FRIEDBERG'S
FOCUS ON FUTURES

Friedberg Mercantile Group Ltd. Volume 19, No. 11 February 27, 2017

# Soybean oil: down but not out

Soybean oil prices, which outperformed the soy complex throughout the summer and well into the US soy harvest, have been hammered (Charts 1 and 2). As we've discussed previously (see *Focus on Futures*, August 31 and December 8), there were two operative bullish issues, both of which seem to have been compromised.

First, palm oil is the world's biggest vegetable oil market, and El Niño-related drought hurt palm yields last year in the largest producing nations, Indonesia and Malaysia. The fallout tightened the market and also put a bid under the other principal oil markets – soy and canola.

While press reports still talk about the lingering effects of El Niño and the possibility of its return later this year, palm crops seem to have recovered. Palm oil production for 2016-17 in Indonesia is estimated at 35 million tonnes, up from 32 million tonnes in 2015-16. For Malaysia, output is expected to jump to 20 million tonnes from 17.7 million tonnes.

Then, in November, the US Environmental Protection Agency (EPA) announced that it is increasing the required renewable fuel volume for 2017 by 6%. That included a 100-million gallon increase for biomass-based diesel – manufactured in the US primarily from beanoil – twice the amount of the minimum congressional target. The incoming administration has given notice that the EPA will be under review, which could mean that some of the enactments pushed through by the previous administration could be on the chopping block.

There has not been too much discussion in the press regarding this issue, so it is unclear whether the new administration even has an interest in playing with the bio-diesel mandates. There is also some doubt as to the degree of authority that the White House has with regard to altering existing protocols without taking the matter up in Congress.

Nevertheless, it would seem that bulls who were banking on an ever-growing amount of soybean oil to be converted to bio-diesel got cold feet. At least part of the rally late last year was tied to the belief that we would see the US soybean oil market tighten as a greater percentage of oil would be diverted from food to fuel processing.

Over the past 30 years, there has been a global vegetable oil production/consumption surplus. The 2015-16 marketing year was the first since the 1986-87 season for which there was a deficit. The recovery of the palm crop put the market back into surplus, but not before inventories were drawn down enough to keep ending stocks from falling for a second consecutive year. Between 2011-12 and 2014-15 the global carryout averaged 13.7% of usage. In 2015-16 and 2016-17 that number will fall to 10.9% and 9.7%, respectively.

Commodity funds were bullish on the soybean oil story and built a formidable net-long position (Chart 3). Not surprising, then, that traders would be spooked by what seemed to be bearish news on all fronts.

But we draw attention to the fact that the heavy selling was limited to soybean oil and not the general vegetable oil market. Palm oil prices remain perched right near their highs (Chart 4). Moreover, even while soybean prices themselves traded up to six-month highs recently, the selling in soybean oil was already underway.

We believe that tightness in the global vegetable oil market has not been alleviated by one good crop year in Southeast Asia. Besides, if predictions of the return of El Niño are realized, the year-round crops will show yield stress sooner or later.

Over time, the issues regarding the relationship between soybean oil and bio-diesel will be clarified, but in the meantime, bio-diesel consumption continues to rise. Chart 5 shows the growth of the US market, from infancy at the turn of the

## Inside

**Cotton:** Inventory illusion? ....................................2
**Wheat:** Emerging bull? ............................................4
**Cocoa:** Napping bear? ............................................5

**Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.**

**Get Focus by e-mail**
*Focus on Futures* is available by e-mail as an Adobe PDF file. If you prefer to receive your copy of *Focus on Futures* by e-mail, please send us a message at *focus@friedberg.ca* with your full name, e-mail address, and street address.

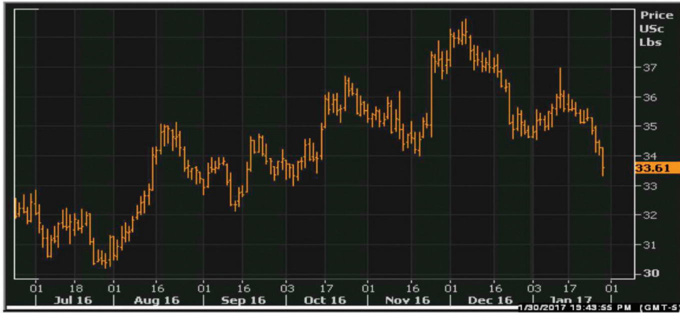
©2017 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

century to the current 2016-17 marketing year.

The market missed our 33.5¢ stop close, basis March, by a hair's breadth. Roll long March soybean oil positions to July, currently trading around 34¢ per pound, and place sell stops at 33¢, close only.

