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Cotton: continuing to chip away at the inventory monster

Cotton prices broke above their long-standing trading range just prior to the release of the July USDA crop report because of poor weather in both the US and India. The market built on the rally after the release of the bullish report, which finally showed a downward tick in burdensome global inventories. Prices proceeded to trade at two-year highs (Chart 1).

It's one month later, and almost the entire rally has disappeared. A few days before the release of the August crop report, traders reacted to forecasts for an improvement in the weather in these two key producing nations with a limit-down thrashing. The selling continued after the crop report was deemed bearish. The only problem is that – in our view – the report was not really very bearish.

The headline items that caught the eye of the bear were related to the 2016-17 US crop, to be harvested this fall. The estimate for the harvested-to-planted ratio was raised to 95.1% from 92.8%. However, the yield estimate was lowered to 800 pounds per acre from 815 pounds. So the revised crop-size estimate increased only by a negligible amount, from 15.80 million bales to 15.88 million bales. There were virtually no changes to the demand side – domestic mill usage or exports – and as a result, the ending stock estimate grew to 4.7 million bales from 4.6 million bales. Big deal.

The pre-report guesstimates are not as comprehensive as they are for grains, but there were "whisper" estimates that believed dry weather had affected the crop, with one estimate as low as 14.8 million bales. This probably explains the magnitude of the bearish activity after the report. When the US crop estimate was just slightly higher than last month, instead of being lower, long positions established in anticipation of a bullish report were liquidated. Indeed, open interest fell back to pre-report levels (Chart 2).

On the global front, on the other hand, there were more material bullish revisions. Indian 2016-17 production was lowered by 500,000 bales, to 27 million bales. That's still higher than the 26.4 million bales harvested in 2015-16, but it may be an overly optimistic outlook because cotton area is estimated at about 7% below the previous year. The logic is that the above-average monsoon rains will have improved yields, but it is too early to know.

Chinese output was lowered by 500,000 bales as well, to 21 million bales. In 2014-15 and 2015-16, China harvested 30 million bales and 22.5 million bales, respectively.

More significantly, the estimate for ending stocks in China and India were revised down by 1 million bales and 800,000 bales, respectively. After all the revisions to output and demand, global ending stocks for 2016-17 were revised down from the July estimate by 1.7 million bales, to 89.61 million bales, or 80.5% of consumption, down from the July estimate of 81.8%. Still chunky, but when compared with 102% in 2014-15 and 90% in 2015-16, we're making some headway.

Much as the bullish reaction to the July report was overdone, so was the bearish reaction to the August report. Cotton cultivation in the world's three largest producing nations – India, China, and the US – has been in decline over the past several years in response to falling prices. Only the US is growing a larger crop than last year, but as can be seen in Chart 3, global output has been trending lower since the mid-2000s.

Consumption growth has not kept pace with growth in other agricultural products as depicted in Chart 4, largely because of the inroads made by synthetics, but has remained steady. The bear market has thus accomplished its function of lowering output, but smaller cultivated area makes the mar-

Inside

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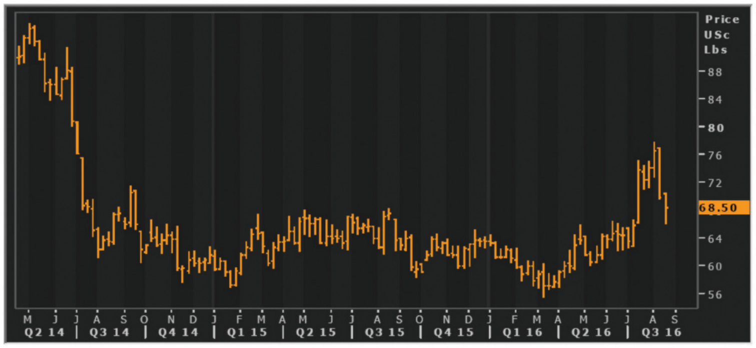
ket vulnerable to crop failures.

The bear market really ended four years ago when the free fall from $2 per pound halted. Yes, there have been gyrations between 65¢ per pound and 90¢ per pound, but we're pretty much at the same price now as we were in 2012.

