analysts (who were actually short) were brimming with pride when the market broke below the early-month lows – a clear resolution to the sideways action of recent months (Chart 7). Oh, the market was headed much, much lower. But the June 30 reports slammed the book shut on that chapter of technical analysis, and the supply and demand fundamentals took charge.

The March planting intentions report estimated that US farmers would plant 88.8 million acres of corn for the 2010-11 crop, up from 2009-10 acreage of 86.5 million acres. Although the latter part of the planting season was hampered by wet weather, most of the crop was planted under ideal conditions. Analysts therefore believed that the March estimate was too low. The average guesstimate was 89.229 million acres, 430,000 acres above the March intentions number. The actual figure came in at 87.872 million acres, just under 1 million acres below the intentions number. It was the first time since 2002 that the USDA made such a large revision for the June acreage update. That was the supply-side surprise.

On the demand side, the average guesstimate for quarterly stocks as of June 1 was 4.598 billion bushels, but the number came in 288 million bushels lower at 4.31 billion bushels. Cattle herds have not been this small in years, and there are ample competitively priced corn substitutes available, so it was quite the eye-opener.

The net effect of the two reports on the US 2010-11 balance sheet would be a sharp downward revision to the June ending stocks figure. Using the June crop report's harvested-to-planted ratio of 92.1% and assuming the analysts' estimate for quarterly stocks was loosely based on the USDA's feed and residual usage figure, we would have to shave about 425 million bushels off the June estimate for US ending stocks, bringing it down to 1.150 billion bushels. The USDA's initial estimate for the 2010-11 carryover – only two months ago – was 1.818 billion bushels, or 13.7% of consumption.

The revised figure, using the acreage update and quarterly stock estimate, would bring the US stocks-to-use ratio down to 8.4%, compared with the June estimate of 11.7%. Ending stocks for 2008-09 and 2009-10 were 13.8% and 12.15% of consumption, respectively. The developing pattern of inventory drawdowns is a throwback to the inventory levels of the mid-1990s and the 2002 to 2004 period which launched major bull markets.

There are several factors affecting the corn market that, while well know to the market, will continue to put pressure on supplies, and which made the market especially vulnerable to the slate of bullish news we just received.

The Chinese have emerged as buyers of US corn for the first time in years. Thus far in the 2009-10 marketing year, Chinese purchases total just under 1 million tonnes, with the bulk of the deals occurring between May 12 and June 17. Traders were disappointed over the absence of any Chinese sales this past week but expect the buying to resume. It has now become obvious that the 2009-10 Chinese crop was overestimated.

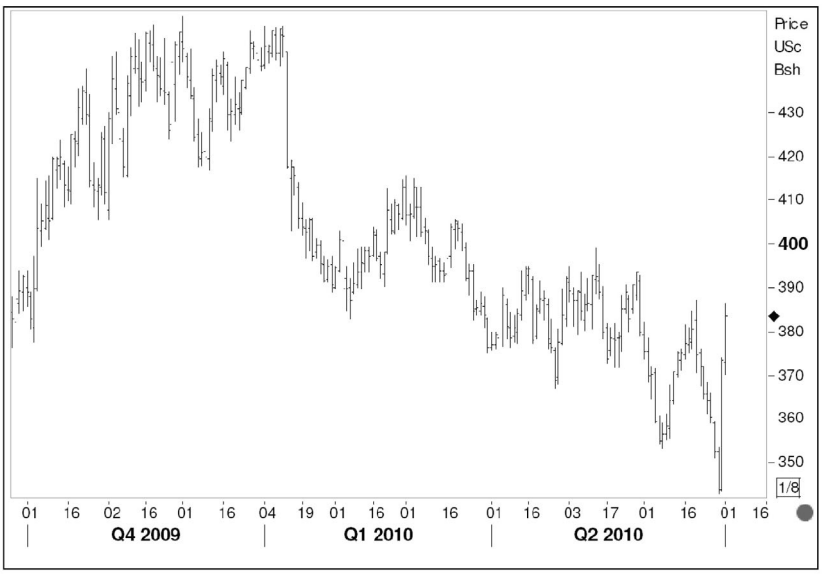
Government planners insist that grain reserves are ample. The public is not privy to the exact levels as a matter of official government policy. If they were as ample as they say, it is doubtful that we'd be seeing these purchases.

The USDA has kept pace with growing demand in the ethanol market. In the June 10 crop report, ethanol usage was increased to 4.7 billion bushels, 100 million bushels above the May estimate. At mid-decade the US was using 15% of the crop for ethanol. Now it's up to about 35%. Dwindling ending stock levels should be clear enough evidence that US farmers are no closer to solving the problem of how to allocate the corn crop efficiently between the traditional feed market and the new ethanol market.

Remain long. *[July 2, 2010]*

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Chart 7 – December corn



Courtesy Reuters

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