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FOCUS ON FUTURES
Friedberg Mercantile Group Ltd.
Volume 7, No. 4 May 10, 2004

Global wheat output estimates may be overstated

Wheat prices have tumbled by more than 50¢ per bushel since early this month. When considering the information the market is working with, there is a fairly good reason for prices to be slumping. A consensus has emerged among analysts that global wheat output for the upcoming 2004-05 marketing year will increase substantially, breaking the six-year trend of declining production.[1] Early forecasts are for a global crop of between 585 million and 600 million tonnes. The USDA's most recent estimate of the 2003-04 global crop was 549.3 million tonnes, an upwards revision from its March estimate of 548.06 million tonnes.

Some key producing countries that had dismal results in 2003-04 are expected to grow larger crops in 2004-05. Blistering hot temperatures in the EU last summer slashed yields, and output fell from103.9 million tonnes in 2002-03 to 90.5 tonnes in 2003-04. Preliminary private forecasts are for a strong recovery in 2004-05 to record levels of 108 million tonnes.

Russian grain crops account for more than 50% of FSU output. Wheat production of 34 million tonnes was far below average in 2003-04 and is expected to improve this season as well. Still, weather has not been ideal for winter crops, which will probably not facilitate the kind of recovery for Russia that is anticipated for the EU. Russian output for 2002-03 was 50.55 million tonnes and 46.9 million tonnes in 2001-02.

While both regions are exporters, neither are as important to world trade as are the US and Canada. In 2003-04, EU and all FSU exports accounted for 16% of world trade, compared with 45% for North American exports. In the US, planted acreage of the winter wheat crop and planting intentions of the spring wheat crop for the 2004-05 season amount to only 59.462 million acres compared with 61.7 million acres planted in 2003-04. Average yields reached a record 44.2 bushels per acre in 2003-04. Even if we repeat those excellent yields in 2004-05, the crop will be 3.6% smaller than the previous season. Thus far, 48% of the winter wheat crop is rated good to excellent compared with 54% at this time last year.

Last season, Canadian production snapped back to 23.5 million tonnes after 2 dismal years plagued by drought. (Output was a sub par 20.57 million tonnes in 2001-02 and 16.2 million tonnes in 2002-03.) Statistics Canada released its estimates for Canadian 2004-05 wheat acreage on April 23. Plantings are expected to decline by 2.1% from 2003-04, although traders were expecting a larger decline, and the estimate was revised upwards from March.

While the acreage report would indicate a drop of about 500,000 tonnes from last season under climatic conditions similar to last year – not a huge loss in the grand scheme of things – moisture conditions in the principal growing regions of Alberta and Saskatchewan are poor. Snowfall over the winter months was 50% of normal in some areas, and rain in the early part of spring has been 40% of normal.

China began increasing its imports of wheat this past season. For 2004-05, it has already booked 1.575 million tonnes of US exports, more than it bought from the US in all of 2003-04. Production is expected to decline once again, to about 81 million tonnes from 86 million tonnes in 2003-04, so we can expect Chinese imports to continue to grow.

In its first estimate for 2003-04 last May, the USDA forecast global output at 569 million tonnes. The most recent estimate, which is fairly close to a final estimate, showed a global wheat crop of only 549.3 million tonnes. The previous season's first estimate was for a global crop of 595 million tonnes, but the final tally was almost 30 million tonnes below that, at 566 million tonnes. So it is a little early to become very optimistic about crops, which in many cases are still in

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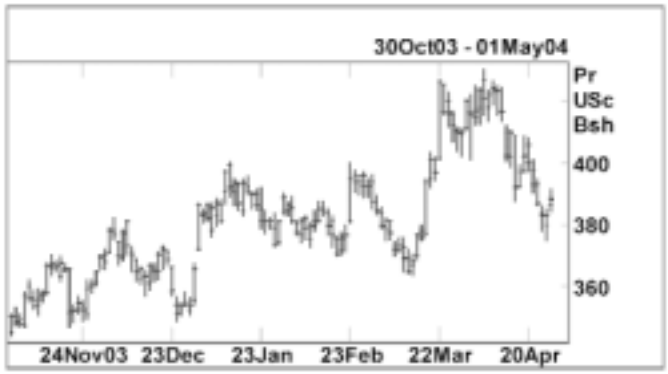
the very early stages of development. And as illustrated, while some key crops are looking fairly good, others are not.

