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Will the Chinese buy more cotton?

Like most commodities, the cotton market is in the grips of the bear. Despite the 2011-12 US crop failure, global output reached a record 123.42 million bales, with China, India, and Pakistan compensating – and then some – for the disappointing US crop.

In its December crop report, the USDA painted an even more bearish picture by lowering the estimate for 2011-12 global consumption by 3 million bales from the November estimate, to 111 million bales. The estimate for ending stocks grew to 57.67 million bales, or 51.8% of usage, the largest carryout since 2008-09.

Two significant developments may have altered the gloomy outlook for prices – at least to a degree.

Between November 10 and November 25, the USDA reported an extraordinary 2.3 million bales of US export sales, mostly to China. Although it was not a complete shock, the volume was quite a bit more than the street believed it would be. The Chinese are restocking, and that's bullish for any commodity.

The USDA target for 2011-12 US exports has been revised downwards several times this season, from a high of 12.3 million bales to the current 11.3 million bales. The three-week surge in Chinese purchases brought US export commitments to 10.1 million bales, which puts it within reach of the USDA estimate for the marketing year. Prior to the Chinese buying spree, that did not seem to be an achievable goal.

Before the Chinese purchases, commitments were 33% behind the previous years' sales and are still 25% below same-time-last-year sales. So reaching the USDA target – while definitely less bearish – may not be a monumental achievement. Average final sales since the 2000-01 season have been close to 13 million bales. Nevertheless, now that there seems to be some life in the market, there is a possibility that the potential for US exports has been underestimated.

Monitoring new sales is obviously important, but not as crucial as keeping track of shipments. Booking sales is one thing, but taking delivery is another. The price of Indian and Pakistani cotton is competitive, and there is always a risk that the Chinese will opt for Asian origins and cancel similar quantities of their US purchases. The shipment pace has been sluggish and would have to pick up to make the boom in sales a convincing bullish argument.

Much the same as soaring prices inspired farmers in producing nations to expand acreage, falling prices will have the opposite effect. We've already seen a couple of examples. Analysts are saying that 2012 cotton area in China is expected to fall by as much as 9%. Assuming normal growing conditions, that would be a drop of about 3 million bales from the current crop year and equal to about 2.5% of global output.

The planting habits of the major producing/exporting countries should move in unison because, for the most part, they will respond to the same issues: demand and profitability of cotton vis-à-vis other cash crops. And the motivation is not great. Fear of recession in Europe has created a perception that demand cannot expand. The unexpected Chinese purchases have modified that view to some degree, but there does not seem to be much confidence that it is the beginning of a trend.

While all commodity prices have been tumbling, cotton prices have fallen harder than those of the crops that would be their biggest competitors. Charts 1 and 2 show how weak new-crop cotton prices have been relative to new-crop soybeans and corn. This does not bode well for increased plantings.

In the US, we are still far from official estimates, but Informa Economics has weighed in with an early forecast of 13.15 million acres for the 2012-13 crop to be planted in the

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spring, down from 14.431 million acres in 2011-12. Under normal conditions, however, that will yield a much larger crop than in 2011-12, because of the disastrous crop and historically low recovery rate.

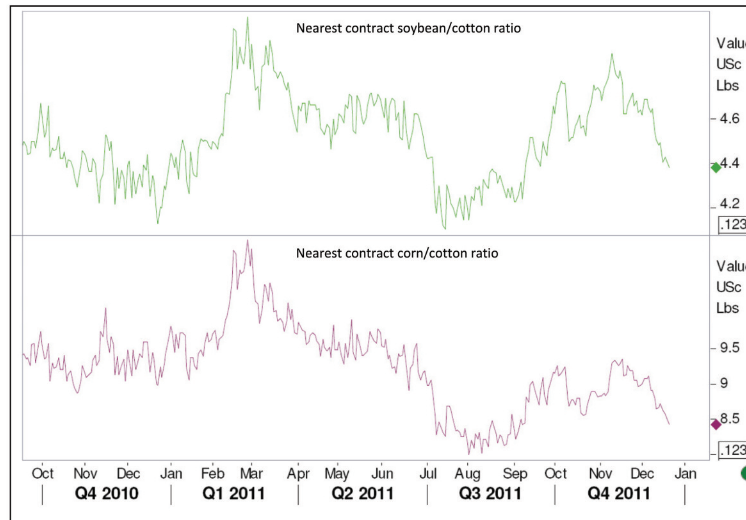
As illustrated above, global inventories are ample statistically, but with demand shaping up to be better than anyone could have expected as recently as five or six weeks ago and producers planning to limit output, a window of vulnerability has opened.

