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Copper: If demand improved, could it be met?

A period of improving or "bottoming" economic statistics propelled the stock market to a 36% rally this past spring. In early June disappointment at the lack of follow-through and fear that economic revival was sputtering brought a correction (Chart 1). Second-quarter earnings season brought some pleasant surprises that in the space of a few sessions erased a fair chunk of the losses. With some variance, copper prices have tracked the moves in stocks (Chart 2).

The demand side is unclear. US industrial production for June was better than expected, but still down 0.4%, compared with a decline of 1.1% in May.

In other key regions, recently reported data show that UK output was off by 0.6% in May. And in the eurozone, output grew by 0.5%, smaller than anticipated, but significantly better than April's 1.4% contraction.

Over in Asia, after plummeting from the $4-per-pound level, Chinese imports almost singlehandedly allowed copper prices to find a bottom. Imports of copper products have been at record levels for five consecutive months now. The rampant buying compensated for the recession that was ravaging the rest of the world.

Few are convinced that this bull run is the direct result of *bona fide* bullish supply/demand fundamentals, primarily because of the two dynamics described above.

The Chinese have been stockpiling copper, as well as many other commodities, such as soybeans and cotton. The magnitude of these large purchases did not reflect end-user demand, however. After all, the economy was growing in China during this period, but at a much slower pace than the Chinese had been accustomed to in recent years. When/if Chinese buying slows down, and there is speculation that this will soon transpire, demand from the other major importers is insufficient to support these price levels.

Production costs have been coming down, and are probably even lower than earlier projections, because the cost of inputs – mainly energy – have been falling. Despite the presence of the incentives provided by fat profit margins, which after by-product credits are extraordinary, miners are reluctant to over-produce, because of fear that demand is not yet poised to return to pre-recession levels.

Evidence that this is the case comes from the world's largest producer. Output in Chile continues to run below last year's levels, although the rate of decline is not as severe as it was a few months ago. After the first quarter, production was running 6% behind 2008. Through the end of May, that pace had improved to only -4.4%, but still nowhere near the forecast for flat or slightly higher output.

In April, The International Copper Study Group (ICSG) forecast that the global balance sheet would show a surplus of 345,000 tonnes for 2009. From the beginning of the year through the end of the first quarter, the surplus contracted by more than 100,000 tonnes. As of its most recent report (June 22), the surplus has fallen to 48,000 tonnes. ICSG data are dated, but with Chinese import activity still running strong, and a tepid improvement in output, it is unlikely that the surplus has increased by much.

Widely watched LME warehouse stocks have come down hard. But looking at LME in isolation can be deceptive, because the other two warehouse networks, COMEX and Shanghai, have spiked upwards. Chart 3 shows that cumulative inventories are still declining, but at a slower rate.

On July 13, ICSG reported that it expects mine capacity to grow at an average annual rate of 3.8% over the next sev-

Inside

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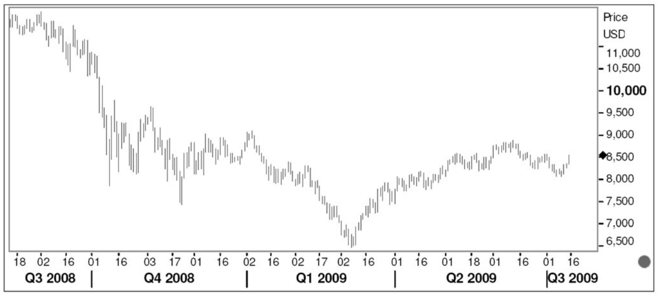
eral years, which is down from a previous forecast of 5% growth. This means that if current usage patterns were to improve, there would be limitations on the ability of producers to meet the demand.

There have been several opportunities to act on our May 1 recommendation to "...use setbacks to establish a conservative long position." Remain long.

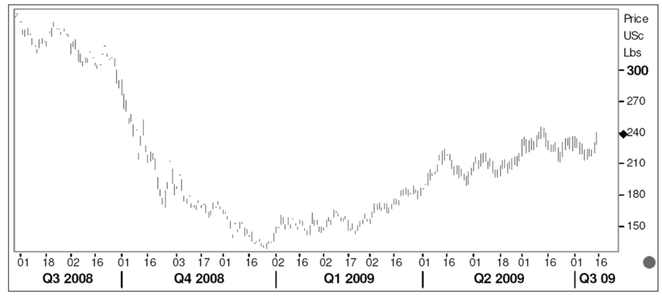
[July 15, 2009]