Aside from the outlook for a better supplied market in the coming months, the market was very overbought in terms of the huge long position that commodity funds have built. As such, a correction was warranted. Having shed a fair bit of the baggage – CFTC data show that the funds' long position shrank by over 10,000 contracts last week – the market will stabilize and resume the long-term trend, which we believe will eventually take prices beyond the $4.40-per-bushel high we saw in September 2002. *[April 28, 2004]*

STRATEGY: *Buy July wheat as per Flash Update of April 27. Place initial stops at 3.70, close only.*

1. *Actually, global output for 2001-02 was up slightly over 2000-01 output, but production declined from 610 million tonnes in1997-98 to 549 million tonnes in 2003-04.*

Chart 1 – July CBT wheat



Courtesy Reuters

CORN

Tight, and tightening

It is quite a challenge to get through an entire conversation regarding ending stocks of commodities these days without hearing about the new reality of just-in-time inventory, which – allegedly – renders comparisons with other eras useless. Perhaps. Without straying very far from the topic of our discussion, however, we can cite at least one example that illustrates how unanticipated developments can quickly create a very tight market. Such a market would leave commodity consumers who had been maintaining only light inventories short, with prices rising uncontrollably out of their reach. Who would have believed that even explosive growth in South American crops – which would see Brazil almost double production over a five-year span – would not be enough to quell insatiable Asian demand?

The USDA estimates that the US – the world's largest producer and exporter of corn – will see 2003-04 ending stocks fall to 21.73 million tonnes, or 8.3% of consumption, compared with 11.5% in 2002-03 and 16.3% in 2001-02. Stocks were last this low during the 1995-96 season, when stocks as a percentage of consumption sank to 5%. There is, however, a significant difference between then and now. At the time, global ending stocks were 22.8% of consumption. This year, the USDA estimate for global ending stocks is at a record low of 10.4% of consumption!

While there has been much fuss over the growth of protein feed demand during the past few years, the rapid increase in corn consumption has not drawn as much attention. Certainly, the issues in soybeans are more pressing at the moment. The US has – almost literally – run out of beans, and the rationing process has begun. US export sales have dried up to a trickle, and prices have risen far enough to swing pending planting decisions in favor of soybeans.

A closer look, however, reveals that growth in corn demand relative to availability of new supplies is equally explosive. Global soybean demand has grown by 26.2% over the past 5 years, but production has kept pace and has increased by 24.4%. Global corn usage has grown by 11% during this period, while output has increased by less than 1%. The global corn market has now completed its fourth consecutive year of production/consumption deficits. We've fallen from a global carryout of 29.1% of consumption at the start of the 5 years in our study period to this year's 10.4%.

Unlike soybeans, there is little in the way of alternate producers. The only other country with any export capacity to speak of is Argentina. Weather-related problems will reduce this year's Argentinean crop to 12.5 million tonnes, and exports are estimated at 8.5 million tonnes. This compares with last year's 15.5-million-tonne crop and exports of 11 million tonnes.

The USDA estimate for 2003-04 US exports is 50.8 million tonnes, a dramatic improvement from dismal 2002-03 sales of 40.45 million tonnes, when an ample supply of carbohydrate feed substitute was available as a result of huge Eastern European crops.

There are 19 weeks left to the marketing year, during which US exporters need to sell 9.6 million tonnes of old-crop corn to meet the USDA target, which is just over 500,000 tonnes per week. Eventually, sales will shift to new-crop as the marketing year winds down. But old-crop still seems to be in demand, with average sales of 1.16 million tonnes over the past 4 weeks.

It is tempting to ignore the bullish statistics and pin the

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historic tightness in the corn market on the shift to just-in-time inventory management. We, however, believe that the market is vulnerable. A tight global supply/demand balance will not allow for any problems at all with the upcoming 2004-05 US crop. The planting season is going well so far, but there is a long summer ahead. *[May 5, 2004]*

STRATEGY: *Remain long July corn as per Flash Update of April 1. Maintain stops at 3.01, close only.*

Chart 2 – July corn



Courtesy Reuters

COTTON

Will economic slowdown in China threaten demand?

