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Has the copper rally run out of steam?

After plunging from the dizzying heights of $4.16-per-pound set in May 2006, the copper market found a floor in early February at $2.40 per pound. But the market has recovered two thirds of the drop in the space of two and a half months (Chart 1). Why such strength, and for that matter, why such weakness in the first place? Which move fairly represents supply/demand fundamentals? After all, is it possible for fundamentals to have been bearish enough to allow prices to fall by more than 40% and then for fundamentals to have suddenly become sufficiently bullish to see the market recover more than half the losses? We think not.

To be sure, there have been ample bullish events to drive the market's recovery. Customs data released on April 23 showed that Chinese imports of refined copper in March hit a record of over 200,000 tonnes, which brings the year-to-date total to a 134% increase over last year.

Chile does not have a monopoly on labor unrest. Some of the world's other major producers, such as Indonesia and Peru, have been weaving in and out of strikes and threatened strikes. Individually, each supply disruption may not be that significant, but collectively the work stoppages undermine the potential production capacity growth we've seen in the industry in recent years.

But despite the headline-grabbing stories of strong demand and vulnerable supply, we are steadily moving further into surplus territory. According to The International Copper Study Group's (ICSG) final numbers for 2006, the global refined market was in a surplus position of 361,000 tonnes, compared with deficits of 107,000 tonnes at the end of 2005 and close to 1 million tonnes in 2004.

While it is quite true that Asian demand remains strong and continued growth should be expected, the market is perhaps not focusing on other significant regional demand centers such as the US, which is dealing with a slowdown in the housing market. Although ICSG's latest figures are a bit dated, it is still the best source for global data. The data show that the market accumulated a surplus of 40,000 tonnes in January alone.

Mine output in Chile is off to a ho-hum start. With a 4% gain in January and flat production in February, projected near-6% output increase for 2007 has already fallen behind the pace. The impediments – whether labor issues or mine accidents such as the recent fire at a Codelco mine – are all of a temporary nature, and ultimately, we believe, production in Chile and elsewhere will overwhelm demand. Although costs have reportedly been rising, which should cut into profitability, the margins are still fat – very fat – and should cause no let up in the incentive for production. Take for example, Freeport McMoran – the world's largest publicly traded copper miner after its merger with Phelps Dodge – which reported cash costs at its Indonesian operations of 60¢ per pound in its 2006 annual report!

Global exchange warehouse stocks have continued to increase even during the recent bull run, climbing to their highest level since early 2004 (Chart 2).

There's been no fresh buying on this rally, neither speculative nor commercial. Open interest has fallen steadily (Chart 2) and did not recover anywhere back to the level it attained at the peak of the market. In fact, commodity funds that rode the dramatic drop down have been covering their shorts – their net-short position has fallen from 22,000 contracts in early February, when the rally began, to the current level of only 8,800 contracts. Commercials have moved from a net-long position of 23,000 contracts in early February to their present position of net-long only 10,000 contracts.

Trading this market is not for the faint of heart. We think we're at or near an intermediate-term – if not permanent – top. Establish cautious short positions commensurate with your financial means and your sleeping habits. *[April 27, 2007]*

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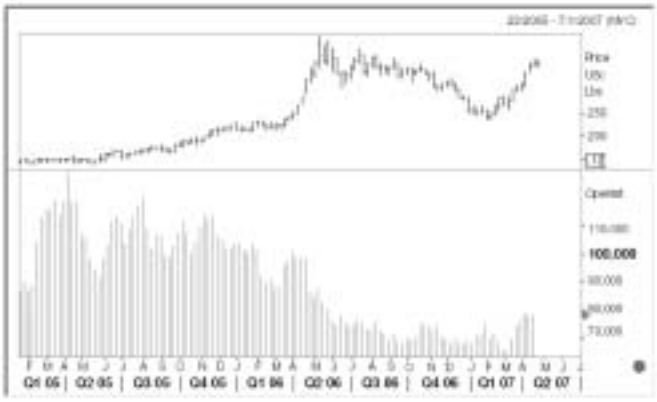
Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: *ssanik@friedberg.ca*).

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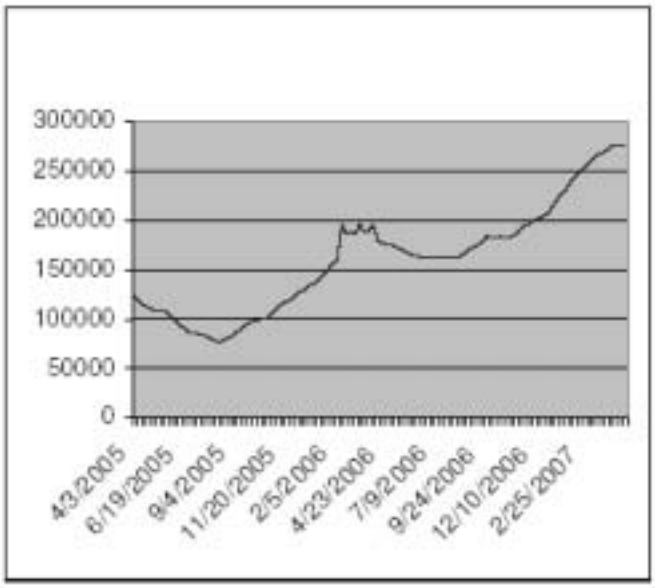
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Chart 1 – COMEX copper (top) open interest (bottom)



Courtesy Reuters

Chart 2 – Global copper warehouse stocks



CORN

Lights out for the bull?

