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West African cocoa output slows, but are we running out of cocoa?

The cocoa market continues to defy gravity. The US dollar index recently traded at new highs, near levels not seen in over a decade. The dollar's strength is dragging down prices of almost all commodities to their multi-year lows – but not cocoa. Front month March is cruising just below $3,400 per tonne, threatening a run at the $3,800-per-tonne level reached in 2011 during the waning days of the broad bull market in commodities (Chart 1).

Although demand has been sluggish, the outlook has turned brighter. Third-quarter grinding statistics were weak in most major processing regions, rising only in Europe, and by only 2% at that. This will probably be less than the growth rate of 2015-16 output.

Cocoa butter prices, however, have finally perked up. After the butter ratio fell to as low as 1.80 times the London spot price, it now stands at 2.4. Powder prices have nearly doubled since their lows in 2013, to just shy of $3,000 per tonne. The combined ratio is at a one-year high (Chart 2). Fourth-quarter grind data, to be released in mid-January, should show improved results as higher product prices provide an incentive for processors to ramp up bean purchases.

On the supply side, West African output seemed to be running smoothly, until it ran into a snag. Ivory Coast received excellent precipitation in the early stage of crop development. Rainfall was ahead of the previous season by about 30%. As a result, port arrivals were out in front of last year's pace by about 30,000 tonnes just a few weeks ago. Weekly arrivals have slowed down, though, and now stand at 534,000 tonnes, just a tad below last year's level. The dry Harmattan wind that blows over West Africa from the Sahara from December to March is always a threat to the last half of the main-crop and to the mid-crop seasons. This year it arrived earlier than usual.

Although Ghanaian production is roughly half that of the Ivory Coast, last year's disastrous crop has been the main driver of the bull run. Output reached only 700,000 tonnes for the 2014-15 marketing year, down from 850,000 tonnes in the previous season. A repeat would indeed keep the bull market alive. Like the Ivory Coast, early results were very strong – arrivals were more than double last year's levels. However, the earlier-than-usual Harmattan wind has likely affected yields as well. Reporting for Ghana is not as timely as it is for the Ivory Coast, so we don't know what the effects were. Any declaration of a complete recovery for Ghana must therefore be put on hold for the time being.

In the meantime, despite the loss of 150,000 tonnes from Ghana's output in the season past, the International Cocoa Organization (ICCO) recently revised its estimate of the 2014-15 balance sheet, from a 15,000-tonne deficit to a 35,000-tonne surplus. Looking ahead, private forecasters are talking about a deficit of between 100,000 tonnes and 150,000 tonnes for 2015-16.

As illustrated, traders are reacting to bullish developments on both the supply and demand sides. But is the exuberance that is making cocoa the king of commodities warranted?

Even if we have a global deficit at the end of 2015-16, the drawdown would still leave ending stocks at roughly 35% of consumption, so it's a bit difficult to see why this market is behaving as if the world is running out of cocoa beans.

Open interest is at a record high (Chart 3). Commodity funds are piling onto the long side (Chart 4). The most recent surge in open interest has not had the power to pull prices convincingly through the top of the one-year range. And that

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could be the first sign of trouble for bulls.

Still, fighting the tape has never been a winning strategy. We were mercifully stopped out of our short position at $3,250 per tonne, as per our October 19 recommendation. Stand aside for now, but reinstate short positions on a failure of the current rally. Sell March cocoa at $3,300 on a stop close. If filled, place initial protective buy stops at $3,450, close only. *[Sholom Sanik, December 8, 2015]*

Chart 1 – Weekly ICE cocoa

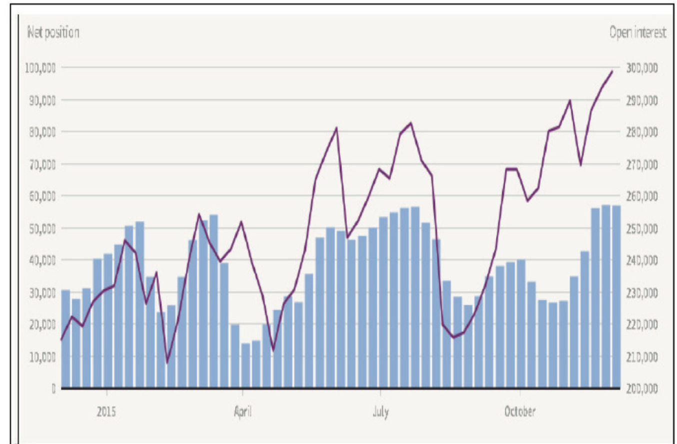
Courtesy Reuters

Chart 2 – Combined butter/powder ratio

Chart 3 – ICE cocoa open interest

Courtesy Reuters

Chart 4 – Fund net-long position (bar)



COPPER

The copper bear doing its job

Copper prices have plunged and have been bouncing off the $2-per-pound level – last seen in 2009 (Chart 5). According to the International Copper Study Group (ICSG), the global balance sheet has shifted from deficit to surplus. For its most recent study period for January through August, reported on November 20, the market showed a surplus of 69,000 tonnes, compared with a deficit of 461,000 tonnes in the same period in 2014.