We are not recommending new long positions while the market still seems to be falling. Remain sidelined, but stay tuned. *[December 21, 2011]*

Chart 1 – March cotton

Courtesy Reuters

Chart 2 – Nearest contract soybean/cotton ratio (upper)/Nearest contract corn/cotton ratio (lower)



Courtesy Reuters

COCOA

Is a cocoa deficit even a remote possibility?

The cocoa market owns the dubious distinction of being the only one of the major commodity-futures markets that we trade whose prices have fallen all the way back to their 2008 pre-bull-market levels (Chart 3). Are the fundamentals that much more bearish than the other markets?

The world's two largest producers, the Ivory Coast and Ghana, who together grow about 70% of the world's cocoa beans, harvested record crops in 2010-11. The long-feared gargantuan cocoa problem – a shutdown of the Ivory Coast – almost happened, but turned out to be a bust. The rightful victor of the presidential elections eventually took office, and the 500,000-tonne stockpile that he kept from leaving the country was eventually exported.

So developments on the supply side certainly warranted an unwinding of bullish bets; hence the wicked slide in prices. Indeed, open interest has fallen by 35,000 contracts, or 18%, since the market began to break down in earnest in early November.

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The headlines continue to encourage bears. All indications are that the trend of bumper crops in West Africa will stretch into the 2011-12 crop year. The most recent figures show that Ivorian port arrivals stand at 648,000 tonnes, up 14.6% from the same time last year. Official Ghanaian purchases are reported at 448,000 tonnes, 6.5% above last year's level.

Developments behind the headlines, however, temper the bearishness. Some analysts argue that the strong arrivals are deceptive for two reasons. First, there are 2010-11 beans that were not shipped during the marketing year, which ended October 1, and are being included in the tally of 2011-12 arrivals. Second, and more significantly, they do not believe this pace can continue. The Harmattan, the dry wind that blows in from the Sahara between December and March, is severe and is depriving cocoa plantations of moisture, which could affect both quantity and quality for the balance of the main-crop season. The weather may be beneficial for harvested beans in terms of lowering moisture for the drying process, but going forward, it is certainly not helpful for plants that need to grow.

The demand side is showing some signs of life. Chart 4 shows that the combined butter/powder ratio has surpassed the highs set in 2007. Butter prices sank dramatically over the past year, falling to lows not seen in over a decade, but seem to have stabilized. Higher prices for processed bean products mean that some growth in consumer demand has emerged, and processors will have an incentive to increase grindings.

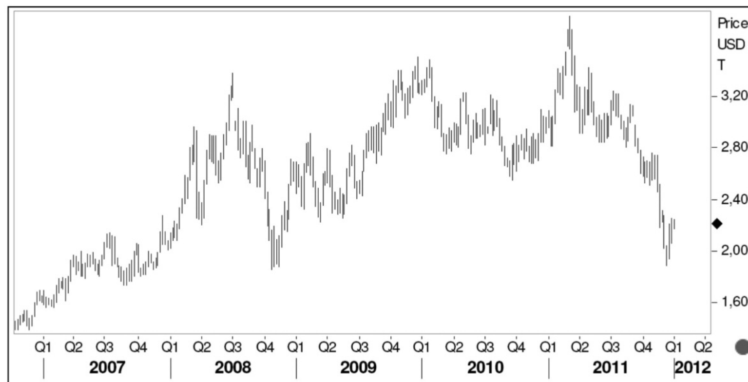
On December 12 one analyst took the market by surprise by forecasting the current marketing year would end in deficit. Its estimate for the 2010-11 balance sheet was a whopping 500,000-tonne surplus, but a halt to the robust arrivals in the Ivory Coast and a pickup in demand would swing the market all the way to a 100,000-tonne deficit in 2011-12. The analyst estimates that Ivorian main-crop output will fall by 350,000 tonnes, to one million tonnes! Coincidence or not, the $1,983-per-tonne inter-day low in March cocoa was set moments after that news was released. The market is now trading $200 per tonne above that level.

The sentiment survey that we watch shows that bullishness has fallen to multi-year lows. Commitment of Traders data show funds are heavily short the market.

