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Cotton: global inventories ticking down

On the surface, the July 12 monthly USDA crop report for cotton did not seem remarkably bullish. True, the estimate for 2016-17 global ending stocks as a percentage of consumption was revised downwards, by close to 4 percentage points, to 81.8%. But when compared with virtually any other commodity, that figure can hardly be construed to be the stuff of a bull market. So what would account for the market's reaction – limit-up! (Chart 1). And the rally continued in the following sessions, driving prices to two-year highs.

For the US, planted area rose by 442,000 acres. That was a non-event. It was merely the June 30 planting report being plugged into the balance sheet. The yield estimate, however, was raised slightly, from 807 pounds per acre to 815 pounds per acre. These two revisions increased the output estimate by 1 million bales from the June estimate, to 15.8 million bales. This compares with 2015-16 production of only 12.89 million bales.

On the US demand side, the estimate for 2016-17 exports was increased sharply, by 1 million bales, to 11.50 million bales. And here is where – if realized – the cotton market may be taking on a bit of a more bullish complexion and may be signifying a turning point – from bear to bull.

The increase in US exports is mitigated by the increase in supply mentioned above and leaves US ending-stock levels little changed from previous estimates. However, in an era in which the Chinese are trying to whittle down their own burdensome stockpiles, which has already resulted in plunging Chinese imports over the past few years, a forecast for a meaningful increase in demand for US cotton can certainly be interpreted as bullish news.

As mentioned, a cursory glance at global ending stocks would still cast the impression that it will take years to make a dent in inventories. But there were several revisions that – for the most part – reflect the success that Chinese mills have had in substituting imports with cotton from the domestic stockpile.

Perhaps as an even more concrete indicator, a good chunk of the downward revision to 2016-17 stocks comes form a revised estimate for the 2015-16 marketing year. Not a prediction, but – assuming the data provided by the Chinese government are anywhere near accurate – a process that is already well underway. Chinese ending stocks were lowered by close to 2 million bales.

As a result of this past season's drought, 2015-16 Indian production fell to 26.8 million bales, compared with 29.5 million bales in 2014-15, the lowest level since the 2009-10 season. Ending stocks have tumbled by 17%. For the new crop, cultivated area is estimated to have fallen by 23% from 2015-16. An ample monsoon has compensated for its late arrival, but the USDA still lowered its output estimate for the new crop by 500,000 bales, to 27.5 million bales. Despite the Indian government's claim that exporters will have no problem equaling – or even exceeding – 2015-16 sales, the USDA estimates 2016-17 Indian exports at 4.2 million bales, down from 5.8 million bales in 2015-16.

Indian mills have reportedly been importing cotton to meet demand. The USDA maintained its forecast for imports at below 1 million bales, the level we've seen in recent years, for both the current 2015-16 and the upcoming 2016-17 marketing years. Based on more current market reports, however, we believe that this estimate will rise and will be reflected in future USDA reports.

The onus therefore falls on the US to be the supplier of last resort. Falling Chinese stocks and tightness in India provide an insight into the market's strength. It is very early in what has thus far been a hot summer in the US. If the crop

Inside

muddles through, then the rally we're experiencing should fade. However, if weather issues threaten US output, we should see bloated global inventories shrivel faster than anyone might have anticipated.

Remain long December cotton, as per our May 26 recommendation. Raise stop from 60¢ per pound, to 66¢, close only.

[Sholom Sanik, July 19, 2016]

Chart 1 – December cotton

Courtesy Reuters

COCOA

A tired bull

It would seem that the cocoa market owns a very impressive portfolio of bullish fundamentals:

For starters, on the supply side, we're near the end of the West African mid-crop, where about 70% of the world's cocoa beans are grown. Output for 2015-16 from the two largest producing nations – the Ivory Coast and Ghana – will be disappointing. The gap between this season's and last season's port arrivals in the Ivory Coast keeps widening. At last count, arrivals stood at 1.419 million tonnes, down 185,000 tonnes from last year at this time.

Ghanaian production is expected to reach 800,000 tonnes, up from last year's output of 740,000 tonnes, but down from early-season estimates of 840,000 tonnes.