In the wake of speculation that the Chinese government is becoming increasingly nervous about an overheated economy, an April 23 Reuters article recalled that in a similar environment in 1993, the central bank chief was fired, and local officials who were not complying with government initiatives were reportedly threatened with having their heads chopped off.

Well, times have changed, and Chinese officials have been chatting with the media, preparing the market for measures that could be taken to cool off the economy, which is expanding at a double-digit rate of growth. Last week, news reports that carried specific steps that the government may take in the near future spooked the markets, and prices of many of the commodities we watch tumbled.

Hardest hit were industrial commodities in which Chinese buying has been the largest factor in the bull runs we've seen over the past year. Copper prices, for example, took a nasty 8¢-per-pound dive. To be sure, these markets would not have looked quite the same without Chinese buying. Does a tighter monetary policy in China mean the party is over?

Cotton prices were not immune, as recent losses were extended with a limit-down move, followed by a stab to eight-month lows. Traders have absorbed the potential for a rate hike and the imposition of other restrictive lending policies on bankers, and cotton and copper prices have since stabilized.

Getting back to China and the demand side, we are reminded of the SARS outbreak in the winter of 2003. The dreaded virus actually did hurt the economy in China, and global cotton prices suffered a sharp setback in anticipation of falling demand. Although there were temporary plant closures, mill usage – and by extension imports – was never affected materially. The Chinese government is not trying to destroy the economy, and certainly is not going to tamper with the country's powerful export infrastructure, a large part of which involves keeping textile mills in operation.

Although fighting inflation often involves unwanted pressures on an economy, we believe that we are best off focusing on the micro fundamentals of each commodity we trade. We are optimistic that we will detect a change in consumption patterns from within.

Before the Chinese economy became the topic *du jour* in the cotton pit, traders focused on the March 31 USDA 2004-05 planting intentions report. Chart 3 shows fairly clearly that the bearish implications of that report were the reason for the most recent 10¢-per-pound downleg of this market.

Analysts were significantly off the mark with this one. The average guesstimate was calling for 13.502 million acres to be planted to cotton, just slightly higher than 2003-04 acreage of 13.48 million acres. But the USDA estimate came in at 14.402 million acres, well above the highest trade estimate of 13.98 million acres. That would be over 1 million bales more than expected, a huge amount even at the global level.

Last month we pointed out that analysts are probably being too generous in believing that cotton acreage will expand this year. Chart 4 shows just how strong soybean prices are relative to cotton. Even with the deferred months in beans pricing in a great 2004-05 US soybean crop (November beans are trading more than $2 per bushel below the July), it is still very attractive to plant soybeans, at least in terms of the historical price relationship between cotton and soybeans. Chart 5 shows a similar relationship between cotton and corn.

We therefore believe that there is a high probability that where a choice can still be made between planting cotton or planting soybeans/corn, a significant amount of acreage will go to soybeans or corn.

The 2003-04 marketing year is drawing to a close with global ending stocks of 31.68 million bales, or 32.3% of consumption. This is the lowest carryout since the 1993-94 sea-

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son and well below average ending stocks of 43.7% for the past 10 years.

The market has been weak, largely in anticipation of a strong recovery in world production. It is a bit early for such optimism, though. In its April 22 forecast for the upcoming 2004-05 season, Cotton Outlook revised global output down by 129,000 bales from its March estimate, and raised its forecast for consumption by 873,000 bales. While these revisions still leave a production/consumption surplus, the percentage of stocks to consumption for the new season falls to slightly below 35%, from the 36.3% we calculated in our March 24 report.

The May USDA supply/demand situation report will contain the first comprehensive look at the 2004-05 season and will provide some further guidance for the key issues such as US and Chinese output.

We have not traded this severe decline in cotton prices very well, but we remain unfazed. We know of no reason for demand not to remain steady, but we do question the supply side of the equation that the market is currently working with. We remain sidelined but maintain a bullish bias.

