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Copper: rising output is not matched by a recovery in demand

On April 28, The National Statistics Institute in Chile reported on the first full month of copper production in the aftermath of the devastating earthquake that rocked Chile on February 27. Output for March was up 5% over March 2009. Not that it was any great surprise.

The principal mining centers are in the north of the country, far from the epicenter of the quake. There were disruptions to smaller installations in the south, mainly in terms of energy delivery, but it obviously did not have an appreciable impact on total national output. It was certainly good news for the Chilean economy. Other key industries in the path of the quake – such as pulp, fishing, fruit, and wine – were not so fortunate and suffered heavy damage to infrastructure and untold lost income.

There were far more substantial tremors to follow that would affect copper prices and that would have little to do with Chile.

The upheaval in weak eurozone economies touched off a wicked correction (bear market? perhaps, but outside the scope of this discussion) in the stock market's bull run. The DJIA fell by 12.3% from its late April peak, bounced to recover almost the entire drop, and most recently, dropped again to test the lows. The chart of July copper superimposed on the DJIA shows clearly that copper prices have moved in lock-step with the stock market (Chart 1).

According to The International Copper Study Group (ICSG), 2009 global refined copper production grew by just over 0.06%, while usage fell slightly, leaving a surplus of 365,000 tonnes. With little hope for a recovery in European consumption and the potential for stress on usage in regions that will be affected by contagion associated with the European problem, there would seem to be little chance for improvement in 2010 global demand.

Chinese imports of refined copper in April were 8% lower than in May, but still quite strong when compared with most months since last summer, when imports nose-dived back to normal levels (Chart 2).

China will no doubt remain the world leader in copper consumption. The pace of imports seen through June 2009, however, is in all likelihood not sustainable – the past two excellent months notwithstanding. As we pointed out in the January 7 issue of *Focus on Futures*, massive imports resulted in accumulated inventories, and Chinese mine output has grown. With Chinese imports no longer growing and with flat-to-falling usage everywhere else, we will see overall global demand bending to the downside.

Production, on the other hand, is slated to return to robust health in 2010. The most recent ICSG data, which cover only January and February, show that global refined production increased by 5.8%. Most of that gain was in the form of secondary production, with mine output up only 1.2%. Chilean output in January was down 1.9%, which dragged the global total down, but as mentioned above, has bounced back. Pre-quake February output was up 4.3%, and post-quake March was 5% higher, so we can expect to see higher mine output figures in the coming months.

ICSG recently estimated that the global balance sheet for 2010 will show a surplus of 580,000 tonnes, up from a previous forecast of 540,000 tonnes. Mine production is expected to grow by 1.1 million tonnes, or 6.7%. Demand, however, is forecast to contract by 269,000 tonnes, or 1.5%.

The bull market in copper began when the global balance sheet reached a deficit of close to 1 million tonnes in

Inside

Corn: China buys US corn 2
Wheat: Looking for a bottom? 4
Cotton: Returning demand 5

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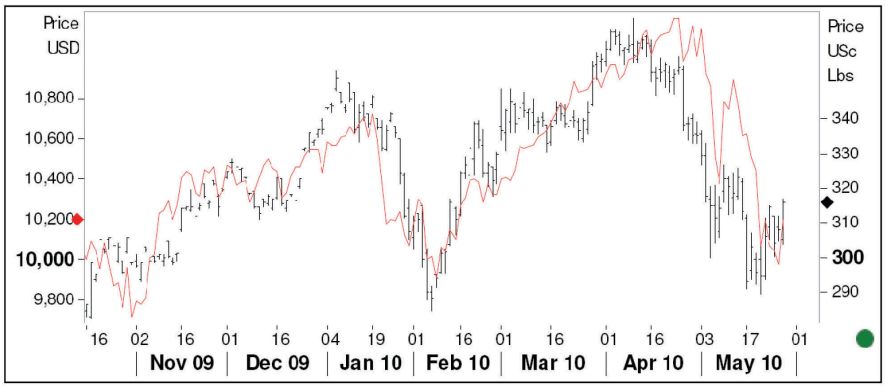
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2004. Now the surpluses are piling up, and inventories are poised to absorb both temporary supply shocks, such as earthquakes and strikes, as well as improved demand.