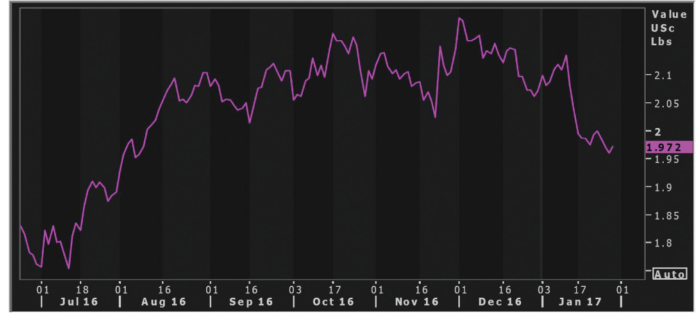
*[Sholom Sanik, January 31, 2017]*

**Chart 1 – March soybean oil**



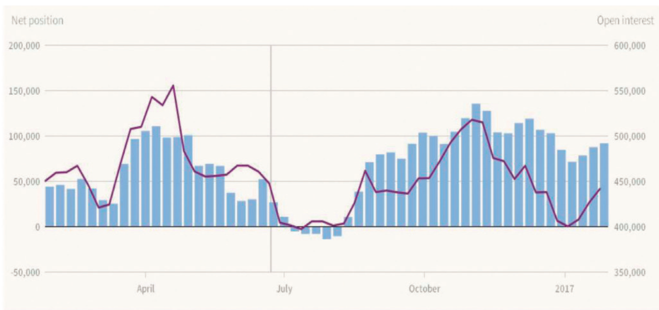

*Courtesy Reuters*

**Chart 2 – March soybean oil/soybeans ratio**



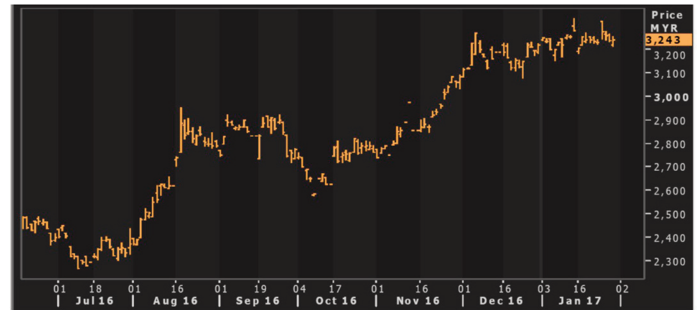

*Courtesy Reuters*

**Chart 3 – Commodity fund net-long position**



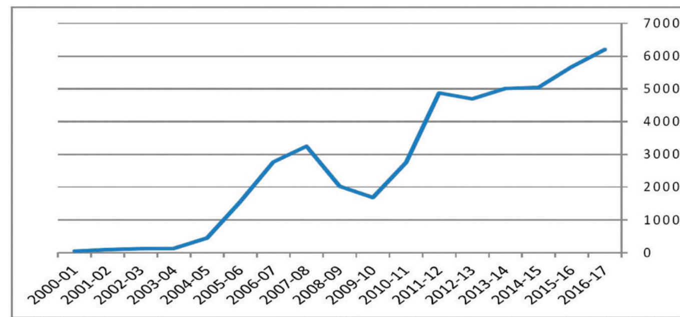

*Source CFTC*

**Chart 4 – Malaysian plam oil (US$ denominated)**




*Source Reuters*

**Chart 5 – US soybean oil-based bio-diesel consumption (mills of lbs.)**




## COTTON

# Are inventories as large as they appear?

Unlike cotton, few – if any – commodities are trading near their two-and-a-half year highs (Chart 6). No other commodity carries such a burdensome global balance sheet. Quite the paradox.

Even after inventories have been whittled down – primarily because of Chinese stock sales – the estimate for 2016-17 global ending stocks stands at 89.2 million bales, or 79.7% of usage. That's down from 100.2% and 87% in 2014-15 and 2015-16, respectively, but still dramatically higher than virtually any other commodity we trade. Is the bull run in cotton sustainable under these conditions?

In terms of the supply side, there will certainly be challenges. Chart 7 shows the prices of new crop cotton *vis-à-vis* soybeans, corn, and wheat – the crops that compete with cotton for acreage based on profitability. Although the three contenders have rallied off their lows over the past few months, none have done as well as cotton.

This is a crucial period for planting intentions because farmers are finalizing their seed and fertilizer requirements – decisions that, for the most part, are not easily reversible. A


©2017 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

material shift in profitability ratios would be required to see a significant shift in intentions.