Bearish exuberance for (outdated?) fundamentals and the general negative outlook for the economy and commodities may well have exacerbated this bear move. We believe there's a low-risk opportunity to get on the long side. We do not see the market returning to the lows – certainly not before the market gets a handle on whether the gloomy forecast for Ivorian production is fact or fiction.

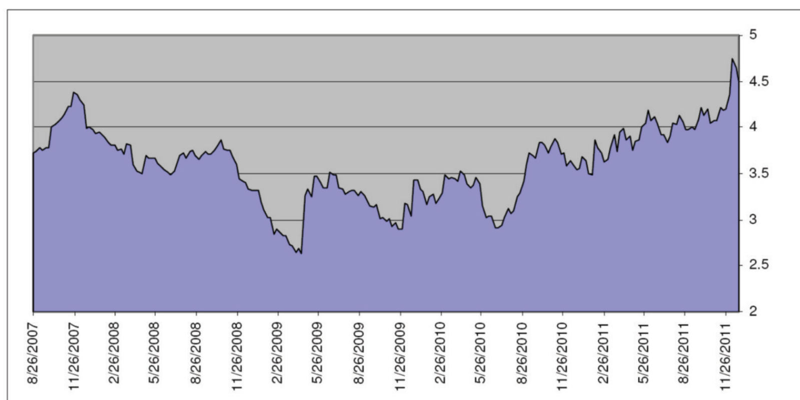
Buy May cocoa at present levels. Place initial stops at $2,050 per tonne, close only. *[December 28, 2011]*

Chart 3 – Weekly nearest contract ICE cocoa



Courtesy Reuters

Chart 4 – Combined cocoa butter/powder ratio



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CORN

A South American-inspired corn rally?

As the Southern Hemisphere growing season advances, the grain markets have been rallying since mid-December under the cover story of extremely dry weather in South America. March corn has been up as much as 70¢ per bushel since it bottomed on December 15 (Chart 5).

Growth in South American soybean production is old hat, but the 2011-12 marketing year will mark the first year in which planted area in Argentina and Brazil expanded enough for a significant increase in corn production. Table 1 shows a comparison – based on the December USDA crop report – between 2010-2011 output and exports for Argentina and Brazil and estimates for 2011-12. Although Brazilian output is estimated to jump to a record 61 million tonnes, exports are not expected to increase by much. A disappointment in the form of a weather-damaged Argentinean crop, on the other hand, could have a meaningful impact on the pool of supplies available for world trade.

Table 1 – Argentina and Brazil, output and export estimates

Millions of tonnes	**2010-11**	**2011-12**
Argentina		
- Output	22.5	29
- Exports	15	20
Brazil		
- Output	57.5	61
- Exports	9	8.5

Analysts have all lowered their Argentinean estimates by about 2 million tonnes, but the starting points were spread over a wide range between 26.5 million tonnes and 32 million tonnes. The USDA's December 29-million-tonne estimate was still based on acreage and trendline yields and has not yet accounted for 2 million tonnes slashed from its estimate.

The net effect on the global balance sheet is negligible, however. US yields were revised downward all summer long, to the extent that production estimates fell by about 10% from mid-summer forecasts to the current estimate. But even after accounting for the drought, South American estimates are still higher than they were in the summer. In fact, estimates for all major growing regions, including the EU, the FSU, and China have been raised significantly. The estimate for global demand has remained fairly constant, which has resulted in an increase in the estimate for the stocks-to-usage ratio, from 13% in August, to the current 14.6%.

Although US exports are running behind last year's pace, they are actually quite strong relative to expectations. The USDA forecast for 2011-12 is calling for a sharp, 6-million-tonne, or 12.8%, drop from 2010-11 exports. Year-to-date commitments stand at 24.37 million tonnes, only 6% less than last year at this time. Year-to-date shipments are 12.2 million tonnes, or 30% of the USDA target. Last year, shipments were 27% of final sales at this juncture of the marketing year. So the export diagnostics are bullish.