Chart 1 – Dow Jones Industrial Average



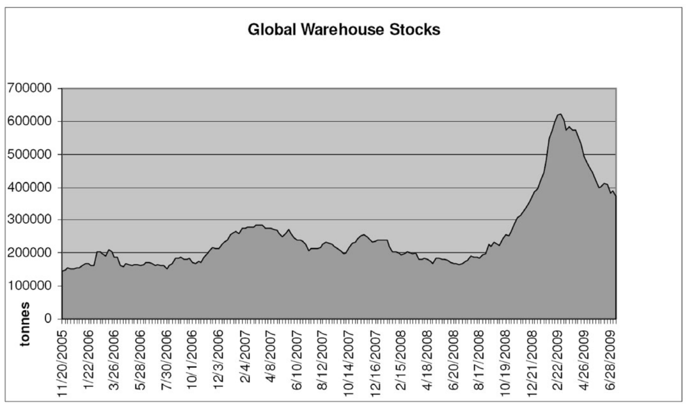
Courtesy Reuters

Chart 2 – September copper



Courtesy Reuters

Chart 3 – Global warehouse stocks



Courtesy Reuters

COCOA

Chocolate demand not as weak as cocoa grind suggests

Ivorian mid-crop production is stumbling into the tail end of the season. The most recent tally shows that port arrivals stand at 1.077 million tonnes, 85% of last year at this time. The October-September 2008-09 crop year was a disaster at the outset, but has improved steadily since January. Over the past several weeks, however, arrivals have stopped catching up to last year.

Actually, arrivals came in at 9,000 tonnes in the most recent reporting period, double that of last year for the comparable period. But that was an anomaly. Ever since mid-June, weekly arrivals have been running at about half of last year's pace. The 2007-08 mid-crop was extraordinary, and even if we see an uptick to last season's rate, the combined main- and mid-crops would reach only 1.15 million tonnes. If we do not see a sustained increase in weekly arrivals, we're more likely to have a crop of only 1.1 million tonnes, down from 2007-08 output of 1.36 million tonnes.

That is the principal supply-side story. Neither of the other major producers, Ghana and Indonesia, are in a position to compensate for the poor Ivorian crop. Estimates for Indonesia have been erratic. On July 13, the International Cocoa Organization (ICCO) revised Indonesian output downward again, by 15,000 tonnes, to 485,000 tonnes.

It's a bit early to worry about the new-crop year, but talk of El Niño has surfaced, which, if accurate, could wreak havoc with output down the road.

The demand side, however, has tempered the extremely bullish supply-side fundamentals. At the consumer level the evidence is mixed and inconclusive. We looked at several confectionary manufacturers with exposure in North America, Europe, and developing regions. For example, Nestlé with broad international coverage saw non-organic confectionary sales fall 1.1% in the first quarter. Cadbury had poor results in Europe, but fared better in developing nations. Hershey, which operates primarily in North America, saw chocolate sales rise 7.4% in the first quarter.

Second-quarter grind results were abysmal. Germany, which represents about a third of all European processing, was down 15.3% from last year. The total European grind was down 11.3%, while North America dropped 6.75%. Malaysia was down 21.8%.

With consumer activity flat at worst, we make the observation that grinding activity has fallen much faster and harder than consumer demand has warranted. Eventually this should create some tightness in bean by-products, which will ultimately ripple through to beans.

We might be seeing the beginning of this process. European and Asian butter ratios (Charts 4 and 5), which have tumbled by 35% over the past 18 months, have been stabilizing since May. Rising butter prices would beef up processing margins and provide an incentive for grinders to buy beans.

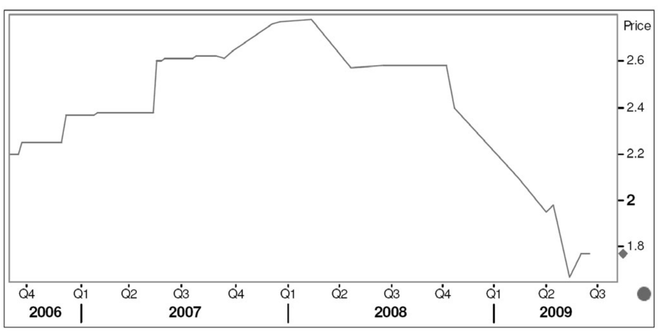
Analysts have been tweaking their estimates for the 2008-09 global balance to show the deficit getting smaller and are justified in doing so, particularly after we've had a look at the second-quarter grind results.

Prices have been rising, though, and are challenging levels we haven't seen in close to a year. A speculative presence exists but, surprisingly, is modest by historical standards. The market has maintained a long-term uptrend (Chart 6). September cocoa is up by about $200 per tonne since we last made this observation on June 1, and indeed the fund net-long position has increased by 7,000 contracts. But as Chart 7 indicates, this bull market has still gone relatively unnoticed.