As a result, the International Cocoa Organization forecasts a global production/consumption deficit of 180,000 tonnes, up from its previous forecast of 113,000 tonnes. In comparison, the 2014-15 marketing year closed with a 46,000-tonne surplus.

Most indicators on the consumption side point to improved demand. Recently released second-quarter grind data from the non-origin-country regions were quite strong. For Europe, the grind rose a stellar 4.9% year-over year. The North American grind was up 3.38% to the highest quarterly tally since the second quarter of 2014.

The European grind figures are published a couple of days prior to their North American counterparts. Early in the trading session following the release of the North American numbers, cocoa prices made a new high for the move. Before the day was out, though, the market sold off sharply, closing out the day down almost $100 per tonne below the previous afternoon's settlement (Chart 2). Strange behavior – particularly in light of struggling port arrivals in the Ivory Coast.

Perhaps traders are concerned about the sustainability of such robust grinding activity. The cocoa butter ratio has been moving up and is now back at 2.4 times the London spot price for beans, a seven-month high (Chart 3). Powder prices, however, have been slipping and have dragged the combined ratio down to recent lows (Chart 4). Butter prices seem to get more attention, but if powder prices remain weak, the incentive for grinders to increase bean purchases is compromised.

We believe that this explains – at least partially – the market's negative reaction to the grind figures.

In recent issues of *Focus on Futures* we've harped on the fact that cocoa is the only one of the major internationally-traded commodities that has maintained price levels near the peak of the broad bull markets that began in the mid-2000s. Commodity funds have maintained a net-long position since 2013 (Chart 5).

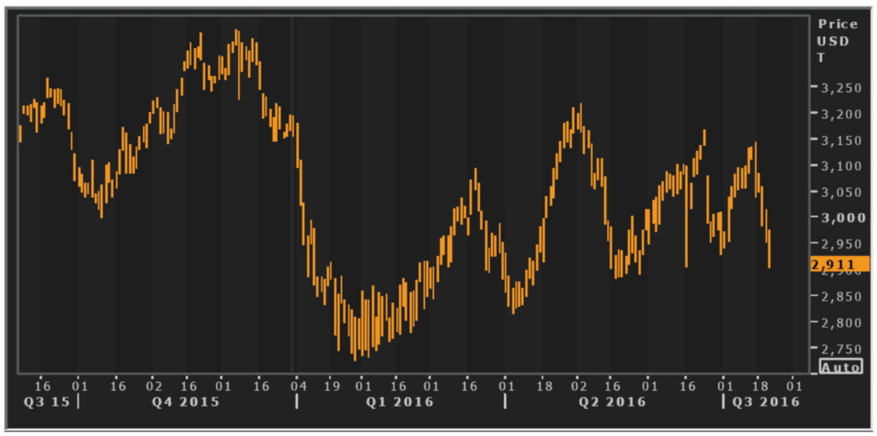
True, the cocoa market has unique features, such as having over 70% of world output concentrated in a single politically volatile region. However, the only time in modern history in which political strife actually threatened cocoa supply shipments, the market muddled through. During the 1999 coup in the Ivory Coast, the government held back 500,000 tonnes, but the beans were shipped eventually, and there have not been any problems since.

Global ending stocks for 2015-16 as a percentage of consumption will dip below 35% for the first time in many years. That's high for most markets, but is considered worrisome for cocoa.

We are intrigued by the recent price weakness in the face of the generally bullish supply/demand fundamentals. Should the funds decide that this market is overvalued – as we believe it is – the liquidation that would ensue should trigger a dramatic fall in prices. We recommend establishing a short position in December cocoa. Place initial stops at $3,250 per tonne, close only.