Early estimates for the US 2017-18 crop, which will be planted in the spring, have been seen as high as 11.5 million acres. That would be the largest area planted to cotton since the 2012-13 season (Table 1).

**Table 1: US cotton acres (millions of acres)**

| | |
|---|---|
| 2011-12 | 14.74 |
| 2012-13 | 12.26 |
| 2013-14 | 10.41 |
| 2014-15 | 11.04 |
| 2015-16 | 8.58 |
| 2016-17 | 10.15 |
| 2017-18 | 11.5* |

*early estimate

For the other large producers, such as India and China, planting decisions should run along similar lines. Inasmuch as the information for the US is sketchy at this juncture, there has not been any published information for other countries at all.

Turning to demand, global usage for 2016-17 is estimated at 111.91 million bales. That's up a bit from the previous year and the highest tally since the 2010-11 marketing year.

The Chinese destocking program has taken its toll on foreign purchases. Chinese imports are estimated at 4.5 million bales, down from a peak of 24.5 million bales in 2011-12. However, as we've pointed out in previous articles, the huge stockpiles in China have only a limited amount of the quality cotton required to meet the manufacturing needs for the sale of finished goods abroad. A closer look at US export data reveals that, indeed, the Chinese are still active buyers. Export commitments by China thus far in the 2016-17 marketing year stand at 1.5 million bales, compared with a scant 279,000 bales last year at this time.

Interestingly, while total commitments to China for this time of year still lag the five-year average by a wide margin, shipments are very close to the five-year average. Thus, if there is any continuity of China's year-to-date purchases, we should see upward revisions to the USDA's 4.5-million-bale estimate in the coming months.

The large global ending stock figure is somewhat of a misnomer. For most of modern history, including the years leading up to the out-of-the-box bull market that drove prices to over $2 per pound, ending stocks averaged near 50% of consumption. Obviously, then, any comparison to other agricultural markets for which ending stocks hover in a range of between 15% and 30% of usage is faulty. As such, while global cotton inventories are still high relative to the past few years, they are trending downwards. Market participants must be discounting a fresh surge in demand that would put the true ending stock figure much closer to the 10-year average of 68%.

In this context, larger crops may not be as bearish as when viewed in isolation.

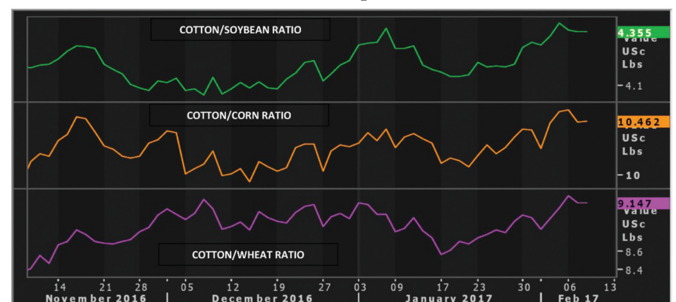
Also of note, the market is not as overbought as a cursory overview might indicate. Commodity funds do hold a massive net-long position, but as Chart 8 shows clearly, that position has not grown even while the market has rallied by about 10¢ per pound since September.

Remain long as per our October 21 recommendation. Roll March contracts to July and raise stops to 72¢ per pound, close only. *[By Sholom Sanik, February 8, 2017]*

**Chart 6 – Weekly nearest contract cotton**

*Courtesy Reuters*

**Chart 7 – New crop cotton ratios**




*Courtesy Reuters*

**Chart 8 – Commodity fund net-long position**

*Source: CFTC*


©2017 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

## WHEAT

# Is the bull emerging from dormancy?

After six consecutive years of production growth, we'll be closing out the 2016-17 marketing year for wheat with global stocks at 34.1% of consumption, the highest level in 15 years. No wonder. The market spent most of the period between 2007 and 2015 at prices well above historical norms (Chart 9). The bull market did its job of allowing farmers to increase planted area while locking in profits.

How, then, do we explain the recent 60¢-per-bushel rally in wheat prices (Chart 10)?

Winter wheat crops comprise the majority of wheat crops for the major bread-quality Northern Hemisphere crops. When they were planted this past fall, wheat prices were trading at 10-year lows. In January, the USDA estimated US winter wheat acres planted for the 2017-18 crop at 32.83 million acres, down 3.76 million acres from 2016-17 seedings. That was even lower than the average of analysts' guesstimates of 34.14 million acres. It will be the least amount of acres planted in 108 years!

The USDA's first comprehensive estimate for 2017-18 global supply and demand will be released in its May crop report. The International Grain Council, however, has published an early forecast.