To be sure, the drop in grinding activity is disconcerting, and if we do not get the bounce in the global economy that many expect, this market could slide into a surplus position despite the stagnation in global output. On the other hand, if overall demand at the consumer level did not contract much, if at all, as we suspect, we should expect a sharp recovery in third-quarter grindings as by-product inventories are run down.

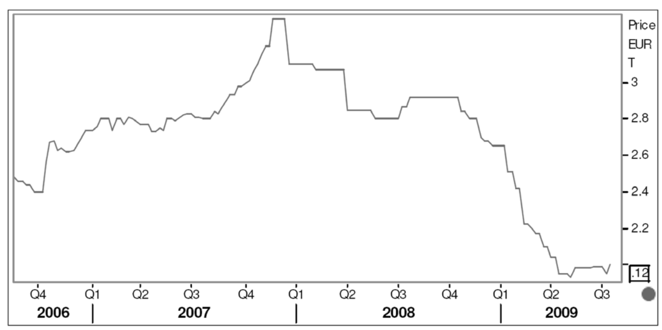
Maintain manageable long positions. *[July 21, 2009]*

Chart 4 – Asian butter ratios



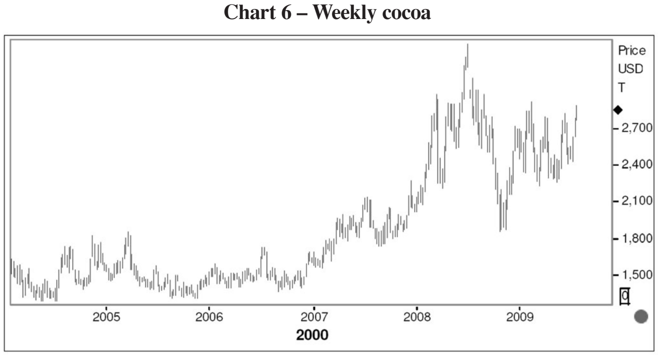
Courtesy Reuters

Chart 5 – European butter ratios



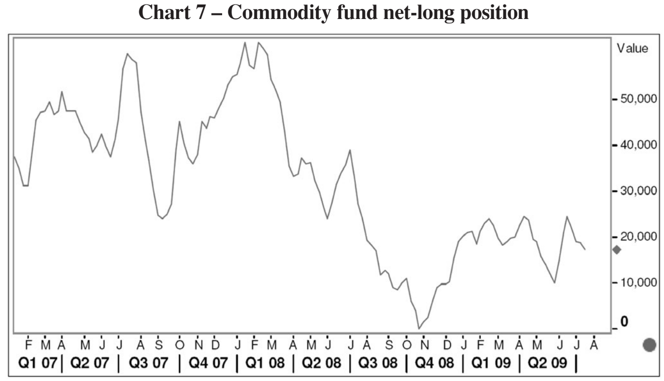
Courtesy Reuters

Chart 6 – Weekly cocoa



Courtesy Reuters

Chart 7 – Commodity fund net-long position



Courtesy Reuters

CORN

USDA acreage reports: shock therapy

On June 30 bewildered traders had to absorb what turned out to be arguably one of the largest and most poignant supply-side revisions the USDA ever published. A late-planting season caused by excessive rains was widely assumed to have reduced the estimated area planted to corn by about 1 million acres below the initial estimate contained in the March 31 planting intentions report. Instead, the USDA reported, the estimate was *increased* by 2 million acres, to 87.035 million acres. See *Focus on Futures*, July 2, "US Corn Farmers Go Wild," for the particulars.

Analysts who conduct independent research using satellite imaging and surveys were left scratching their heads wondering how they could have been off by such a wide margin. As it turns out, their confusion was not unfounded. On July 22, the acreage saga took another turn. In a post-market-closing release that caught everybody off guard once again, the USDA announced that the August 12 crop report will contain the results of a re-survey of key growing regions that were affected by the late-spring adverse planting conditions. The new survey will cover seven of the key corn-growing states that were most affected by the excess precipitation.

Although it's impossible to know how many acres the USDA will chop, market chatter has come up with a rough estimate of a reduction of 500,000 to 1 million acres.

Any potential bullish impact has been downplayed by the media. There is a perception that farmers are enjoying perfect growing weather, and that has many analysts talking about achieving record yields, with some estimates as high as 162 bushels per acre (bpa).

