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Cotton: Is the pop in ending stocks real?

The July USDA supply/demand situation report was chock full of bearish data for the cotton market. Prior to the report's release, it seemed prices were consolidating the 7¢-per-pound rally we saw in June. But the report caused December cotton to gap sharply lower and to close out the session down the 3¢-per-pound daily trading limit, a rather uncommon event.

Starting with the US, the USDA raised its estimate for old-crop final exports by 300,000 bales, to 13.3 million bales, to reflect strong sales over the past few months. That was the only bright spot, though. The estimate for new-crop exports was revised downwards by 500,000 bales, from an early and – on the surface – very optimistic 15 million bales.

The estimate for the 2005-06 crop was increased by 300,000 bales, to 19.5 million bales. Actually, given that the yield per acre was not changed, this item was not news, because it merely reflects the June 30 planting intentions report in which the estimate for planted acres was raised from the March 31 acreage estimate.

Turning to the global picture, the most extraordinary change was the increase in Chinese ending stocks. The Chinese government "found" previously unaccounted for inventories and revised carryover data all the way back to the 1994-95 season. The net result was a 2.6-million-bale jump from the June USDA estimate for 2005-06 Chinese ending stocks, to 9.86 million bales.

Among major exporters, 2005-06 production was revised up from the June estimate by 1.75 million bales.

Favorable weather pushed the estimate for Indian output up sharply – by 1.25 million bales – to 16.75 million bales. Largely self sufficient in recent years, India must grow beneficial crops, or it will need to become a significant importer in the future because the export-geared textile mill industry is booming. Large US retailers such as Wal-Mart and J.C. Penny have been negotiating directly with manufacturers for the purchase of billions of dollars worth of clothing and textiles.

The situation is somewhat similar to what happened in the sugar market, when India was mostly ignored by analysts until a supply shock caught everyone's attention. There were not enough imports or exports to make a dent in global trade balances until two consecutive disastrous crops forced India to become a net importer.

Given the labor cost advantage available in India for manufacturing cotton products, an increase in the rate of growth of valuable contracts with Western apparel purchasers is inevitable, which in turn could create a demand shock and send Indian purchasers to the import market.

Early in the 2004-05 season it was widely believed that world trade would drop sharply and US domestic consumption would fade because China would be able to feed its mills with its own fantastic crop. Neither turned out to be accurate assumptions. US mill usage is obviously in a perpetual retreat because of the shift to the more cost-effective system of shipping cotton to Asia and having it return in the form of finished goods, but it is not declining at quite the rate expected by the market. As it turns out, however, 2004-05 US mill consumption will be slightly higher than the previous year, and China continues to be a steady buyer of US cotton.

It is difficult to say if US mill consumption would survive the next wave of increases in Indian mill consumption. In any case, the early USDA estimate for 2005-06 global consumption is 111.76, up 3.4% from last year.

Overall, increased output from the US, India, and other countries and the "appearance" of additional inventories in China combined to alter the outlook for 2005-06 considerably and statistically justify the steep dive in prices. The USDA raised its estimate for ending stocks by 4.9 million

Inside

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bales, to 48.95 million bales, or 43.8% of consumption, compared with last month's 39.5%.

The key crops are not made yet and are still vulnerable to weather, which has been rather volatile this year. Demand was much stronger than expected early in the season, and that demand may very well continue to surprise. We maintain a bullish bias, believing that the generally bullish environment has been temporarily clouded by the Chinese inventory news. Prices have begun to consolidate around the 50¢-per-pound level. This market should be traded from the long side. *[July 25, 2005]*

Chart 1 – December cotton

Courtesy Reuters

SUGAR

The bull charges into new high ground

Sugar prices have broken through their long-held resistance level of 9.35¢ per pound (Chart 2). There is nothing terribly new, but most of the issues that inspired our bullishness over the past year are coming to fruition.

Pakistani sugar output was severely affected by the same drought that plagued neighboring India in 2004-05, falling to 3.2 million tonnes from 4 million tonnes in 2003-04. Traders say that Pakistani buyers purchased 500,000 tonnes in just the past few weeks, quite a bit of sugar in a short period of time for a country that has traditionally been a net exporter. This item in particular very likely serves as an explanation for the recent price strength that helped prices puncture the top of the range.

India is preparing for a production recovery after two dismal seasons. It recently announced that the incentives created to facilitate imports to cover its shortfall will be terminated in October when the new-crop harvest begins.

The implications of EU sugar reform, which will be phased in over the next three years, vary from country to country, but eventually, the predominant impact will be lower EU output. The removal of protectionist policies will discourage farmers from growing sugar that they will be able to sell only at the prevailing world price, which – naturally – will be lower than the artificially inflated prices that were created by subsidies in the form of prohibitive import tariffs.