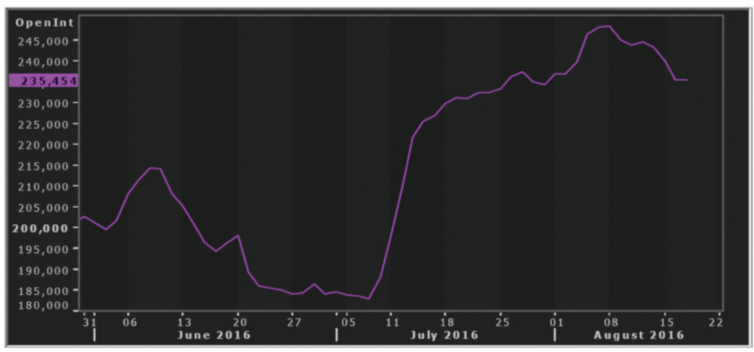
The market has moved higher since we established a long position on May 26. The market came close to taking out our revised July 19 stop of 66¢ per pound, but we were spared, for the moment anyway. Maintain moderate-sized long positions. *[Sholom Sanik, August 19, 2016]*

Chart 1
Weekly nearest contract ICE cotton



Courtesy Reuters

Chart 2
ICE cotton open interest



Courtesy Reuters

Chart 3
World cotton production

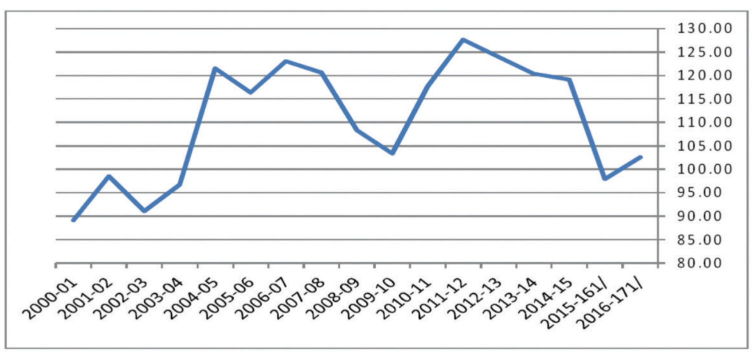
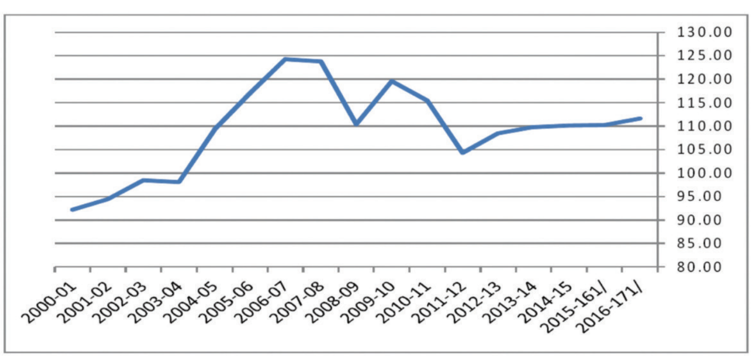


Chart 4
World cotton consumption



CORN

Bin-busting crops, but is there enough to go around?

The reaction to the August USDA crop report was a testimonial to the old trading rule "buy the rumor, sell the news," or as it happens in this case, "sell the rumor, buy the news."

Up until the July crop report, the USDA took a cautious stance with its forecast for the 2016-17 US corn crop. After all, it was a hot summer, and there was no way of knowing what the weather would be like as the crop matured in August.

Weekly crop-progress reports leading up to the August crop report, however, were showing the good-to-excellent portion of the crop at 74%, compared with 69% during the same period last year, so it seemed that it was a safe bet that the USDA was going to revise its outlook upwards. The average of analysts' yield guesstimates was 170.6 bushels per acre (bpa), up from the July estimate of 168.1 bpa, but the actual figure came in at a record 175 bpa. If achieved, that would surpass the record 171 bpa set in 2014-15.

Planted acreage and the recovery ratio were unchanged from the July estimate, but the yield upgrade will be enough to allow US farmers to harvest a record crop of 14.450 billion bushels. Ending stocks will rise to 2.409 billion bushels, or 16.6% of usage, compared with 1.706 billion bushels, or 12.5% in 2015-16. This would be the highest US carryout since 2005-06.

The USDA revised Brazilian 2015-16 output downward again, by 1.5 million tonnes from its July estimate, to 68.5 million tonnes. Private forecasters had even lower estimates, so this was not news at all.

In the short term, the Brazilian crop failure remains a bullish factor. Brazilian exporters even needed to import 1.5 million tonnes to meet their commitments.