Indeed, even if we assume conservative revisions, the August 12 estimate for US 2009-10 output would actually be higher than the July estimate, despite smaller acreage. If acreage was reduced by 750,000 acres, to 86.25 million acres, and the yield estimate jumped from 153.4 bpa (the July estimate) to 160 bpa (using the July harvested/planted ratio estimate), US farmers would harvest a crop of 12.7 billion bushels, up from the July estimate of 12.3 billion bushels!

Getting back to the progress of the US crop, talk of a 162 bpa yield is definitely optimistic, but not outrageous. Much of the corn belt is having excellent weather, which for now means cooler and wet. The north-western section of the corn belt has been cool and dry. The biggest issue for corn, which can be compensated for in some part by perfect weather, but not completely, is that late planting has left the crop on average about one week behind schedule, which makes the crop more vulnerable to an early frost. In 2004-05, when final yield was 160.4 bpa, the August yield estimate was 148.9 bpa. So the crop is in fine shape to reach a record yield.

Although analysts all seem to agree that weather has been ideal for crop development, the most recent weekly USDA progress report showed that the good-to-excellent portion of the crop fell by 1 percentage point from the previous week, to 70%. It's still a great number – last season at this time the good-to-excellent portion was 66%.

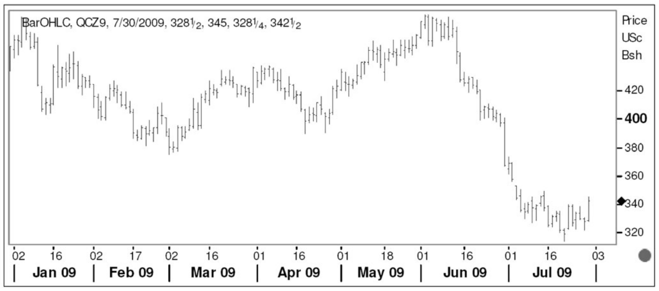
So it really comes down to how deep the cut to US acreage will be. We should bear in mind that the average analysts' estimate to June 30 was 83.96 million acres, more than 3 million acres below the actual number. And most importantly, it's now been shown, by the USDA's own admission, that the analysts were certainly not as wrong as initially believed.

CFTC data show that since early June, commercials have swung from being net-short over 100,000 contracts, to a net-long of 67,000 contracts (Chart 9). Not that the commercial group in corn has a stellar track record. The same chart shows that during the 2008 bull market, they began buying near the top. That bit of ill timing, however, was anomalous and can be attributed – at least in part – to the huge bust by ethanol producer VeraSun, which was late to hedge its corn needs and was forced to liquidate when the market started coming down. For the most part, though, it typically pays to pay attention to large movements in the commercial position.

Demand, of course, is another crucial area, but was not in the scope of this issue. One brief note: US export commitments are only 77% of last year at this time, but that is slightly ahead of the USDA estimate of 73.9% of 2007-08, and more importantly well ahead of where we were as recently as early June at 70% and 67% in early May. So international trade has definitely picked up.

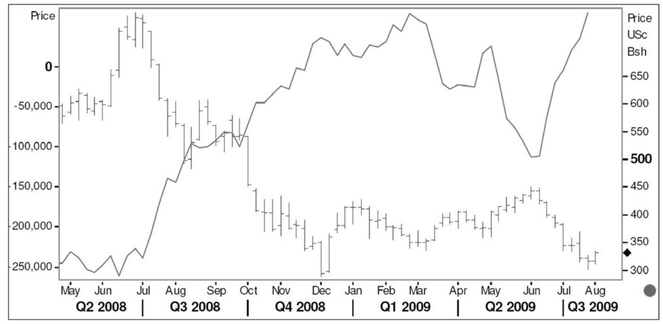
If you followed our recommendation to use the December lows as a sell stop to protect long positions, you would have been stopped out. The market could remain range-bound until August 12, when we get the acreage and yield estimates. Yields are likely to be revised upwards, but the acreage question makes the market extremely vulnerable. We expect that the bearish news has all been discounted. Buy December corn. *[July 30, 2009]*

Chart 8 – December corn



Courtesy Reuters

Chart 9 – Nearest contract corn (bar), Commercial net-long position (line)



Courtesy Reuters

WHEAT

Small crops will meet current demand

The wheat market has been something of a laggard among commodities. Prices have poked their head out of the recent range, but the rally pales, even when compared with some of the other correlated markets (Charts 10 and 11). For good reason. Corn has the impending acreage revision, soybeans have the unexpected mega sale to China, but there's been little to excite wheat bulls.