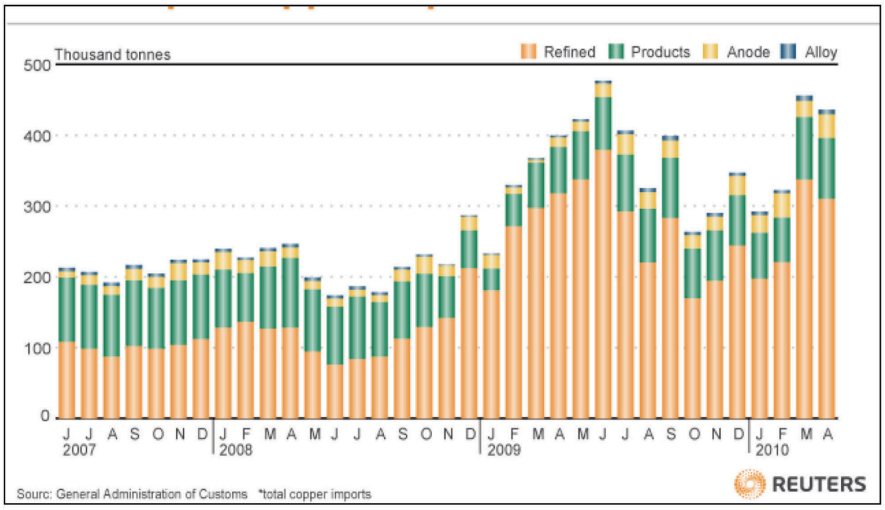
We were stopped out of our short position in the post-earthquake rally. Market volatility should provide opportunities to re-enter the short side. We recommend selling July copper if it rallies to recent highs between $3.25 and $3.30 per pound. *[May 27, 2010]*

Chart 1 – July copper (bar), Dow Jones Industrial Average (line)



Courtesy Reuters

Chart 2 – Chinese copper imports



Courtesy Reuters

CORN

China becomes a buyer of US corn

Corn prices have been wandering aimlessly over the past few months. July corn is currently in the process of testing the bottom of the range (Chart 3). Indeed, the chart paints a bearish picture. An examination of the supply/demand fundamentals, however, tells a different story.

China harvested a record 166 million tonnes of corn in 2008-09. A drought-reduced 2009-10 crop yielded only 155 million tonnes, according to USDA figures. Until recently it seemed that the Chinese had adequate supplies, despite the smaller crop. According to the USDA, Chinese 2009-10 ending stocks were estimated at 53 million tonnes, or about 35% of consumption, and at about the same level as recent years. When the Chinese began to buy corn from the US a few weeks ago for the first time in four years, market participants began to question whether the government's 164-million-tonne tally of the 2009-10 crop – and by extension the ending-stock level – may not have been overstated. While the USDA figure is 155 million tonnes,

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some private analysts say the crop may have been as small as 140 million tonnes.

Domestic prices have been on the rise, and it would seem that there may have been a degree of urgency in the sudden need for imports. Thus far, the Chinese have purchased 600,000 tonnes, part of which is already on its way overseas. It's a relatively small amount, but enough to have sparked speculation over how much more the Chinese may need in this marketing year until their own 2010-11 harvest comes in. Current legislation would allow for the import of a total 4.3 million tonnes. Press reports have indicated that analysts expect the quota to be expanded by 4 million to 5 million tonnes.

Even before the Chinese purchases surfaced, US exports – very sluggish in the early part of the marketing year – picked up a head of steam. At the beginning of the season, the USDA forecast a recovery in foreign sales for 2009-10, at 56 million tonnes, up from 47.2 million tonnes in 2008-09. Sales were very slow, however, and that estimate was lowered each month until it bottomed at 48.2 million tonnes. In May, for the first time this marketing year, the USDA raised the estimate for corn exports to 49.5 million tonnes. In early January, commitments were running 19% behind the same time last year, but that margin has narrowed to only 10.7% behind last year.