Old-crop corn prices (Chart 3, top) have fallen $1 per bushel – more than 20% – during March and have spent April consolidating those losses. What kind of bull market is that? The spreads favored the new-crop months (Chart 3, bottom) as the market slid, with December corn shedding only 65¢ per pound.

In 2006-07 US farmers planted 78.32 million acres of corn. High prices were sure to inspire a huge leap in acreage, but the March 30 planting intentions report was still quite a surprise. The report showed that corn acreage would swell to 90.5 million corn acres, 2.5 million acres more than analysts' estimates.

Old-crop prices tumbled by 50¢ per bushel over the next three sessions. The old-crop/new crop spread continued to deteriorate, however, which was not a wholly logical outcome. If the new acres were the primary factor in driving prices lower, December should have been weaker. Our theory is that the market was responding to a different bearish influence: softer demand. The extra acreage was "in the market," and it was not until we started facing serious planting delays that the market responded to the possibility that the new crop would fail to meet growing demand.

The export sector remains powerful. The USDA's forecast for 2006-07 foreign sales is 57.15 million tonnes – 4.7% larger than the previous season – but current commitments stand 10.7% ahead of last year. With four months remaining in the marketing year, shipments as a percentage of commitments are running at the same pace as the past couple of seasons, so we're right on target to meet the robust USDA estimate.

The problem lies with the other consumption sectors: feed and ethanol. Traders did not focus as much attention on the quarterly stock report that accompanied the acreage report on March 30. Corn stocks on March 1 were 6.070 billion bushels, 76 million bushels above analysts' guesstimates.

In its monthly supply/demand situation report, the USDA trimmed domestic feed usage by 125 million bushels. The estimate for US ending stocks rose to 877 million bushels, or 7.5% of consumption, still very low in historic terms, but not quite the panicky "we're-running-out-of-corn" level we became accustomed to this season.

Furthermore, the USDA maintains its US ethanol consumption estimate at 2.15 billion bushels. EIA data show that current usage during the corn marketing year still lags and would actually reach only 2.05 billion bushels, which would put US ending stocks up close to 1 billion bushels, about 8.5% of consumption, a level with very little bull market luster left.

In February, the USDA forecast that new-crop ethanol consumption would climb to over 3 billion bushels. Given current consumption trends, that seems very futuristic, particularly in light of the fact that ethanol producers have become more efficient. Commodity trader John Bondurant says that efficiency rates have increased over the past two

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years by about 7%, to 2.85 gallons of ethanol per bushel of corn.

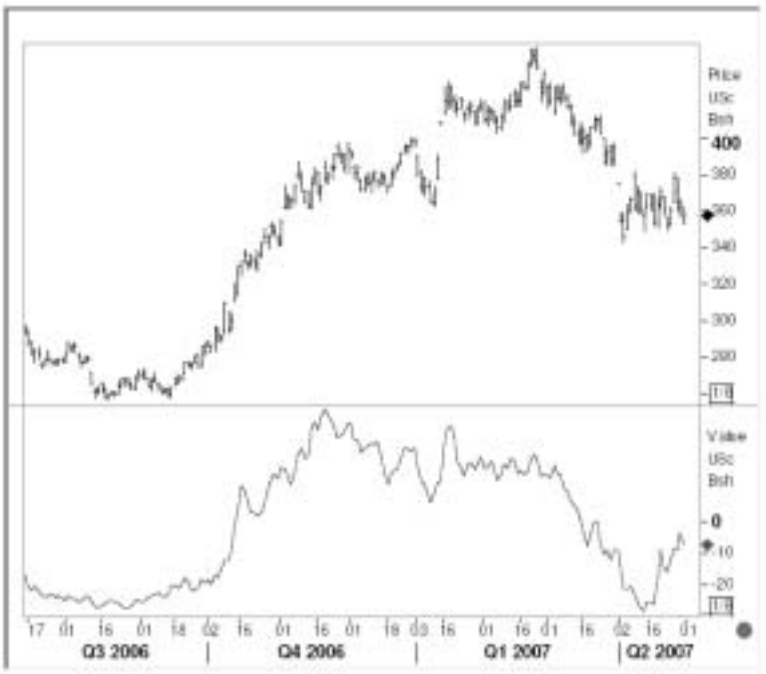
Thus, the sharp drop in the old-crop/new-crop spread makes more sense when viewed in terms of an overestimation of 2006-07 consumption. We correctly identified this situation back in February and profited from the collapse of the spread, although we were a bit hasty in exiting the position (see *Focus on Futures*, February 15).