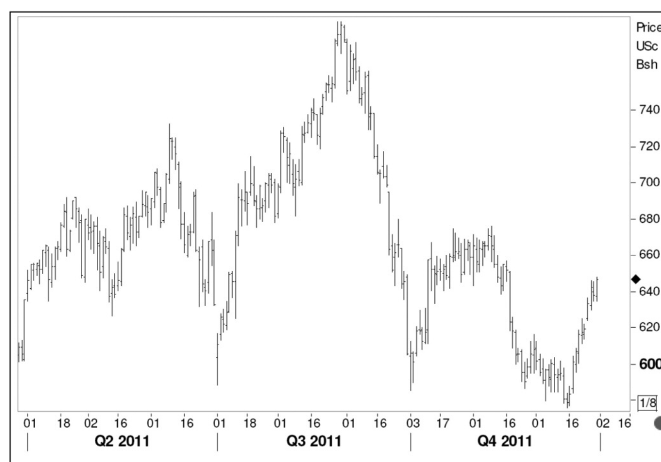
The anticipation of a greater reliance on South American supplies – once harvesting begins in the spring – should mean that US sales will tail off and explains why the USDA has kept its estimate at 40.66 million tonnes for annual sales, despite the strong commitment and shipment tallies. Of course, this is why weather in Brazil and Argentina is more important for corn than it ever has been in the past. If the bleak forecasts come to fruition, Argentina may just eke out small gains over 2010-11, and US corn would be in greater demand than anyone would have imagined. As it is, US ending stocks remain near historic lows. After falling by $2 per bushel since August, a rally in corn prices was well warranted.

Nevertheless, it is hard to get very bullish for the long term. Informa Economics raised its already robust estimate for spring planting of the 2012-13 US corn crop to 94.389 million acres, up from 91.5 million acres planted in 2011-12, a modern-day record by far. Bushel-per-acre yields in 2011-12 were a disastrous 146.7, down from 152.8 in 2010-11 and 164.7 in 2009-10. A return to normal yields would deliver a record US corn crop of well over 13 billion bushels.

South American weather can push corn to further gains, but we believe that this market reached its highs back in the summer. Any indication that the weather scare in South America has been overstated should be viewed as a sell signal. Remain sidelined for the moment.

[December 30, 2011]

Chart 5 – March corn



Courtesy Reuters

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Copper

Have the Chinese regained their appetite for copper?

Copper prices plunged by over $1.25 per pound, or more than 25%, this past September (Chart 6). The market has since rallied and is straddling the $3.40-per-pound level. Are we looking at just a dead-cat bounce and soon to see prices revisit the south side of $3.00 per pound, or has the market bottomed?

US economic data on the whole have been fairly positive. Employment data in particular have been better than just about any economist predicted. That should be mitigated by an impending recession in Europe. By and large, however, the copper-specific supply and demand indicators have been sliding to the bull side.

Chinese imports – the single most important fundamental in the copper market – have been rising since June (Chart 7). Data for December imports – reported on January 9 – showed imports for the month surging to a record 508,000 tonnes. That surpassed the largest monthly tally recorded in June 2009. The large numbers have been interpreted as nothing more than arbitrage between LME and Shanghai prices and the financing mechanism used by Chinese businesses to circumvent tight credit conditions orchestrated by the government. Analysts say that industrial demand has been sluggish. Nevertheless, the Chinese are buying, and assuming the trend continues, it takes copper off the market and is certainly not a bearish factor.

Chilean output is anemic, and that is a generous description. Through November, year-over-year average monthly production was down 3.8%. Plagued by constant labor problems, as well as sporadic weather constraints, there were only three months in which output was above previous-year levels.

Warehouse stocks have increased slightly over the past month, but are down substantially since they began to fall earlier this year. Since March, combined LME, COMEX, and Shanghai inventories have fallen by about 125,000 tonnes, to 560,000 tonnes (Chart 8).

According to the International Copper Study Group's (ICSG) latest data for 2011, which covers the period through the end of the third quarter, global demand was up 1% over the same period in 2010. Consumption in China, the US, the EU, and Japan was down, but strong demand in Russia and India – particularly Russia – compensated to see global demand grow by 1%. At the same time, global mine production was down 1.8%.

The ICSG global balance sheet shows a 170,000-tonne refined-production/supply deficit, which has grown steadily since the summer. The market is in better shape than last year at this time when the balance sheet showed a 429,000-tonne deficit, but with the fragile state of the global economy and the stream of financial trouble every region is struggling with, that is a fairly tight balance sheet.

However, the ICSG data for China obviously do not include the powerful recovery in Chinese imports over the past few months. After including apparent demand implied by Chinese buying patterns and the continuation of weak output in Chile, the deficit is surely higher than the ICSG's dated report.

CFTC data show that commercials remain heavily long this market, which means that commodity funds are still heavily short and are playing the recession card in this and most other markets. At many trading desks it has become somewhat sacrilegious to be bullish, particularly when it comes to markets that should normally be ultra sensitive to the economic environment.