Commitments to date stand at 44.6 million tonnes. Over the past four weeks, old-crop new sales averaged 1.26 million tonnes. With three full months left in the marketing year, we should easily surpass the USDA's 49.5-million-tonne estimate for the year. The current pace is not sustainable for too long, because old-crop sales will eventually fade, but we're confident that the USDA estimate is too low.

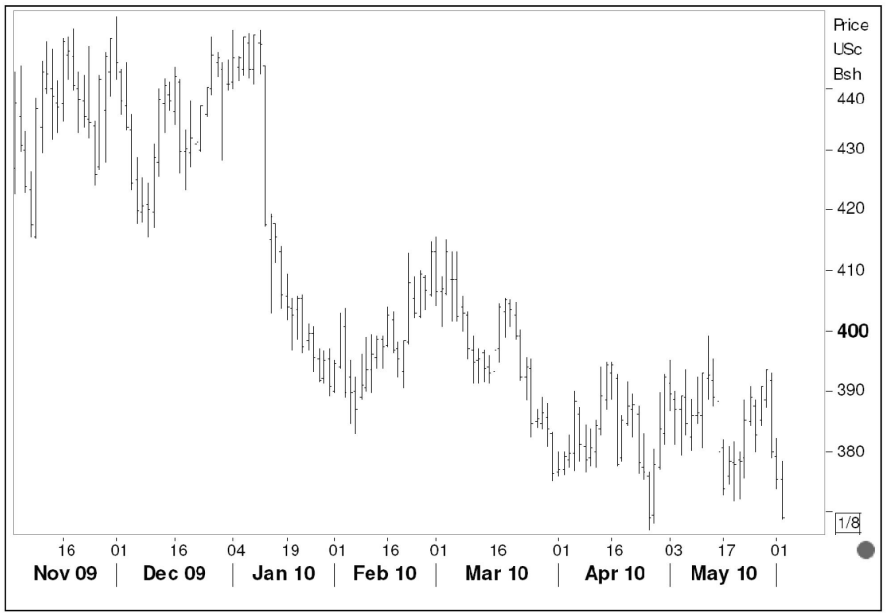
Looking ahead to the 2010-11 crop year, we find ideal planting and growing conditions for the US crop. Last year, a soggy spring delayed planting – which, incidentally, didn't matter much, because after much hyperbole all summer, US farmers harvested a record crop of 13.131 billion bushels (333 million tonnes). At 97% planted, we're significantly ahead of last year's 92% and slightly ahead of the 96% five-year average. The portion of the crop rated good-to-excellent is 76%, compared with 70% last year.

Corn weather in China has not been of much interest in its time as a self-sufficient corn producer. The early part of the planting season was cool and wet and hampered planting progress. Drier weather has moved in, though, which should allow adequate time for the crop to be planted in optimum fashion.

Global ending stocks for 2010-11 are estimated at 154 million tonnes, or 18.6% of consumption, almost identical to the past two seasons. While that's an improvement over the mid-decade inventory levels that sparked a massive bull market, we remain at a vulnerable level. The USDA estimate for US exports is 50.8 million tonnes, which as illustrated, is very likely significantly understated, both because general demand has recovered, and more importantly, the possibility that China might become a big buyer of US corn. Unlike wheat, and now soybeans, no other country grows nearly enough corn to meet China's needs.

Buy December corn at the market. *[June 3, 2010]*

Chart 3 – December corn



Courtesy Reuters

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WHEAT

Looking for a bottom?

Wheat prices have been sliding since the now-difficult-to-fathom $13.30-per-bushel peak was set in early 2008. Although the magnitude of that bull market was clearly exacerbated by a falling dollar, hedge funds, and the like, prices rose because of years of global under-production.