Yet the trending indicators are not necessarily all that bearish.

First, global warehouse stocks more than doubled earlier this year. After peaking in the summer, however, they have been drifting lower (Chart 6). The significance of warehouse stock movement, though, is limited because much of the inventory is hedged with derivatives, making it difficult to know how much is actually available for delivery.

With copper prices down 50% from their bull market highs, the incentive to produce has waned. We've seen mine closures and downsizing. In ICSG's study period through the end of August, global mine output grew by 2.8%. However, its early forecast for 2015 mine-production growth was 6.7%. That was subsequently lowered to an increase of 4.4%. The

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most recent estimate puts global mine growth at a scant 1.2%. Global capacity of utilization for mines in the period declined by 2 percentage points, to 83%.

Chilean production accounts for about one third of global output and studying its output pattern makes sense of the progression of the ICSG's declining output forecasts. The monthly press releases have shown some erratic volatility for Chilean output, with both gains and losses of about 10%! But through the end of October, Chilean output has averaged a gain of just 0.55%. This compares with some heady forecasts for production that at one point were projecting growth of 3.7%. The most recent estimates are looking for continued weak output through the end of the year. One forecast sees Chilean output falling by 1.2% below 2014.

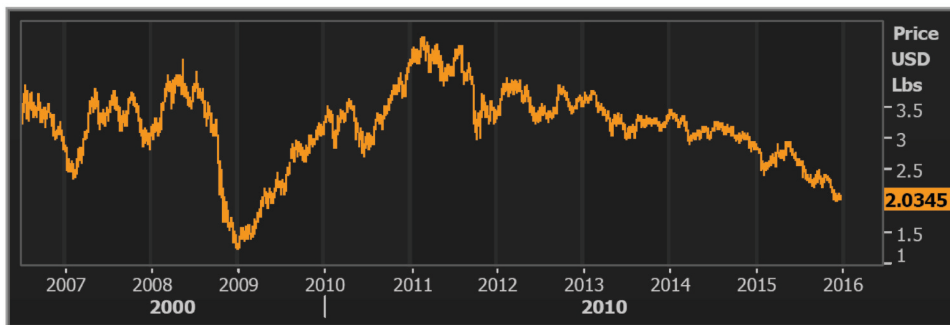
ICSG data show that global usage declined by about 2% for its study period. The problem with making a case for declining demand, however, is there does not seem to be any slowdown in the pace of Chinese imports. Chinese copper imports are the single largest factor on the demand side. China imported close to 40% of total 2014 Chilean exports. And unless the customs data are fabricated, there has been no letup at all in Chinese imports. Chart 7 shows September imports at their highest level in almost two years. Save for one soft month earlier this year, average monthly purchases are down just a tad from 2014. The continuous flow of imports comes amid predictions that the scandal that emerged earlier this year would curtail bank financing for copper import deals.

The trend of declining output is in gear, and we expect that it will continue in the absence of a meaningful price recovery. And as long as Chinese imports are maintained at these levels, we can see the global balance sheet surplus disappearing or even slipping back into a deficit.

Regardless, should you have been fortunate enough not to heed our premature concerns and you did not exit the short side as per our October 13 recommendation, then do not fight the tape. Remain short. Lower stops to $2.15 per pound, basis the active trading month, close only.