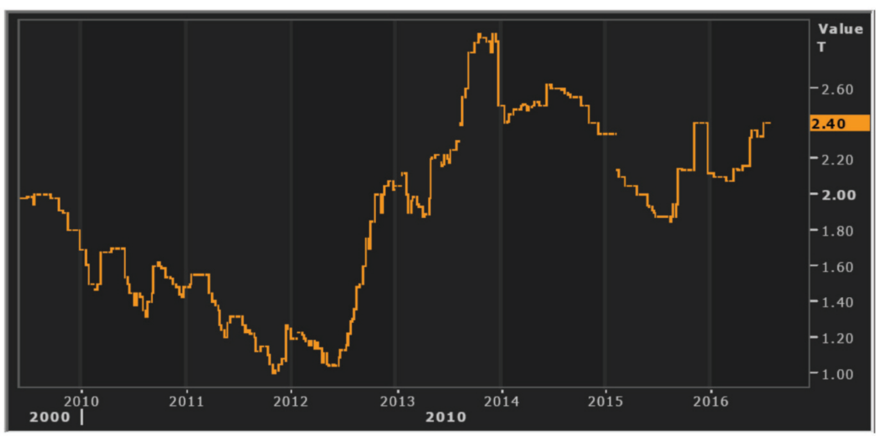
[By Sholom Sanik, July 21, 2016]

Chart 2 – December cocoa



Courtesy Reuters

Chart 3 – Cocoa butter ratio



Courtesy Reuters

Chart 4 – Combined cocoa butter/powder ratio

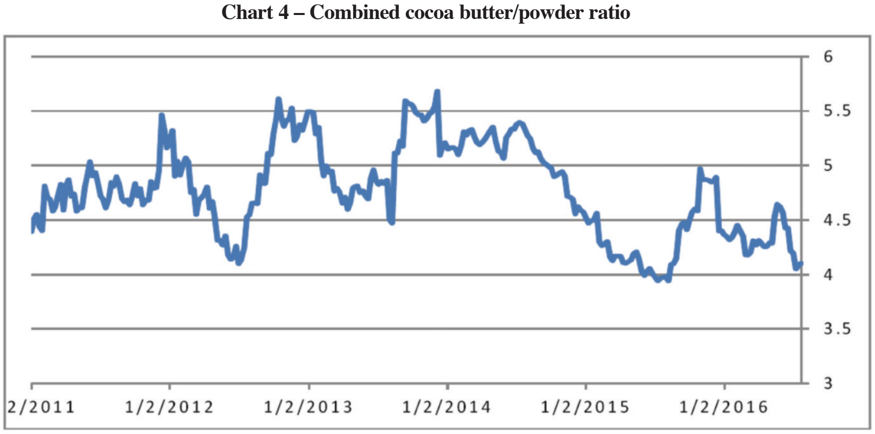
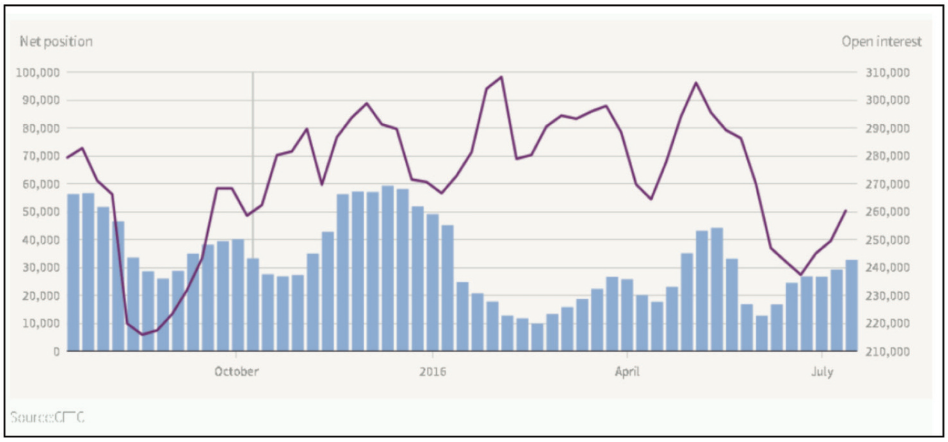


Chart 5 – Commodity fund long position and open interest



Source: CFTC

SOYBEANS

A Chinese stock reduction: fact or myth?

From the end of the 2015-16 US soybean harvest in the autumn of 2015, through spring this year, soybean prices crawled along in a narrow range, at multi-year lows. The 2014-15 marketing year had closed out with global ending stocks of 26.1% of usage, their highest level since the 2010-11 marketing year. Anticipation of bumper crops in South America for 2015-16, to be harvested in spring 2016, kept a lid on any rallies.