Excluding 2004-05, in each marketing year between 2000-01 and 2007-08, the global balance sheet showed a production/consumption deficit. Global ending stocks fell from a 1990s average of 31.8% of consumption to a low of 20% at the end of 2007-08.

Even after the top was in and while the market was tumbling, wheat prices remained above the historical norm, stimulating farmers to increase output. The pendulum swung and the 2008-09 and 2009-10 global balance sheets now show substantial production/consumption surpluses. For the just-completed 2009-10 season, ending stocks rose to 29.6% of usage.

When we last looked at wheat (*Focus on Futures*, March 5) we observed that prices would "...slosh around in the $4.5 to $5.5-per-bushel range with no clear trend" and suggested an option strategy consistent with a range-bound market. The market has trended lower, so we were wrong, but with July wheat trading at $4.35, not terribly so.

Typically, at this time of year, the condition of the US winter wheat crop is the focal point of the wheat market. Incidentally, 66% of the crop is in good-to-excellent condition, compared with only 44% last year. But the relevance of the US crop is diminishing. The profit motive that inspired farmers in other significant producing nations has been absent in the US. At 53.8 million acres for the combined winter and spring crops, we'd have to go back to the early 1970s to find so few acres planted to wheat in the US.

At the start of the decade, the US crop represented 10% of world output, compared with 8.5% at present. More important, though, the US share of world trade has fallen from 28% in 2000-01 to only 18.6% currently.

Conversely, exports from the countries of the FSU have grown from only a 4.5% share of world trade in 2000-01 to a projected 26% for the 2010-11 marketing year.

For the incoming 2010-11 marketing year, the USDA is forecasting a global crop of 668 million tonnes, down from 680 million tonnes last season. Demand, on the other hand, has not stopped growing. The USDA estimates that consumption will grow to a record 667.5 million tonnes, up from 652 million tonnes in 2009-10.

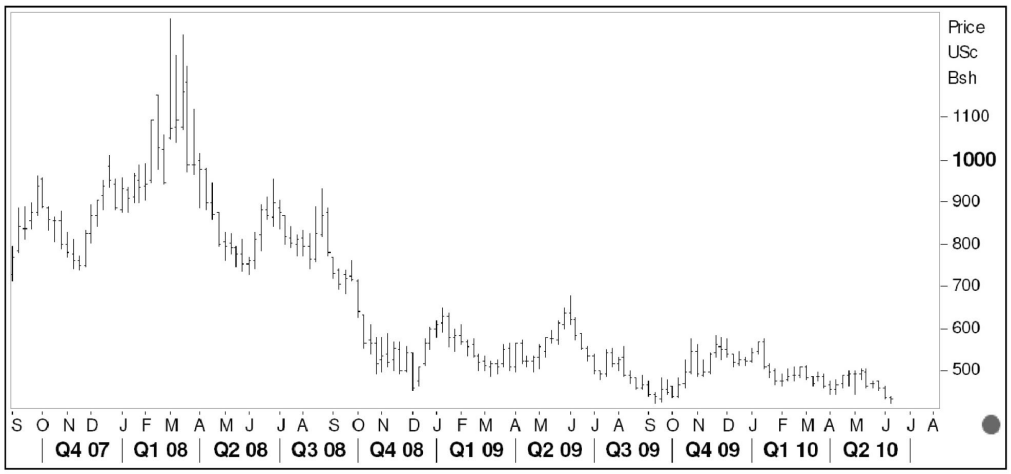
So the outlook for 2010-11 is a balanced market, which is fine with carryover stocks near record levels. There is a certain degree of complacency, though, and there is probably more demand just beneath the surface, which is not reflected in current data. Chart 5 shows that wheat prices are near their lows relative to corn, which makes wheat a commercially viable feed alternative. Second, it has been quite some time since US wheat has been even remotely competitive with foreign sources.

Therefore, while the market will probably drift somewhat lower, we maintain that a return to below pre-bull-market price levels is improbable – as we maintain for most commodities.