[May 7, 2004]

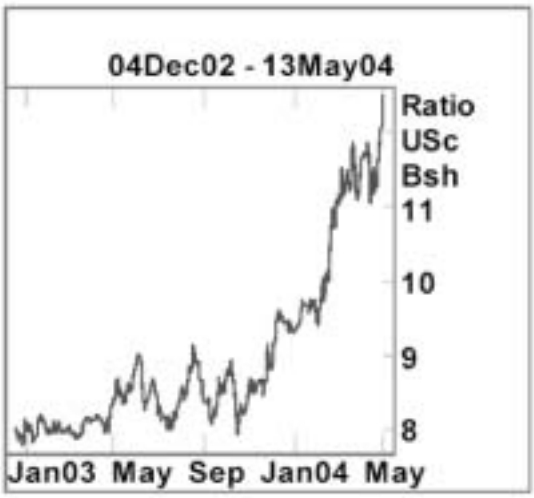
STRATEGY: *Stay tuned.*

Chart 3 – July cotton



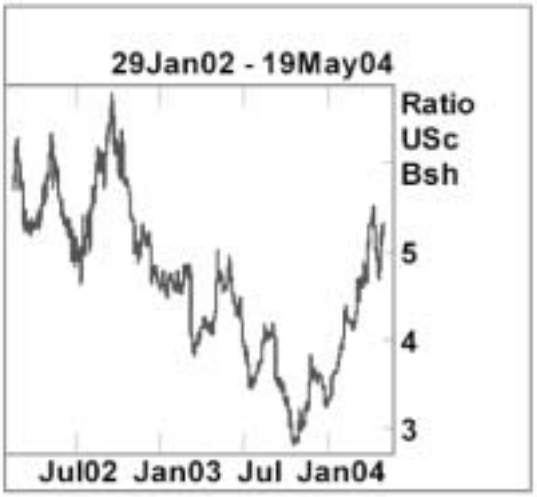
Courtesy Reuters

Chart 4 – November beans/December cotton



Courtesy Reuters

Chart 5 – December corn/December cotton



Courtesy Reuters

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COCOA

Good crops, but better demand

Cocoa prices have been threatening to break down below the $1,350-per-tonne support level. Given the success of the 2003-04 Ivorian main crop and the premium that was built into the market in anticipation of a crop failure, the weakness can be understood. We are long this market and holding on – barely. What is the bullish case, if any?

Even bullish news has not inspired this market. By early April, Ivorian arrivals had not only caught up with last year's arrivals, they had actually slipped out ahead of last year's pace. On April 29, it was reported that arrivals had dipped back below 2002-03 arrivals at 1.117 million tonnes. Prices had a little blip upwards, but retreated in short order. In any case, E.D.&F. Man's March 30 estimate of the 2003-04 Ivorian crop was for 1.3 million tonnes, down slightly from 2002-03 output of 1.36 million tonnes, so this was not surprising news.

Although Man is calling for a 40,000-tonne global surplus for 2003-04, stocks as a percentage of consumption will be drawn down to 41.4% from last season's 42.2%, because grindings grew more than output. Production increased by only 80,000 tonnes, or 2.6%, to 3.167 million tonnes. Grindings grew by 148,000, or 5%, to 3.127%.

This draws our attention to the demand side. All available indicators of demand are pointing – at the very least – to a repeat of the strong gains seen in 2003-04, and perhaps even a much stronger performance. Grinding results for the first quarter for the three principal Northern Hemisphere grinding regions all showed increases. First to report was Germany, with the largest gain of 23%. This was well above market expectations. The US grind, with a gain of only 1.26%, was below analysts' guesstimates. Finally, the pan-European grind came in at a very respectable 6.4%.

Market participants are accustomed to watching for the release of grinding statistics from the above-mentioned countries. But origin countries such as Brazil, Indonesia, and Malaysia have developed significant grinding industries and the data are often overlooked.

Malaysian grindings for 2003-04, for example, are estimated by Man at 165,000 tonnes, 22% above 2002-03 grindings. Indonesian grindings will be up slightly from the previous season at 115,000 tonnes. Brazil has become a major player, grinding 202,000 tonnes, 6.2% higher than the 190,000 tonnes ground in 2002-03.

All these data have been accounted for by Man and other analysts in their global supply/demand balances for 2003-04. The market is well aware that grindings rose 5% over the course of the marketing year. The point is that if the current pattern of stronger growth in demand *vis à vis* output is sustainable, bears will be in for a surprise.

Furthermore, butter ratios have been very strong. Butter prices have been quoted steadily at 2 times over London futures for several months now, something we have not seen in years. As recently as last summer, the ratio was as low as 1.5. This ratio has been over 2, but this is the first period we can remember that the ratio has been this high for this long. Asian ratios have recently been quoted as high as 2.4 and European ratios have been as high as 2.55.