A more immediate bullish factor is the sustained bull market in petroleum markets, which has intensified the global pursuit of alternative fuels. In Brazil, where the automotive industry is rapidly moving towards the day when close to 100% of new cars sold will run at least partially on ethanol – the goal is 90% by the end of 2006 – the ethanol/sugar crush ratio is growing. Officially, the ethanol portion of the crush can fluctuate in a range between 45% and 55% of the crop. According to recently released figures, the centre-south region, where close to 90% of sugarcane is grown, will move from a 51%/49% ethanol/sugar crush ratio in 2004-05 to a 53%/47% ratio in the 2005-06 season. So the pressure on Brazil – the world's largest exporter – to keep producing larger crops every year is on, to meet both increasing demand for ethanol as well as compensating for the shortfall that will ultimately result from EU reforms.

As the 2004-05 marketing year draws to a close, estimates for the global production/consumption balance have moved from early-season forecasts for a small deficit into surplus territory. Still, the most recent estimate from German statistician F.O. Licht casts a slightly bullish tone on the market. Licht raised its production estimate by a 180,000 tonnes, to 146.4 million tonnes, but raised its consumption estimate by 600,000 tonnes, to 145.1 million tonnes, which leaves a 1.3-million-tonne surplus, down from the previous estimate for a surplus of 1.72 million tonnes. Global stockpiles hover at a still-burdensome 45% of consumption.

As in previous bull markets in sugar, however, traders obviously feel that the high level of inventories is not necessarily as useful in averting tightness as the figure itself suggests. Market participants choose instead to concentrate on the level of exportable surpluses.

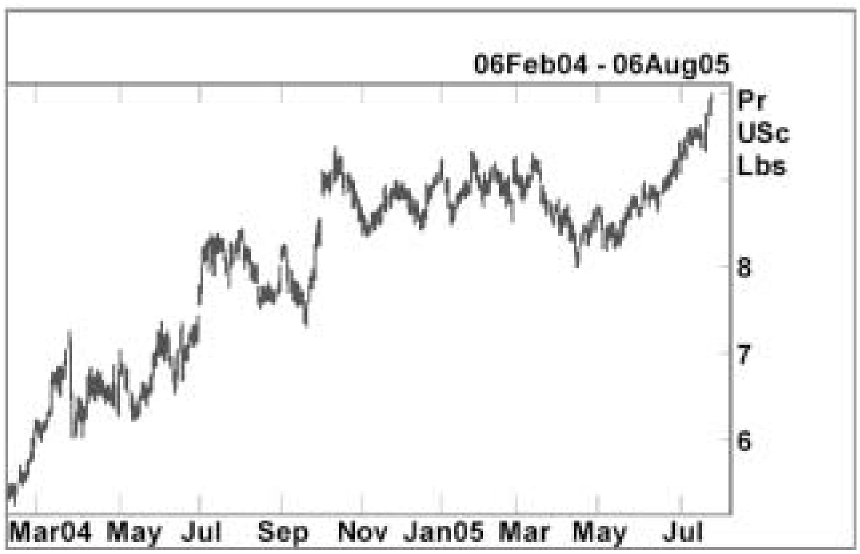
A good case in point is India. For years, a sizeable chunk of the global carryover figure – close to 20% – consisted of that country's stockpile. When the Indian drought lasted for two crop years, the previously staggering inventories were quickly run down by about half, and imports were required to keep domestic prices from spiraling out of control.

It's quite clear that the foundations of this bull run were rooted in the Indian situation. It became apparent that the pool of sugar available for import was not quite that overwhelming.

The market is being driven primarily by growing ethanol consumption and – we feel – uncertainty over the magnitude of the recovery of the Indian crop.

If you're fortunate enough to be long, stay that way. Both open interest and speculative long positions are growing, so look to establish new long positions on the inevitable, but temporary, setbacks that will result. *[July 27, 2005]*

Chart 2 – Nearest contract sugar



Courtesy Reuters

COPPER

Are new highs sustainable?

The copper market has extended its rally, with fresh record prices almost a daily occurrence. Prices have gone well beyond what we thought was possible, given what we believed were the pertinent supply/demand fundamentals. Recent data have supported the bull case, however, and the market seems poised to continue its run.

One of the key issues we were monitoring, which established our bearish case earlier this year, was Chilean production. Monthly production figures in 2004 indicated a runaway supply situation. We reasoned that there wasn't any good reason for that to abate. With prices so strong, the lure of extraordinary profits was a temptation too exciting to resist. But we were wrong. While output has been steady, it has not met our expectations and has fallen well below what we believed were conservative estimates by other analysts – output growth of about 5%.