Then, as South American harvests approached, weather problems led to reduced output estimates. Estimates for 2016-17 US acreage were slipping. Global ending stocks for 2015-16 were set to fall sharply, to 22.7% of consumption. A powerful rally ensued that saw the new-crop November soybean contract soar to close to $12 per bushel.

In the next phase, planting progress in the early going for the 2016-17 US crop was lagging the 5-year average. South American crop losses were significant. The April estimates for Brazilian and Argentinean production were 100 million tonnes and 59 million tonnes, respectively. By May, those estimates had fallen to 97 million tonnes and 56.5 million tonnes. That kept the rally alive through late June.

Since early July, however, the market has retraced about two thirds of the gains. While there hasn't been any single stark factor that has pummeled the market, there have been several bearish supply/demand developments – some real, others simply *perceived* to be bearish (Chart 6).

The US crop got into the ground in ample time to benefit from optimum growing conditions. Weekly crop progress reports show that the good-to-excellent portion of the crop has been running consistently about 9 percentage points ahead of the 2015-16 crop. Nobody seems concerned about weather problems that may develop.

There is a vulnerability factor, though. Although it has been a hot summer, the crops, as noted, are faring well. There have been several incidents in recent history in which a La Niña event followed an El Niño, which caused drought conditions in key growing regions. With each passing day, however, the likelihood of crop damage diminishes, and this has been part of the reason for the market's weakness.

The other issue that has sent bulls for cover and has seen the CFTC net-long fund position drop about 90,000 contracts is talk that demand has slowed down. In particular, the Chinese were eager buyers all season long. The long-discussed destocking of commodities, such as corn, cotton and soybeans, that would eventually see import levels drop materially has apparently been picking up steam (see *Focus on Futures*, July 19). *Oil World*, a respected industry publication, said recently that the USDA estimate for 2016-17 Chinese soybean imports was overstated by 5.5 million tonnes.

If this were accurate, it would have a significant impact on the global balance sheet, mainly because it would mean that US ending stocks would swell.

For corn and cotton, the process of lowering burdensome inventory levels makes much sense. As a percentage of consumption, Chinese stocks of corn and cotton closed out 2015-16 at 50.8% and 178%, respectively. No, it's not a typo: 178%! When it comes to soybeans, however, we have trouble understanding what exactly it is that the Chinese are destocking. According to the USDA, 2015-16 ending stocks were 17% of usage. China grows only about 15% of its soybean needs and relies on imports for the balance. As can be seen from the carryover levels, the Chinese didn't over-import soybeans as they did with cotton. So we are skeptical regarding the media reports that are effectively saying that there is enough inventory to see imports curtailed.

And there is evidence to support our theory. This past week was the first in which net-new US foreign sales were net negative, meaning that there were cancellations. Typically, at this time of year, US soybean sales have dried up. This year, over the past six weeks, new sales averaged 588,000 tonnes, of which China has been a participant. In the previous five years, new sales averaged only 68,000 tonnes during the same period.

This past week's cancellations may have triggered the annual shift to South American origins. However, it is not likely to have any meaningful effect on the balance sheet. US exporters have already shipped 45.6 million tonnes of the USDA's 48.8-million-tonne estimate. With five weeks left in the marketing year and based on the recent trend in weekly shipments, we will probably come up shy of the target – we estimate by about 1 million tonnes. Those sales will be carried forward to the New Year.

We are focusing on the early forecasts for 2016-17 global ending stocks, which the USDA estimates at 20.4% of usage, the second consecutive decline. The carryover has not been this low since 2011-12. We therefore remain long-term bullish.

We were stopped out of our long position at $9.90 per bushel, basis November, as per our May 13 recommendation. Simply taking back the position at this point would constitute the classic bad habit of trying to catch the falling knife. We will therefore assume that if the market can trade above the recent consolidation, it could be an indication that the complacency among market participants regarding the vulnerability factors, such as US weather, have come back in to play.

Buy November soybeans on a close above $10 per bushel. If filled, place initial sell stops at $9.50, close only.