[By Sholom Sanik, December 18, 2015]

Chart 5 – Weekly COMEX copper



Courtesy Reuters

Chart 6 – Global copper warehouse stocks

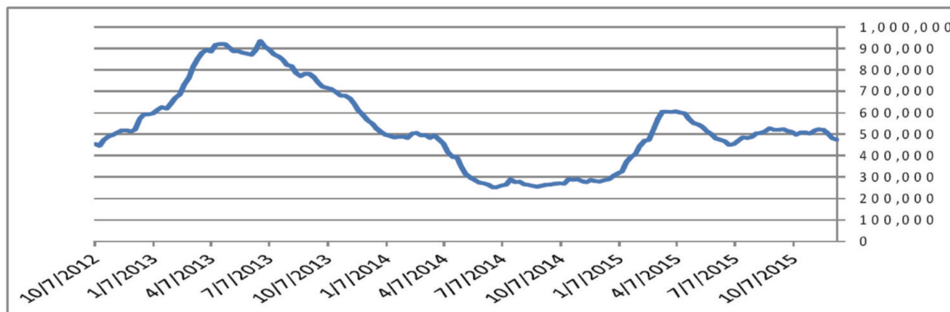
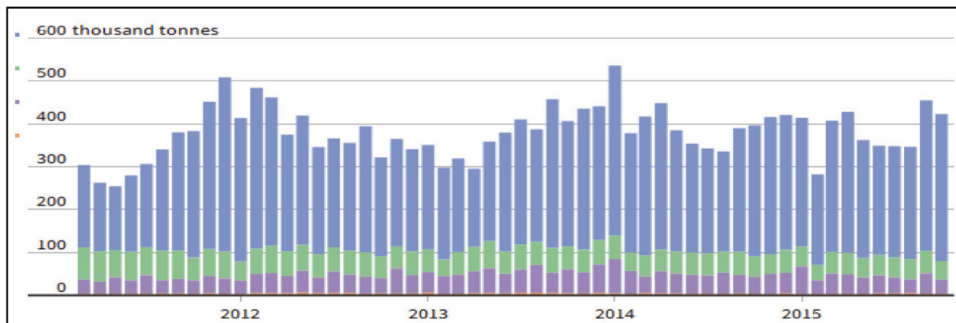


Chart 7 – Chinese Copper imports



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SOYBEANS

Burdensome beans

Recently elected Argentinean President Mauricio Macri has made good on his election promises: a currency devaluation and reduction of the soybean export tax, from 35% down to 30%. The plunge in the peso will encourage farmers who have been holding on to soybeans – as well as other commodities – to starting selling off their stockpiles. The export tax factor is not nearly as potent as it will be for corn and wheat for which the tax is being eliminated completely. March soybeans traded down to new recent lows when the devaluation was announced, but rallied later in the session (Chart 8). Sell the rumor, buy the news.

The planting window for Argentinean soybeans is a bit later than in Brazil, extending through early January. The main crop is planted by mid-November. Then about 25% of the crop is double planted after the wheat harvest is complete. So there is still an opportunity for farmers to take advantage of the devalued currency.

The weather has been dry in the principal growing regions in Brazil during the key development stage of the crop. This has caused some concern about achieving the record 100-million-tonne production target. It is very early, though, and even if 1 or 2 million tonnes are lost, we will likely exceed 2014-15 output of 96.2 million tonnes.

The completed harvest in the US yielded a record crop of 108 million tonnes. Ending stocks are forecast to grow to 12.4% of usage, compared with 4.9% and 2.6% in 2014-15 and 2013-2014, respectively. US ending stocks have not been this high since the 2005-06 marketing year, when they reached 18.6% of consumption.

If consumption patterns do not improve, that ending stock figure is likely to rise. Although there was a string of strong weekly export reports, the total is still shy of the pace that would be required to meet the USDA target. As of the most recent weekly report, commitments stand at 35.1 million tonnes, 14.4% below last year at this time. The USDA forecast is 46.68 million tonnes, only 7% below 2014-15.

Global ending stocks are currently estimated at 26.5% of consumption, the highest level since 2010-11. With soft demand and the likelihood of a material upwards revision to Argentinean output, that figure is likely to rise. While the soybeans hiding in Argentinean silos have already been counted into 2014-15 production figures and will be neutral for the balance sheet, the extra beans soon to appear should cause additional pressure on soybean prices.

It will be difficult for the weak demand environment to absorb the wall of beans that will be coming to market over the next few months, first from the US and then from South America.

Commodity funds are short this market, but have been covering over the past several weeks, even as the market was selling off (Chart 9). We therefore do not believe that this market is excessively oversold.

Sell short March soybeans, presently trading around $8.75 per bushel. Place initial stops at $9.25, close only.