For the first five months of 2005, output has grown a paltry 0.6% compared with the same period last year. For most of 2004, monthly output grew by more than 10%. The Chilean Copper Commission reported a small reduction in its estimate for 2005 output, to 5.504 million tonnes from 5.554 million tonnes, still up 1.7% over 2004, but nowhere near where we thought we'd be at this time.

The International Copper Study Group's (ICSG) July report confirms the trend, recording the first monthly supply/demand deficit of the year. Through April, the supply/demand balance stands at a 22,000-tonne deficit, still very small when compared with the 595,000-tonne deficit at the same time last year. But after several months of surpluses, things are heading in the wrong direction for bears.

Combined inventories at all three principal warehouse systems – the LME, COMEX, and Shanghai – sit at an astoundingly low 75,000 tonnes, compared with about 1.5 million tonnes at the bear market low price. But there is a debate that is bubbling among market participants regarding the validity of these statistics, considering that the ICSG claims that worldwide inventories are in fact 890,000 tonnes. Price and steep backwardation at both the LME and COMEX seem to be saying that there is a *bona fide* tightness in the market, but many are skeptical.

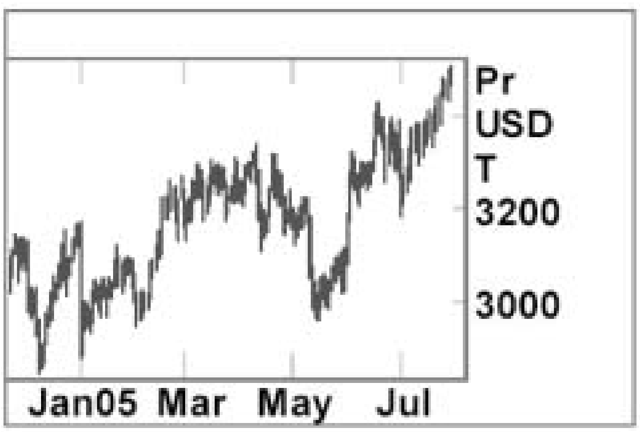
Aside from the obviously failed argument that high prices would push output up to a point where supply would overwhelm demand, the bear case has other problems as well. Economic conditions in most regions around the globe were softening earlier this year, which should eventually have trimmed demand. Recently released economic data, however, have caused many economists to revise upwards their outlook for the third quarter.

One nagging concern, which we pointed out in our previous article on copper (*Focus on Futures*, June 28) and which still holds true, is price performance of the other base metals that trade at the LME. Right down the list – aluminum, lead, nickel, tin, and zinc – none of these markets have joined copper in its recent run to record prices (Charts 3 to 8). All the other metals remain significantly below the highs they set in recent months. If demand generated by strong economies is driving this bull market, the others should be participating to some degree, but they are not.

While little is known about potentially "hiding" copper inventories, it may be prudent to consider the possibility that the demand for physical copper, which is allegedly represented in steep backwardation, may be telling us less about industrial usage of copper than it is about a speculatively motivated squeeze.

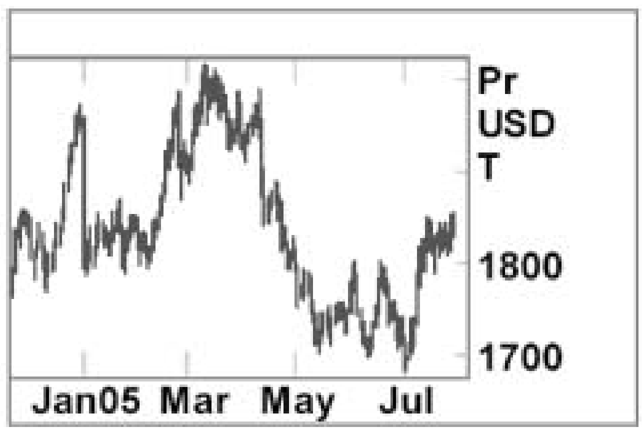
We therefore find it difficult to utter the words "we're bullish," but at the same time it would be ludicrous to fight the trend. Watch the monthly copper output numbers from Chile. We still believe that the world is producing more copper than can be absorbed by usage and that these prices are ultimately unsustainable. Stand aside. *[July 28, 2005]*