In the US, substantial acreage was lost for the spring wheat crop to a very wet planting season. Spring wheat represents less than 30% of the total US crop, so crop losses would have to be substantial to affect the overall wheat picture. And at one point it seemed significant. Perfect growing weather, however, has resulted in above-average yields in some of the key spring wheat regions, which has mitigated at least some of the impact of the lost area. A recent crop survey in North Dakota – the largest spring wheat state – shows that average yields are 44.6 bushels per acre (bpa), compared with 38 bpa for that region last year at this time.

The only problem is that the late-planted crop is more than two weeks behind the average development stage, which makes it vulnerable to an early frost. In a normal year, harvesting would be underway by now, but the most recent USDA crop progress report shows that by August 2, only 3% of the crop has been harvested, compared with an average of 15% by this date in the previous five years. In North Dakota, it is estimated that crops will not be ready for harvesting until the end of August.

Northern Hemisphere winter wheat crops are no longer much of an issue. As of August 2, 85% of the US crop was harvested, with similar progress indicated elsewhere. Although substantially smaller than last year, the intentional planting of smaller crops by major exporters to reflect the anticipation of weak demand – both in the US and other Northern Hemisphere exporting nations – has long been factored into prices (Chart 12).

One area of great concern is Western Canada, where 90% of the country's wheat is grown and which has been ravaged by drought in some areas and inclement weather in others. Canada is the world's second largest single-country wheat exporter, behind the US. Production is estimated at more than 20% below 2008-09 output. The Canadian Wheat Board recently revised its June estimate a notch lower, but the lion's share of the smaller crop has already been factored into the global balance sheet in the July USDA supply/demand situation report.

The US export book confirms that demand for wheat in international trade remains weak and that farmers in exporting countries did well by planting smaller crops to avoid the risk of rebuilding burdensome carryover stocks that for years had kept wheat prices low.

The current USDA estimate for 2009-10 US exports is for yet another drop in foreign sales, to 25.17 million tonnes, down from 27.63 and 34.4 million tonnes in 2007-08 and 2006-07, respectively. According to weekly export sales data, however, we are dramatically behind the pace required for achieving the USDA estimate. With two months gone in the wheat marketing year, commitments stand at a scant 6.3 million tonnes, compared with 11.9 million tonnes at this time last year.

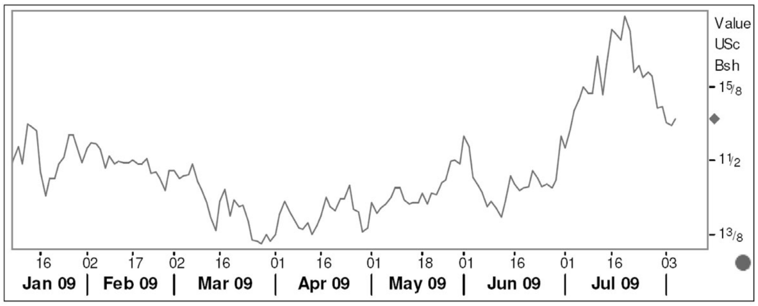
Unless there are major shifts in production or consumption, it would seem that despite the 25-million-tonne drop in global production for 2009-10, the market is well supplied. The supply side is unlikely to change in the near future, because as illustrated above, the bulk of the Northern Hemisphere crops have been harvested. The wild card is an increase in demand, which of course is not only possible, but very likely as economies around the world begin to stabilize.

As it stands now, however, even a drawdown in global ending stocks caused by an uptick in consumption would leave the market with ample inventories. The current estimate puts global stocks at 181 million tonnes, or 28% of consumption, up from 26% last year, and 20% in 2007-08.

We advise liquidating long positions. Stand aside.

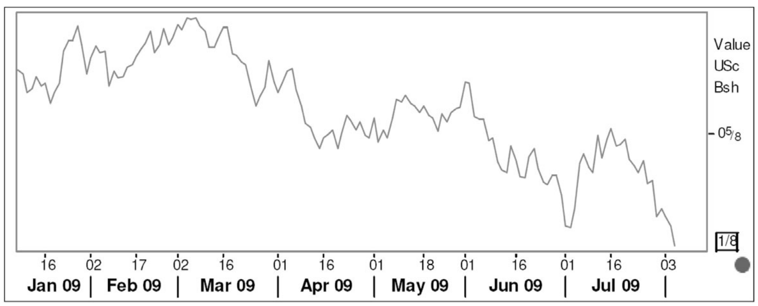
[August 5, 2009]

Chart 10 – Wheat/corn ratio



Courtesy Reuters

Chart 11 – Wheat/soybean ratio



Courtesy Reuters

Chart 12 – Wheat exports

	2008-09	2009-10
millions of tonnes		
US	68	57.5
Canada	28.5	23.5
EU	152	134.65
FSU	115.5	106.4

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