Looking ahead, the 2016-17 planting season will be the first under the new regime in Argentina, where the elimination of the corn export tax is expected to play a material role. Early forecasts are calling for a 25% increase in area planted to corn. While on the surface this may seem to be a bit of a stretch, the USDA, not known for liberal and futuristic predictions, increased its estimate to 36.5 million tonnes, up from 34 million tonnes in July, and compared with 28 million tonnes harvested in 2015-16. This can only be accomplished with an extraordinary expansion of planted area.

We have one hesitation, though. Analysts say that such a massive increase in Argentinean corn production would have to be at the expense of soybean output. But the USDA is forecasting a healthy Argentinean soy crop of 57 million tonnes. That's shy of the record 61.4 million tonnes harvested in 2014-15, but still larger than last year's crop. We do not have a reasonable explanation. In any case, tax-free exports will stimulate corn output in Argentina.

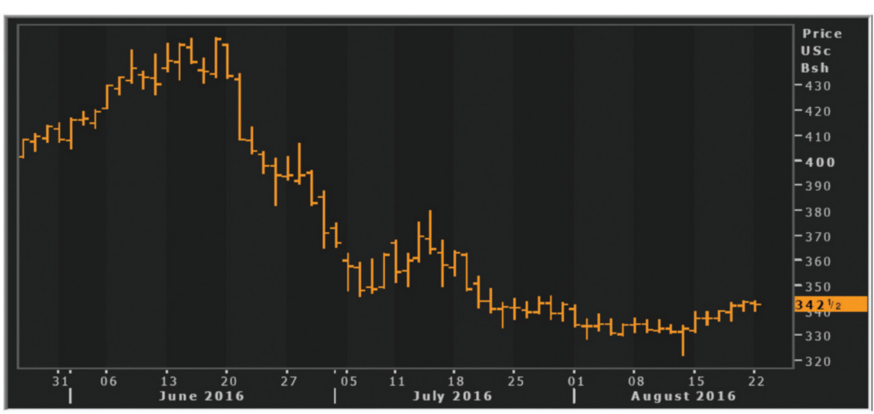
In terms of making sense of the market's reaction to what seemed to be a generally bearish report, we should take a look at demand. Global production will indeed jump to a record high, but the USDA is forecasting record demand as well. As such, 2016-17 global ending stocks are estimated at 21.7% of consumption, which is actually down a notch from 21.83% in 2015-16.

Bumper crops all around would certainly justify $3-per-bushel corn. However, the 175-bpa yield in the US and the fantastic expectations for the increase in Argentina would have to be realized before the market takes another leg down. If the North and South American crops pan out in line with current forecasts, prices should continue to drift lower.

We have been stopped out of our long position in December corn, as per our June 24 $3.60 per bushel sell-stop recommendation. We are now presented with a low-risk opportunity of buying corn at near-seven-year lows. Buy December corn. Place initial sell stops at $3.25, close only.

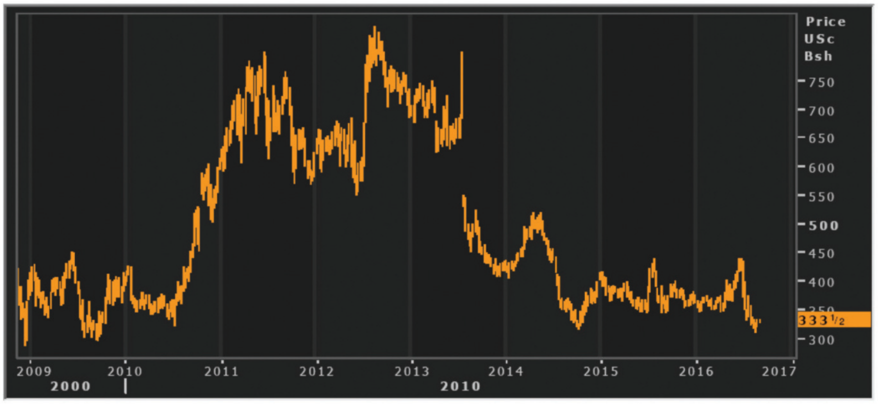
[By Sholom Sanik, August 22, 2016]

Chart 5 – December corn



Courtesy Reuters

Chart 6 – Weekly nearest corn contract



Courtesy Reuters

SOYBEAN OIL

Not all soy products were created equal

Soybean oil and soybean meal may be cousins, but they're certainly not identical twins. The two main products of the soybean serve completely different functions – vegetable oil and animal protein feed, respectively. As such, their price behavior can be dramatically different as well. Both markets were weak for most of this summer. Meal prices, however, continue to erode, and are now about 25% below their spring peak (Chart 7). Oil, on the other hand, has rallied by as much as 20% during August before setting back a bit (Chart 8).