[By Sholom Sanik, December 18, 2015]

Chart 8 – March soybeans

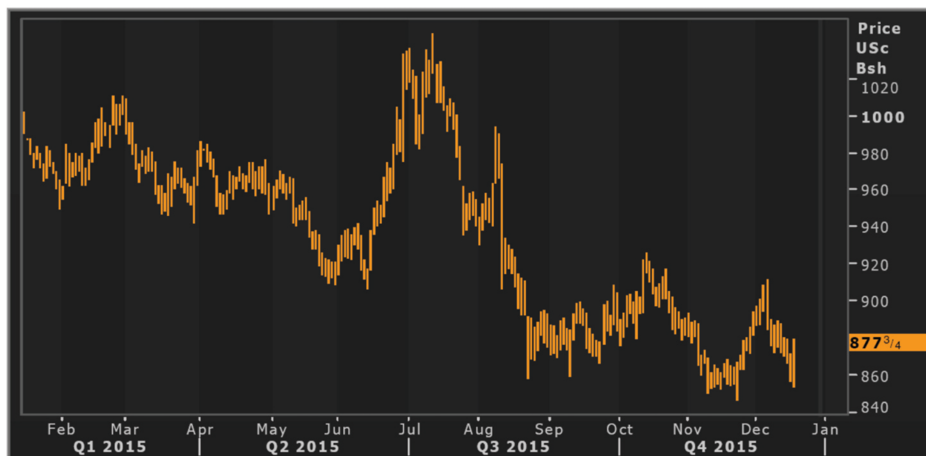

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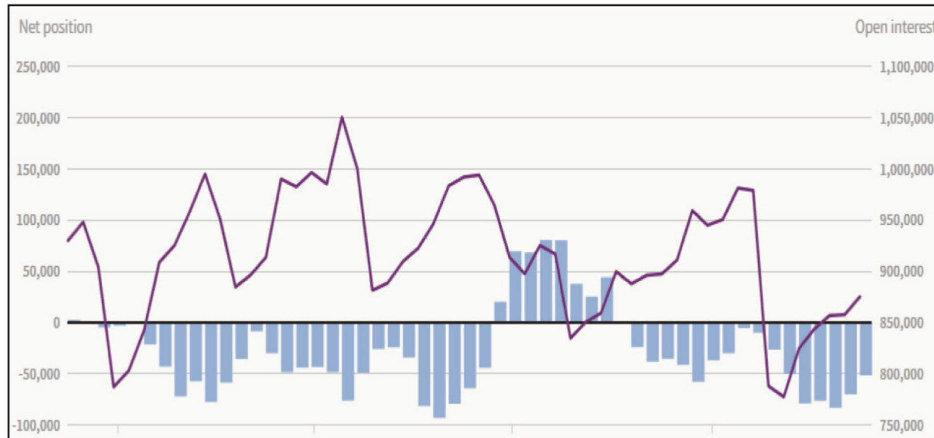
Chart 9 – Commodity fund net-short position – soybeans



SUGAR

Volatility we can live with

March sugar reached just shy of the doorstep of 16¢ per pound (Chart 10). Prices dropped sharply, wiping out all of November's gains. Those skeptical of the budding bull market in sugar shook their heads knowingly. After five years of surpluses, what's one year of deficit? And the favorite bearish argument: The explosive growth of the fund net-long position has propelled prices but has failed to advance the market past the highs, even while the long position keeps getting larger and larger (Chart 11).

In the meantime, sugar prices have held up remarkably well considering what the strength in the US dollar has done to almost all other commodities. It is quite true that the massive fund long position is dangerous. Any bearish news can trigger a wave of selling. However, Chart 12 shows that when the actual level of open interest is viewed in a longer-term context, it may not be quite as burdensome as believed.

First, we packed on much more open interest in the mini bull run in 2007. More significantly, open interest has not grown at all over the past few years – we're not even near the highs of this year. Thus, while the net position has switched from the bears to the bulls, the actual size of participation is muted. So yes, when a fund or a group of funds decide to unload, we will live through some uncomfortable selling. The evidence thus far has shown that the fundamentals are strong enough to withstand the storm.

Speaking of which, there are several developments. Indian ending stocks for 2015-16 are estimated at 6.7 million tonnes, down more than 25% from the past season. The drawdown is partly a result of anticipated exports, which were facilitated by government subsidies. It is still very early for estimates of the 2015-16 crush.

The one thing we do know is that projections that were based on cultivated area should be revised downwards because of the dry weather in key growing regions. Depending on how bad yields actually are, the wisdom of providing generous export subsidies that will result in much lower ending stocks than the government is comfortable with may be called into question.