Chart 3 – Copper



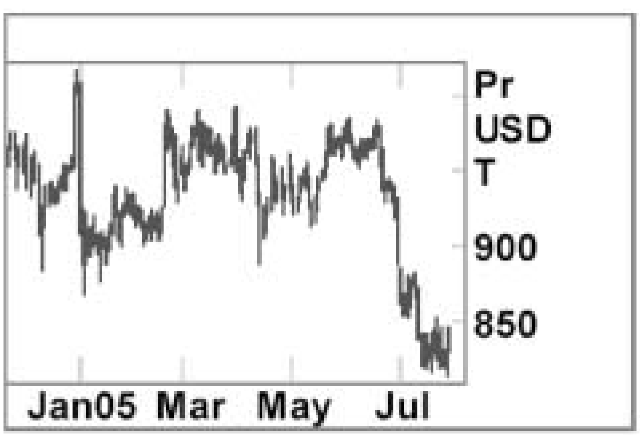
Courtesy Reuters

Chart 4 – Aluminum



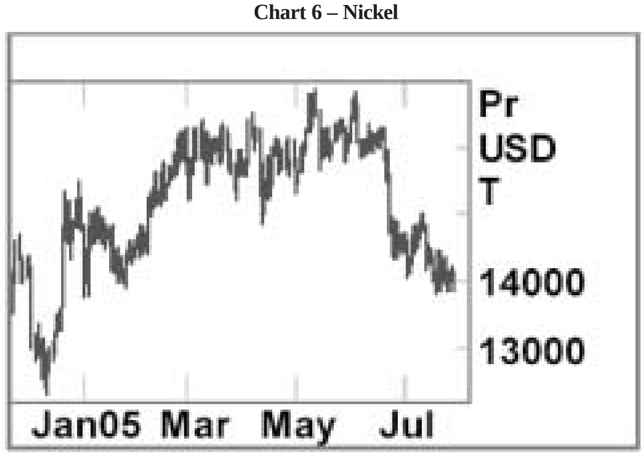
Courtesy Reuters

Chart 5 – Lead



Courtesy Reuters

Chart 6 – Nickel



Courtesy Reuters

Chart 7 – Tin

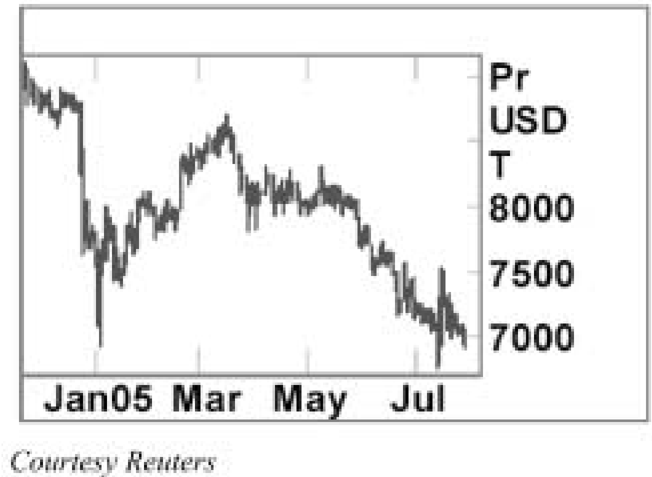
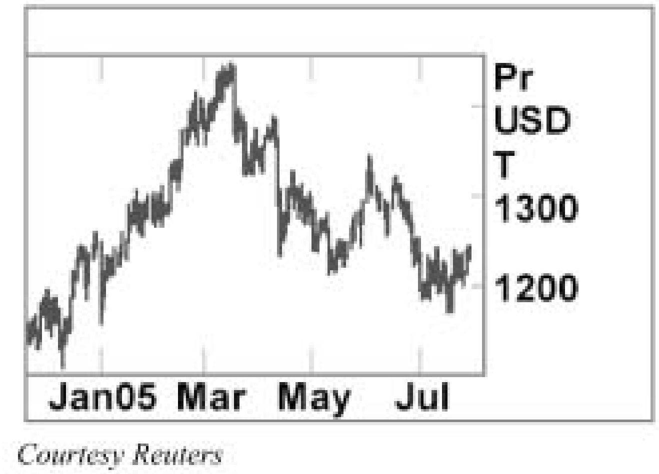


Chart 8 – Zinc



SOYBEANS

Supply side remains uncertain

Early *optimistic* forecasts for the Brazilian soybean crop have become something of an annual ritual. This past crop year, the USDA was still listing the 2004-05 Brazilian crop at 64.5 million tonnes as late as February 2005. By March, estimates had begun to drop as it became obvious that drought would wreak havoc with the crop. This month's supply/demand situation report shaved yet another 2 million tonnes, leaving Brazilian output at 51 million tonnes. Similarly, in 2004, the high forecast came in February at 61 million tonnes, but the final figure was 50.50 million tonnes.