Some of the bullish indicators cited above are admittedly tentative. One disappointing month of Chinese import data can send the market into a tailspin. Many analysts still have hopes that new production expected to come on line in Chile will soon facilitate a recovery in mine production. Still, the balance of evidence at the moment favors the lonely bull.

Buy March copper, risking $3.30 per pound, close only.

[January 10, 2012]

Chart 6 – March copper

Courtesy Reuters

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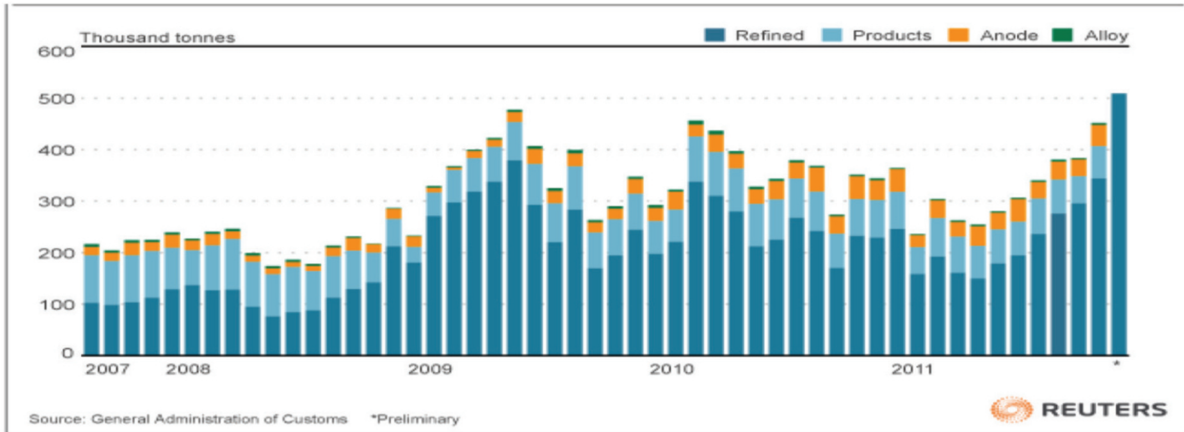
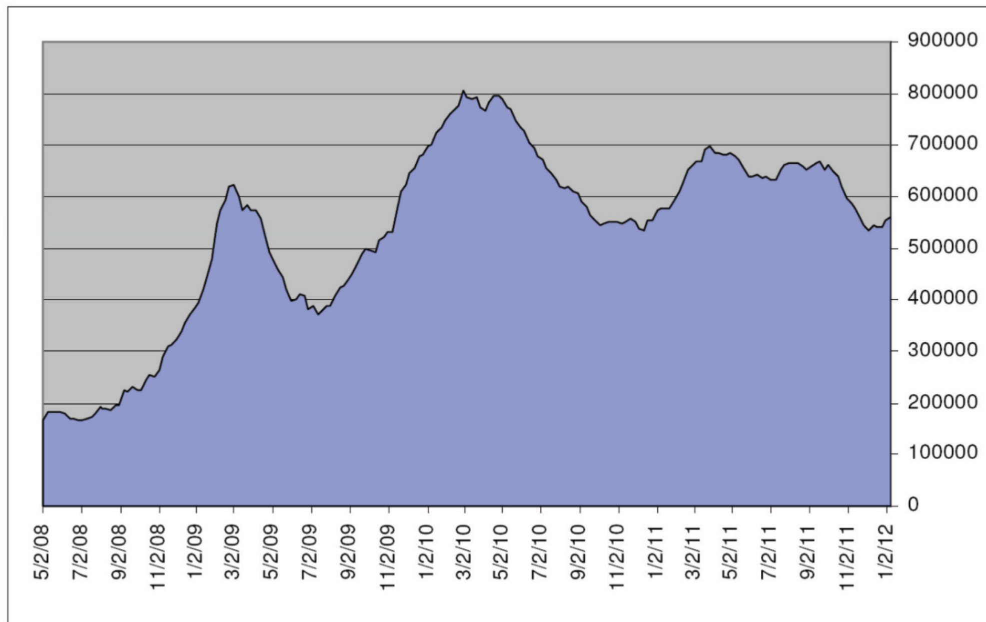
Chart 7 – Chinese copper imports



Courtesy Reuters

Chart 8 – Global copper warehouse stocks



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