[By Sholom Sanik, July 29, 2016]

Chart 6 – November soybeans

Courtesy Reuters

SUGAR

The bull blinks

After peaking in late June at just over 21¢ per pound, sugar prices slipped through early August, to below 19¢ per pound. Then in the space of three sessions, the market recouped most of those losses (Chart 7).

The selling was inspired by a number of factors that spooked commodity funds, which had built a massive long position of 280,000 contracts (Chart 8).

First, the new 2016-17 Brazilian crushing season started in April. Early results for the Center South, where 90% of the country's sugar is produced, were on pace for record output of 36 million tonnes. Those estimates have since been modified because of inclement weather, but production is still expected to reach 35 million tonnes, up from the record 34.4 million tonnes recorded in 2013-14.

After two years of drought in India, the strength of this year's monsoon was a key concern for 2016-17 output. When the monsoon rains proved to be quite healthy, traders began to question forecasts for another year of sub-par sugar production in India.

The above-average monsoon was certainly welcome news for Indian sugar farmers. However, it is not expected to facilitate a recovery to normal production levels. First, subsoil moisture levels are still low from the drought conditions. Furthermore, Maharashtra state has traditionally been the largest producing region in India, responsible for about 35% of the country's output. But area under cultivation for 2016-17 has fallen by more than 20%, mostly because of switching to crops that are less reliant on the monsoon.

Other regions are expected to see small increases in cultivated area, but for India as a whole, area is estimated to be 5.5% lower than in 2015-16. Coupled with lower yields, total 2016-17 output is currently forecast at 23.5 million tonnes, down from 25.2 million tonnes in 2015-16.

At the moment it would seem that Indian ending stocks will close out 2015-16 at about 7 million tonnes – already low by historical standards. Domestic consumption is expected to rise to a record 26 million tonnes, which would leave 2016-17 ending stocks at just over 4 million tonnes, a throwback to the drought seasons of 2008-09 and 2009-10.

On the demand side, the primary hot spot is China. As we've pointed out in the past, China has not normally entered into discussions regarding the global sugar balance. That has changed. Up until a few years ago, China would meet its production/consumption shortfall with imports of between 4 million and 5 million tonnes.

Domestic production is plagued by the same problems that affected Brazil and India in recent years. Mills have been shutting because of poor profitability. As recently as the 2013-14 season, output reached 14 million tonnes. The early forecast for 2016-17 output is 8.2 million tonnes, down slightly from 2015-16. Estimates for 2015-16 and 2016-17 imports stand at about 7 million tonnes and 8 million tonnes, respectively.

Even with a bumper crop in Brazil, average estimates for the 2016-17 global production/consumption balance call for a deficit of 8 million tonnes, which follows a 2015-16 deficit of 6 million tonnes.

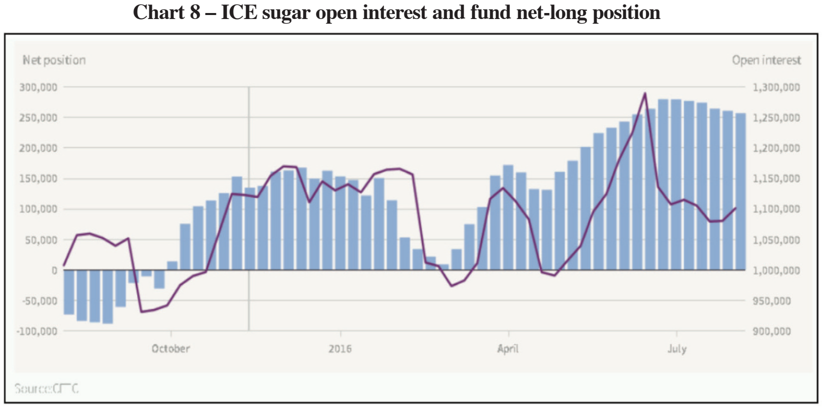
On January 26, we recommended the purchase of October 2016 16¢ call options. These are now deep in the money and near expiry. Roll these options into March 2017 22¢ call options.

[By Sholom Sanik, August 10, 2016]

Chart 7 – October sugar

Courtesy Reuters

Chart 8 – ICE sugar open interest and fund net-long position



Source: CFTC

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