We're kicking off 2005-06 with the same pattern. The USDA is forecasting Brazilian production at 62 million tonnes before the crop has even been planted. Of course, crop estimates based on acreage intentions are fine if the recovery rate is not hampered by weather. But the hard fact is that Brazil has yet to prove that it can grow a crop much larger than 50 million tonnes.

This issue is on the backburner, though, because traders are focusing all their attention on the US weather situation. It's been a hot summer in the Midwest, and there has probably been some impact on yield. The window is a couple of weeks longer for soybeans than it is for corn, so precipitation can still be beneficial. There's been some rain over the past 10 days, but at the moment, weather forecasters are calling for another round of hot and dry conditions.

This past week's crop progress report showed the good-to-excellent portion of the crop at 54%, up 1 percentage point from the previous week, but still significantly below last year at this time when the good-to-excellent portion was 69%. Although 2004-05 was an anomaly, both in terms of record acres planted and record yields, a 54% rating is near historical lows.

Remnants of the hurricane season, which brought some wet relief to the Midwest, also brought rust spores further north than they've been before. So far, the dreaded crop disease has been detected only at testing centers set up by the USDA and private university research facilities, but it is also a factor that cannot be ignored. The word from researchers studying the issue is that based on behavior of the rust to date, the risks of serious crop damage are contained. We have no experience in the US yet with rust, however, and we suspect that the market has not really taken the threat to crop size seriously.

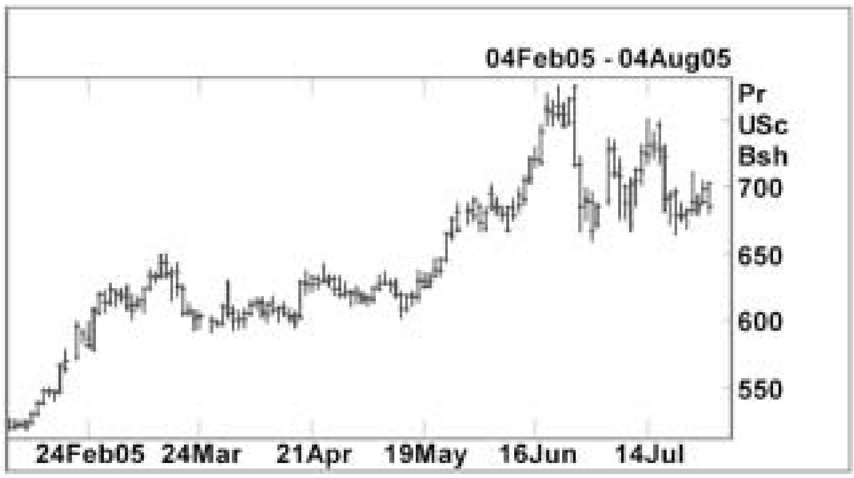
As the 2004-05 marketing year draws to a close, we find demand letting up a bit, but only after US exports exceeded expectations by a fairly wide margin for the year. The market ignored this week's export report, which showed net cancellations of old crop commitments of 63,000 tonnes, and rightfully so. With 5 weeks left to the marketing year, commitments stand at 30.1 million tonnes. The USDA target is 30.2 million tonnes, of which US exporters have already shipped 29.1 million tonnes. While a worst-case scenario would involve more cancellations, which would mean a higher carryover, it is quite common at this point in the season for exports to slow down, and it does not detract from the general pattern of solid demand.

Overall, one would have to say that price action is not very constructive for bulls. Having peaked in mid-June, the market is struggling to maintain support at current levels (Chart 9), even though there are ample bullish vulnerabilities in the form of weather and rust that can still threaten the 2005-06 US crop.

Actually, we think the most bullish story is in Brazil. Having established that no evidence exists that Brazil can grow a 60-million-tonne crop, we should tweak the 2005-06 ending stocks forecast to see what things would look like if Brazil simply maintained a trendline or somewhat better crop. The July USDA estimate for global ending stocks is 50.73 million, or 23.8% of consumption, compared with 22.2% for 2004-05. If we take the best Brazilian crop achieved to date – 51 million tonnes – and meet the USDA half way with its estimate for 62 million tonnes, we can lop 5.5 million tonnes off ending stocks, which would bring global ending stocks way down to 21.2%, a completely different picture than the market is working with at present.

With many issues regarding the US crop unresolved, the market's skepticism about a further advance has presented a low-risk buying opportunity. *[July 29, 2005]*

Chart 9 – November soybeans



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