Russia and the Ukraine will be the only major exporting nations that expanded planted area, but only by a small amount. All other significant producers planted similar or smaller area. As a result, global output is expected to decline by about 2.5%, to 235 million tonnes.

US wheat exports peaked in the 1980s, and farmers have responded to growing competition from other exporters by diverting acres to other crops. In 2015-16, US foreign sales sank to a modern-history low of 21.09 million tonnes. For the current marketing year, however, demand for US wheat is forecast to rebound to 27.9 tonnes.

The USDA estimate for US exports had been lagging the export commitment pace. In response, the January crop report increased its estimate for 2016-17 US exports by 1.34 million tonnes, to 27.9 million tonnes. Commitments to date stand at 23.41 million tonnes, or 37% ahead of last year at this time. That still indicates a jump of only 32% from 2015-16.

If recent activity is any indication, the USDA estimate for final sales will have to be revised higher yet again in future crop reports. New sales over the past 10 weeks have averaged 454,000 tonnes, compared with only 261,000 for the comparable period last year.

By planting such a small crop in the fall, it is possible that US farmers – and perhaps others – have been complacent in underestimating demand. The robust ending stock figures certainly make for a compelling bearish case on paper. However, in much the same way that high prices created a prolonged 10-year bear market, low prices may have planted the seeds of the next bull market.

Furthermore, and in explanation of recent activity in the market, commodity funds have been in the process of covering a massive net-short position. And they haven't even scratched the surface. The short position peaked at 164,000 contracts back in October, but still stands at 93,000 contracts (Chart 11).

Establish moderate long positions in July Chicago Board of Trade wheat, currently trading at about $4.80 per bushel. Add to positions on 20¢-per-bushel setbacks. Place initial stops at $4.30, close only.

*[By Sholom Sanik, February 16, 2017]*

**Chart 9 – Weekly nearest contract CBOT wheat**

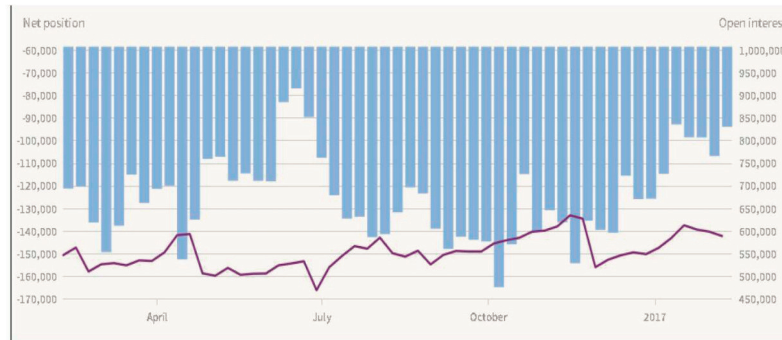
*Courtesy Reuters*

**Chart 10 – July wheat**

*Courtesy Reuters*


©2017 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

**Chart 11 – Commodity fund net-short position**




*Source: CFTC*

## COCOA

# The bear is napping but will return

Ivory Coast port arrivals – the single most important supply-side fundamental for the global cocoa market – has seesawed all season long between ahead-of-last-year's and behind-last-year's level. Most recently, arrivals have been strong. As of the most recent reading, 2016-17 arrivals have climbed from 32,000 tonnes, to 1.227 million tonnes.

The main-crop season closes at the end of March, and the mid-crop harvest extends through September. The harmattan-wind season, which depending on its severity, can cause serious drought conditions, is almost over. The winds were moderate this year, and as a result, most growing regions in the country have had ample rain. Analysts are therefore talking about a record mid-crop of near 600,000 tonnes. According to the latest estimates, that would put total 2016-17 output at a record of close to 2 million tonnes. That compares with 1.8 million tonnes and 1.6 million tonnes in 2014-15 and 2015-16, respectively.

Output for Ghana, the world's second-largest producer, is expected to reach 800,000 tonnes, about 50,000 tonnes shy of early-season forecasts.

On the demand side, butter and powder prices have been steady, with butter prices improving slightly over the past couple of months. Chart 12 shows that the combined butter/powder ratio has moved up during this period, but remains confined inside a two-year-long range. This leaves processors with little incentive to accelerate bean purchases beyond hand-to-mouth needs.

For the most part, this is confirmed by grinding activity. Fourth-quarter statistics for the EU released last month show that grinding activity fell 0.9% year-over-year. The North American grind was 1.1% lower. Only the Asian grind showed some meaningful progress with an uptick of 17%, but that is off a much smaller base than the EU.