Wet weather in Brazil has resulted in lower yields and has caused analysts to revise their estimates significantly lower. Most analysts have slashed the estimate for sugar in the Center South by close to 2.5 million tonnes, or 7.5%, from previous estimates. Ethanol estimates, on the other hand, have grown by 2.5%. All this despite fears that cheap petroleum would put a dent in the ethanol industry.

On December 17, commodity trader Czarnikow raised its estimate for the current marketing year's global production/consumption deficit to 8.2 million tonnes. That compares with its own previous forecast of 4.1 million tonnes and is now the largest deficit forecast among major analysts.

Yes, the participation by funds is large, and it will create volatility. But this is a *bona fide* bull market based on supply/demand fundamentals that are becoming increasingly more bullish. Fasten your seat belts, but hold on to long call options. *[By Sholom Sanik, December 18, 2015]*

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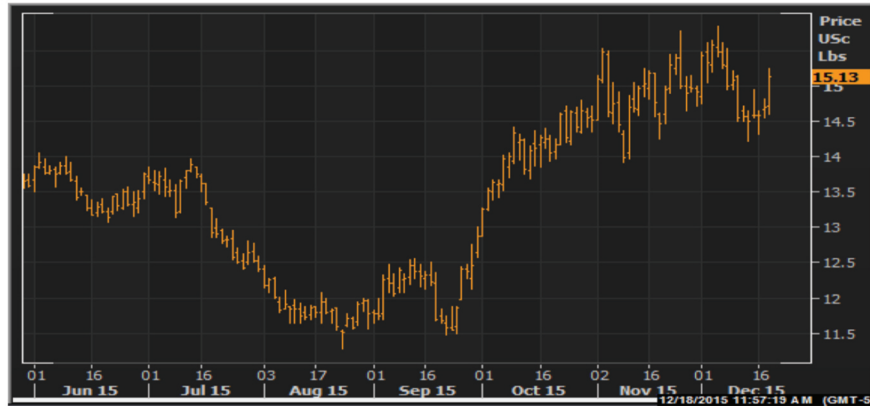
Chart 10 – March sugar



Courtesy Reuters

Chart 11 – CFTC net fund positions – sugar

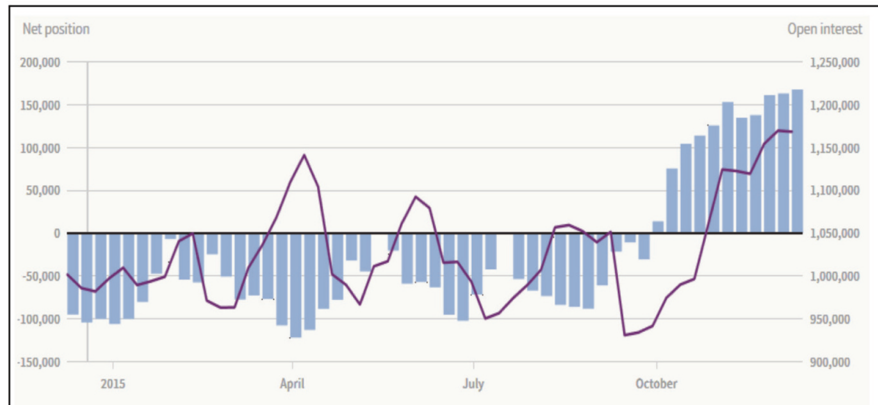
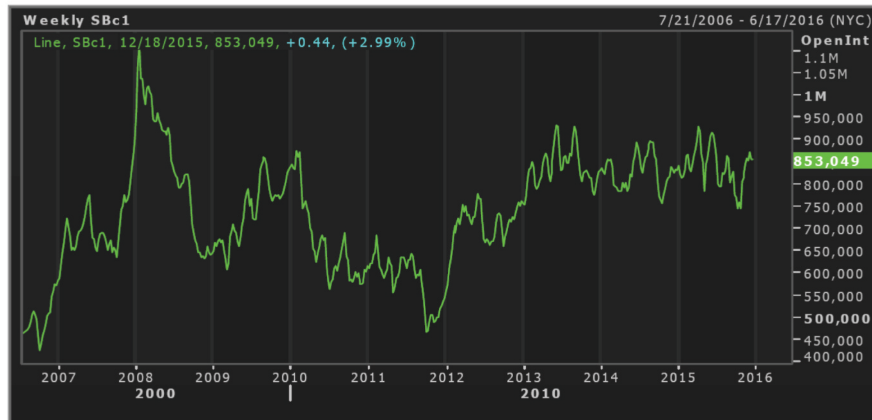


Chart 12 – ICE sugar open interest



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