First, some background to understand why the two markets are distinct. Soybean meal accounts for over 70% of the global protein feed market. Rapeseed meal and cottonseed meal come in a distant second and third. Soybean oil represents only 30% of the global vegetable market, with palm oil comprising 35%.

The protein meal market's supply/demand dynamics are then largely governed by what is happening to soybeans, whereas the vegetable oil market will be influenced by both soy and palm fundamentals.

Turning to palm oil, we find a tightening market. Indonesia and Malaysia are the largest growers of palm, and together produce 85% of the world's palm oil. The strongest El Niño in Asia in 20 years has ended, and has given way to La Niña, but not before drought compromised the 2015-16 palm crop. Palm oil output was 5% lower than in 2014-15. Analysts are forecasting a return of the required moisture, but the shortfall that developed over the past year has lowered inventories significantly. The USDA estimates 2015-16 global ending stocks at 7.5 million tonnes, or 12% of usage, down from 9.435 million tonnes, or 16% in 2014-15.

Global vegetable oil consumption has grown steadily over the past five years, and as a result of the poor palm crops this past year, global ending stocks are estimated at 11% of usage, down from 13% in 2014-15.

Palm oil prices are therefore challenging multi-year highs (Chart 9), while many global agricultural prices are testing multi-year lows.

Another wrinkle in palm oil tightness is the Indonesian government's bio-diesel program. The country's increasing dependence on imported crude oil has inspired a push toward blending gasoline with palm-based bio-diesel fuel. The minimum bio-diesel blend requirement was recently raised to 20% from 15%, ensuring that more palm resources will be devoted to fuel down the road. Government subsidies are part of the mandate.

Soybean oil prices will certainly be influenced to a large degree by the supply/demand fundamentals of soybeans. However, soybean oil and palm oil are readily substitutable in the food processing industry, so tightness in the palm oil market could drive up demand for soybean oil, even in an environment of ample soybean production. Chart 10 shows the historical volatility between soybean and soybean oil prices.

There are many variables. The US is set to harvest a record soybean crop this fall. On the other hand, in South America, late-season weather problems yielded somewhat disappointing Brazilian and Argentinean 2015-16 crops. There is uncertainty over the size of the 2016-17 Argentinean crop as farmers may substitute large swatches of soy area for corn to take advantage of the elimination of export taxes on corn.

In conclusion, we believe vegetable oil prices are undervalued because of the vulnerability of the palm crops and the absolute necessity of a strong recovery.

Seemingly, the most logical strategy would be to establish long positions in the primary market – palm oil. The problem is that it trades in Malaysia. Aside from the impracticality of trading a market that is only open while North Americans are sleeping, the contract is denominated in Malaysian ringgits, which adds the dimension of currency risk.

We regard the departure of soybean oil prices from the downward trend in the balance of the soybean complex as a strong buy signal. We therefore recommend buying December soybean oil, currently trading at about 33¢ per pound. Place initial sell stops at 29.50¢, close only.

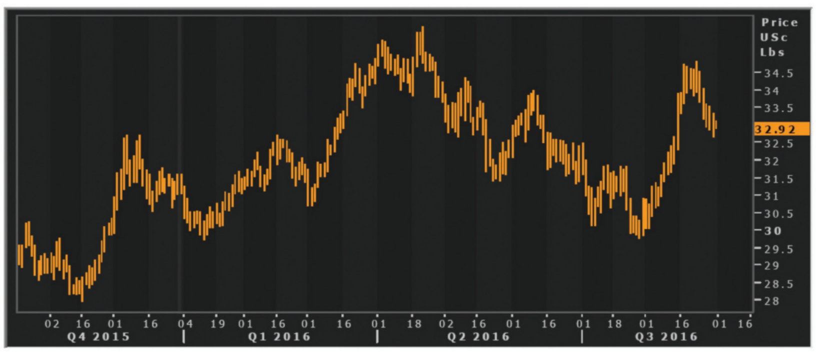
Alternatively, buy December soybean oil and sell December soybean meal on a spread, at a ratio of 1.5 soybean oil contracts for every 1 soybean meal contract.