The action in this market looks fairly bleak for bulls and does not support any of the theories presented above. Judging from price movement alone, it does not seem that commercial users are stepping in to buy the dips and support this market. A closer look at the anatomy of the open interest, however, reveals that the heavy selling that is pressuring prices originates from speculative interests and not from well-informed industrial concerns. Commodity funds are net-short 20,836 contracts, their largest short position since last June. Commercial traders have maintained a low profile, but are nonetheless taking the other side of the trade and gradually building what we believe to be a formidable long position.

[May 7, 2004]

STRATEGY: *Remain long July cocoa as per Flash Update of April 5. Maintain stops at 1310, close only.*

Chart 6 – July cocoa



Courtesy Reuters

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HOTLINE UPDATE

***Flash Update* – Monday, April 5, 2004:**
Good afternoon for Monday, April 5, 1:05 pm. This is a Flash Update. We have purchased July cocoa at 1433, placing our initial stop at 1310, close only.

Thursday, April 8, 2004:
Good afternoon for Thursday, April 8, 4:05 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On April 5, we purchased July cocoa at 1433.

We are currently long June gold at 422.20, with our stop at 378; long June Japanese yen at 9093, with our stop at 8890; long July crude oil at 33.95, with our stop revised to 31.95; short June mini S&P at 1124.75, with our stop at 1164; long July corn at 326, with our stop at 301; and long July cocoa at 1433, with our initial stop at 1310. All stops are close only.

Friday, April 16, 2004:
Good afternoon for Friday, April 16, 4:35 pm. The following is a recap of our latest recommendations and stop levels. We are currently long June gold at 422.20, with our stop at 378; long June Japanese yen at 9093, with our stop at 8890; long July crude oil at 33.95, with our stop at 31.95; short June mini S&P at 1124.75; with our stop at 1164; long July corn at 326, with our stop at 301; and long July cocoa at 1433, with our stop at 1310. All stops are close only.

***Flash Update* – Wednesday, April 21, 2004:**
Good morning for Wednesday, April 21, 10:20 am. This is a Flash Update. We have liquidated our long July crude oil position at 35.20.

Friday, April 23, 2004:
Good afternoon for Friday, April 23, 4:35 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On April 21 we liquidated our long July crude oil position at 35.20.

We are currently long June gold at 422.20, with our stop at 378; long June Japanese yen at 9093, with our stop at 8890; short June mini S&P at 1124.75, with our stop at 1164; long July corn at 326, with our stop at 301; and long July cocoa at 1433, with our stop at 1310. All stops are close only.

***Flash Update* – Tuesday, April 27, 2004:**
Good morning for Tuesday, April 27, 1:10 pm. This is a Flash Update. We have purchased July wheat at 388, placing our initial stop at 370, close only.

***Flash Update* – Thursday, April 29, 2004:**
Good morning for Thursday, April 29, 8:30 am. This is a Flash Update. We have liquidated our long June Japanese yen position at 9099.

Friday, April 30, 2004:
Good afternoon for Friday, April 30, 4:05 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On April 27, we purchased July wheat at 388. On April 29, we liquidated our long June Japanese yen position at 9099.

We are currently long June gold at 422.20, with our stop at 378; short June mini S&P at 1124.75, with our stop at 1164; long July corn at 326, with our stop at 301; long July cocoa at 1433, with our stop at 1310; and long July wheat at 388, with our initial stop at 370. All stops are close only.

***Flash Update* – Tuesday, May 4, 2004:**
Good afternoon for Tuesday, May 4, 12:25 pm. This is a Flash Update. We have covered our short June mini S&P position at 1114.

***Flash Update* – Friday, May 7, 2004:**
Good afternoon for Friday, May 7, 12:05 pm. This is a Flash Update. We have liquidated our long June gold position at 377.80.

Friday, May 7, 2004:
Good afternoon for Friday, May 7, 4:25 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On May 4, we covered our short June mini S&P position at 1114. On May 7, we liquidated our long June gold position at 377.80. We are currently long July corn at 326, with our stop at 301; long July cocoa at 1433, with our stop at 1310; and long July wheat at 388, with our stop at 370. All stops are close only.

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