Indeed, the recovery in the spread we've seen since mid-April was directly related to a new crop issue. Poor planting weather threatened to force farmers to abandon significant area that was slated for corn planting. This week's crop progress report showed that only 23% of the crop was planted, compared with 48% last year at this time and a 5-year average of 42%. But this report is obviously somewhat stale, because the weather has improved over the past two weeks and farmers have been getting the crop in the ground. We can expect this to be reflected in the progress reports in the coming weeks.

We're not prepared to declare an end to the bull market. However, it seems that demand may have been overstated. And, as we have seen in other instances (most recently in the sugar market), the "efficient" market responds to a shift in demand. It took about one and a half years and a powerful bull to create the incentive, but we may be there.

We believe that this market will drift aimlessly until new-crop acreage and the demand picture become somewhat clearer. We advise standing aside. *[May 1, 2007]*

Chart 3 – May corn (top), May/December spread (bottom)



Courtesy Reuters

SOYBEANS

The South American soy onslaught

The March 30 USDA planting intentions report sent November (new-crop) soybeans to what was a new high at the time, but the market faltered in classic "buy-the-rumor-sell-the-news" fashion (Chart 4). The average analysts' estimate was for US farmers to plant 69.18 million soybean acres for the 2007-08 season, down rather dramatically from 75.22 million acres in 2006-07. The number came in at 67.14 million acres. It was actually the flip side of the increase in corn plantings, which were 2.5 million acres higher than expected.

Soybean prices continued to slip through mid-April despite the sharp reduction in acreage. At 67 million acres and with trendline yields, US production would fall to 2.8 million bushels, or about 77 million tonnes, the smallest crop since 2003-04. Even if demand did not grow in the 2007-08 marketing year, we would be looking at the largest production/consumption deficit since the bull market of the mid-1990s.

Two factors were responsible for the weakness. First, corn farmers were experiencing poor planting conditions.

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This would result in many acres that were originally designated for corn being switched to soybeans, which can be planted past the corn-seeding deadline.

Then on April 10, the USDA confirmed private South American forecasts for an increase in the estimates for the Brazilian and Argentinean crops, which are now in harvest. Brazilian production was raised by 1.8 million tonnes, to 58.8 million tonnes, and Argentinean output was boosted by 1.5 million tonnes, to 45.5 million tonnes. True, these South American figures were no great shock to the market, but the endorsement by the USDA seemed to matter.

We had worked ourselves up into quite a bullish mode (see *Focus on Futures*, March 8) mostly because of the vulnerability that would be created for US output with such a drastic reduction in acres. It seems, however, that this was the only bullish factor, and while a poor growing season may yet expose that vulnerability, all other factors seem to be coming together to ease any fears of tightness.

Now that we're much closer to the end of the South American harvest, the estimates have a much smaller probability of tapering off the way they have in previous years. This season, rather than starting early season forecasts at unrealistic estimates of over 60 million tonnes, the market came from the other direction. When planting season was getting underway this past fall, there was talk of a 7% reduction in Brazilian soy acres because of poor profitability. As prices rose, however, all that changed, and instead, both South American producers are slated to produce record crops.

Perhaps bulls – like us – were living in a bit of a fantasy world before the USDA gave its nod to much higher estimates for South America. The revisions will raise 2006-07 global ending stocks to 61 million tonnes, or 27.06% of consumption, up from 25.07% last season and the highest level on record.

The US crop that is being planted this spring for the 2007-08 season is the wild card. The worst case acreage scenario is already in the market, as evidenced by the market's inability to hold November beans over $8 per bushel, even after learning that the crop will be sown on a scant 67 million acres. What is left is the exposure to the possibility of poor planting and growing conditions. Even if the weather is not ideal over the next several months, we should keep in mind that the new generation of seeds has proven to be very hardy in recent seasons, even when we thought drought conditions would reduce yields.

We have developed a bearish bias, but we expect excessive volatility in the immediate future as the market tries to figure out if soybeans or corn will be planted on the variable acres. Estimates for changes to the March 30 intentions report range from 1 million to 2 million acres. Stand aside, but do stay tuned. *[May 2, 2007]*

Chart 4 – November soybeans



Courtesy Reuters

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Subscription Enquiries for
Friedberg's Focus on Futures
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
416-364-1171

All enquiries concerning trading accounts should be directed to:
In Canada
Friedberg Mercantile Group Ltd.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

For U.S. Persons
Friedberg Mercantile Group, Inc.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario, Canada M5J 2T3
1-800-461-2700

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