[By Sholom Sanik, August 31, 2016]

Chart 7
December soybean meal

Courtesy Reuters

Chart 8
December soybean oil

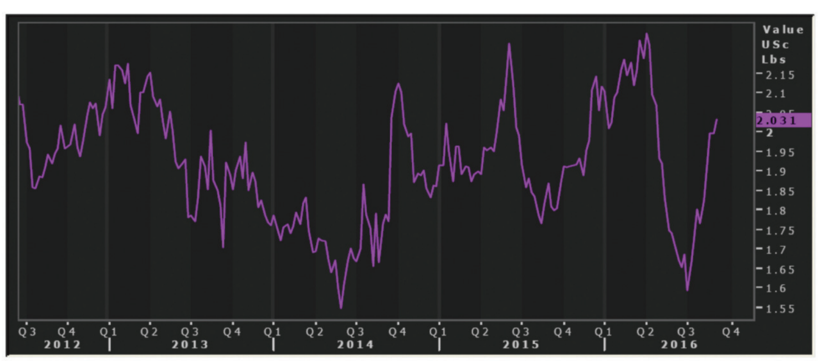


Courtesy Reuters

Chart 9
Weekly nearest contract Malaysian palm oil

Courtesy Reuters

Chart 10
Weekly nearest contract soybean oil/soybeans ratio



Courtesy Reuters

SOYBEANS

Is bounty in the soy patch enough to meet demand?

The headline data in the August USDA crop report were decidedly bearish for soybeans, mainly because of revisions to the soon-to-be-harvested 2016-17 US crop. The market actually rallied in the days following the release of the report, but subsequently drifted lower and is now trading near five-month lows.

Planted area and the estimate for the harvested-to-planted acreage were unchanged from July. The estimate for the bushel-per-acre (bpa) yield was expected to rise – the average of analysts' guesstimates was 47.5 bpa, up from 46.7 bpa in July – but the actual figure came in at a record 48.9 bpa. Quite a meaningful jump. As a result, US farmers should harvest a record crop of 4.06 billion bushels (110.5 million tonnes), up from the 3.88-billion-bushel (105.6 million tonnes) July estimate, and compared with 2015-16 output of 3.929 billion bushels (106.93 million tonnes).

The estimate for US ending stocks moves to 330 million bushels (8.97 million tonnes), or 8.2% of consumption, up from the July estimate of 7.3%.

The major private analysts agree that crop conditions are favorable enough – for both soybeans and corn – to expect excellent yields. With soybeans, however, which are planted later than corn, the data used to arrive at the 48.9-bpa yield did not include most of the August crop development. With the exceptionally hot summer experienced in North America, we believe that the final yield could still be a wild card.

Since the early 2000s, when South American production began to exceed US output, the US is no longer the supplier of last resort. Nevertheless, the outcome of the US harvest remains crucial. This past season, the spring harvests in both Brazil and Argentina did not meet early-season forecasts, because of inclement weather and extended old-crop US sales well beyond the norm (see *Focus on Futures*, July 29). Although old-crop sales dwindled towards the close of the marketing year on August 31, they were still above average for this time of year.

Mostly as a result of the late-season surge in exports, the USDA lowered the estimate for 2015-16 US ending stocks by a very significant 95 million bushels. While revisions to old-crop estimates do not garner as much attention as new-crop revisions, the amount by which the USDA increased the 2015-16 export estimate mitigated significantly the impact of the increase in 2016-17 supply from the bigger crop.

For the upcoming 2016-17 marketing year, the USDA is forecasting another round of large crops in Brazil and Argentina, at 103 million tonnes and 57 million tonnes, respectively. However, these are crops that have not even been planted yet, so it is premature to cast overly optimistic estimates.

Of note, the USDA gave the nod to ideas that elimination of the Argentinean export tax on corn may result in substitution of some planted area from soybeans to corn. At 57 million tonnes, it will be a larger crop than this past season, but well shy of the 61.4 million tonnes harvested in 2014-15.

The revision to the US crop accounted for just about the entire increase in the estimate for 2016-17 global ending stocks to 71.24 million tonnes, or 21.5% of usage, up from the July estimate of 20.4%. But demand has grown sharply over the past few years, and global inventories continue to contract. Ending stocks in 2014-15 reached 26% of consumption and fell to 23% in 2015-16. Despite the enticing bearish headlines, the 2016-17 season will mark a second consecutive season of falling stocks.

And it always pays to bear in mind that the Chinese grow only 10% of their soybean needs, unlike corn and wheat, in which they are completely self sufficient. Chinese demand growth has averaged 7% over the past five years.

We were stopped out of our long position as per our July 29 recommendation to use a $9.50-per-bushel stop close, basis November. We continue to believe, however, as illustrated, that a bearish case is not compelling. Respect the stop and stand aside for now, but stay tuned.

[By Sholom Sanik, September 7, 2016]

Chart 11 – November soybeans

Courtesy Reuters

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