One of the fallouts of this bear market was a series of defaults by exporters who reneged on contracts they entered into with the Coffee and Cocoa Council (CCC), the Ivorian marketing board. There was a large amount of beans involved – about 350,000 tonnes. And perhaps this explains the rapid plunge from $2,100 per tonne to $1,900 per tonne from late-January through mid-February (Chart 13) as the bearish implications of that much cocoa becoming part of global inventories terrified whatever bulls remained standing. At first, the default was denied, but eventually the CCC announced that it had retendered the beans in question and that most had been sold. That in turn would explain the price recovery.

In any case, the whole affair was a lot of noise that does not deter us from focusing on the fact that production is very strong – much stronger than believed possible earlier in the marketing year – and demand continues to be sluggish.

Recent forecasts for the 2016-17 marketing year are calling for a global production/consumption surplus of 250,000 tonnes, a complete turnaround from a 150,000-tonne deficit in 2015-16.

If there's a bullish case, we don't know what it is. The funds continue to build a net-short position (Chart 14) and the larger it gets, the sharper the countertrend rallies are going to be, as evidenced by the pop in prices we saw when it seemed that the CCC had solved the cancellation issue. But in the grand scheme, we expect new lows and beyond.

Remain short as per our July 21 recommendation. Lower stops from $2,700 per tonne, basis the near contract, to $2,350.

*[By Sholom Sanik, February 24, 2017]*


©2017 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

**Chart 12 – Combined cocoa butter/powder ratio**

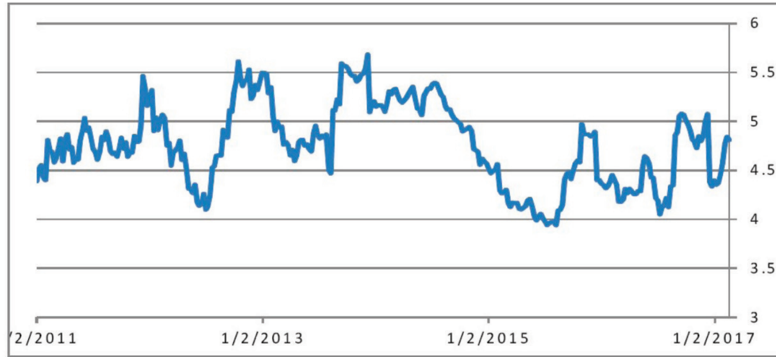
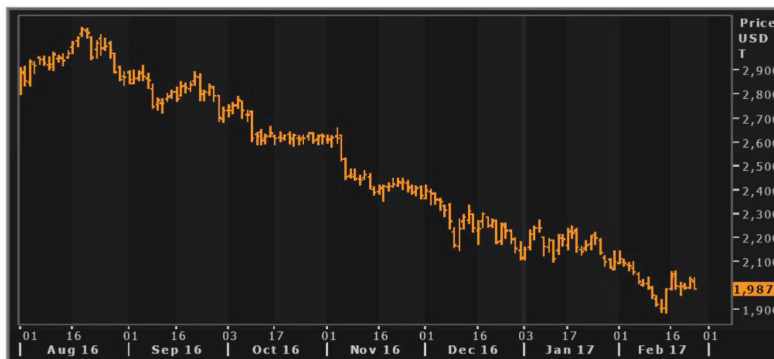



**Chart 13 – May cocoa**




*Courtesy Reuters*

**Chart 14 – Commodity fund net-short position**

*Source: CFTC*

Friedberg's Focus on Futures is published by Friedberg Mercantile Group Ltd., P.O. Box 866, Suite 250, 181 Bay Street, Toronto, Ontario, M5J 2T3. Contents copyright © 2017 by Friedberg Mercantile Group Ltd. All rights reserved. Reproduction in whole or in part without permission is prohibited. Brief extracts may be made with due acknowledgement.

**Subscription Enquiries for**
Friedberg's Focus on Futures
Suite 250
181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
416-364-1171

**All enquiries concerning trading accounts should be directed to:**
Friedberg Mercantile Group Ltd.
Suite 250
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits. This report is a solicitation for entering into a derivatives transaction. The author of this report may have a position in the underlying derivative securities mentioned in this report. The information in this report was obtained from sources we believe to be reliable but is not guaranteed by Friedberg Mercantile Group Ltd. or its affiliates. Derivatives are high-risk investments, and there can be no assurances that the securities mentioned or recommended will maintain their value at a constant amount or that the full amount of your investment will be returned to you. Derivatives' values change frequently and past performance may not be repeated.