Economic stability should ensure a continuous upward trend in wheat demand. The future of the supply side, however, depends on how competitive profitability of wheat farming will be vis-à-vis other crops. It's very early in the cycle, because as indicated, tightness is near impossible, with inventories at 30% of consumption.

We continue to recommend option strategies, such as selling straddles, that should be profitable in this market, which we believe is going nowhere. *[June 11, 2010]*

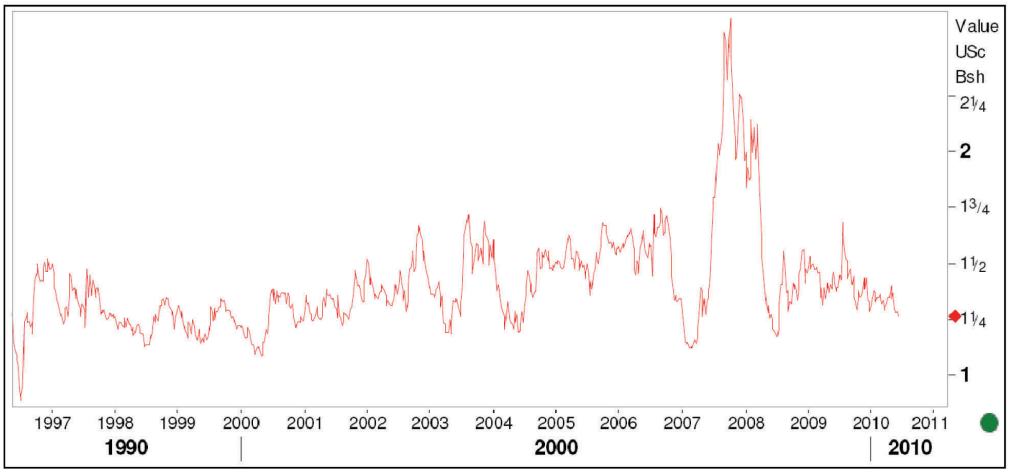
Chart 4 – Wheat weekly nearest contract



Courtesy Reuters

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Chart 5 – Wheat/corn ratio



Courtesy Reuters

COTTON

Demand has returned

After setting two-year highs in mid-April, cotton prices tanked, tumbling by 11¢ per pound through early June (Chart 6). It looked like the bull run was over. Three consecutive years of shrinking production in the US and a drought stricken 2009-10 Chinese crop drove prices high enough for US farmers to expand cotton area for the 2010-11 season. US acreage is expected 15% above 2009-10 area.

Over the past week, however, the market stormed right back into the range, and recent developments fully support the revival of the bull market.

Weather in the principal US cotton regions has not been perfect lately, but we can't be too concerned about that. Until this point conditions have been near perfect. As of the most recent progress report, 91% of the crop had been planted, compared with 86% this time last year and the five-year average of 88%. The good-to-excellent portion of the crop is 66%, compared with only 45% this time last year and the five-year average of 48%. Of course, persistent weather problems this early in the growing season can wreak havoc, but the market's recovery is not dependent on crop problems.

The June USDA crop report did not contain any monumental changes, but despite a 420,000-bale upwards revision to the forecast for 2010-11 global production, global inventories continue to be drawn down.

As recently as January, the estimate for US 2009-10 exports was 11 million bales, well below the 13.3-million-bale average of the previous three years. The estimate keeps inching up, though, and with this month's 250,000-bale revision, the tally is up to 12.25 million bales.

The most recent weekly export report was expected to show above-average sales, but was actually much stronger than expected. Old-crop commitments were 624,000 bales and new-crop sales were 199,000 bales, which we're quite certain is the highest weekly total in modern history. With export commitments to date at 12.7 million bales, the USDA may still have to raise its 12.25-million-bale estimate for 2009-10.

The marketing year ends on July 31, and actual shipments stand at 8.6 million bales, behind last year's pace of 10.4 million bales. Under normal conditions it will be a challenge to get the balance of outstanding sales shipped. Watching shipment levels in the coming weeks will give us an idea if US exporters will make the USDA target. But either way, foreign buyers are back in droves, and the sales will be carried forward to 2010-11. This probably leaves the USDA's current 13.5-million-bale forecast for new-crop sales understated.

Before the recession hit, 2008-09 sales were on track to reach 15 million bales. Given a return to normal economic conditions, estimates for global consumption are on the low side.

Chinese acreage for 2010-11 is expected to be 2.5% to 5% below last season. Output is estimated at 33 million bales, just slightly above last year's inclement-weather-reduced output of 32.5 million tonnes, and substantially less than 2008-09 production of 36.7 million bales. China has been a buyer of US cotton, and respected analysts speculate that the close-to-20-million-bale Chinese ending

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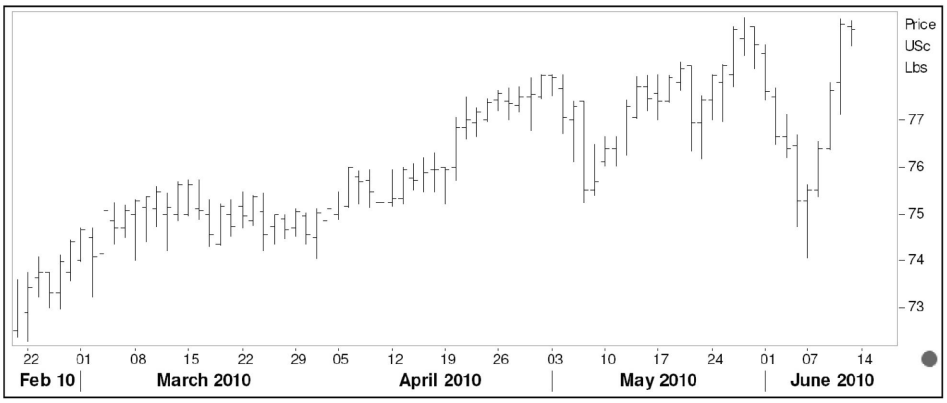
stock estimate is a fable.

The estimate for global consumption for 2010-11 was increased in the June USDA crop report by 410,000 bales, which drops ending stocks to 49.59 million bales, or 41.5% of consumption, down from last month's estimate of 42.1%, below 2009-10 inventory level of 45%, and light years from 2008-09 carryover of 57% of usage.

Open interest dropped 20,000 contracts with the market's dip, to 177,000 contracts, and the speculative community's net-long position has been contained (Chart 7), which leaves ample buying power on the sidelines.

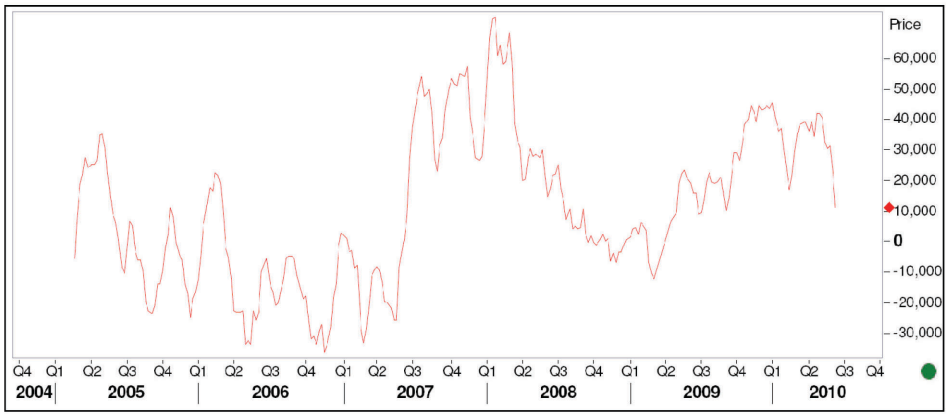
Our May 4 recommendation to use a 79¢ stop close basis July was triggered – sad but true. Buy December cotton at the market. *[June 14, 2010]*

Chart 6 – December cotton



Courtesy Reuters

Chart 7 – ICE cotton non-commercial net-long position



Courtesy Reuters

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