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Ivorian cocoa crop shrivels, but demand is holding

After participating in the great commodity plunge, cocoa was the first market to recover some of its fantastic gains (Chart 1). The driving force behind the rally was an extremely weak start to the 2008-09 Ivorian crop.

The season begins in October, and for the first two months, port arrivals were running at a rate of only 55% of the previous season. As the market entered December, when arrivals are typically heaviest, weekly arrivals began to normalize. As of the most recent estimate, the pace had moved up to 68% of last year's. The final arrivals figure for 2007-08 was 1.365 million tonnes, which includes both the main and mid crops.

At the current pace of arrivals, global output would be 435,000 tonnes below last year, which could result in the largest global production/consumption deficit in many years. If the improvement we saw over the past few weeks proves to be unsustainable, the smaller crop would deal a devastating blow to the market.

That's the primary bullish case. Cocoa is one of the markets in which producers were not enticed to increase production to take advantage of higher prices. With the prospects for demand weakened because of the global economic slowdown, however, it is difficult to envision a sustainable bull market in anything – even in markets that are having serious supply problems.

The markets have made some large assumptions regarding imploding demand. For cocoa, there is ample evidence that there has been a downtick in consumption. For the moment, though, it is not big enough to tip the market out of the deficit that will almost certainly result from the smaller Ivorian crop.

Charts 2 and 3 show that both European and Asian butter ratios have been falling since the start of 2008. This means that butter prices are falling relative to beans, because demand for products has weakened. Processing and selling products becomes a less profitable venture, so grinders are less likely to stock up on beans.

The reporting season for the fourth quarter grind began with alarmingly bearish data. Germany – the leader in growth for grindings over the past few years among non-origin countries – reported its second consecutive negative grind. Fourth-quarter grindings were 17.2% below the same period in 2007. With the rest of Europe still to report, it was believed that the outlook would be even more bearish, given that the other European countries typically lag Germany. Traders were expecting the European grind to follow the weak German results, but the number came in unchanged.

Finally, the US grind was up 1.86% for the quarter, also a surprisingly strong number. So while demand growth is definitely running below the 2% to 3% growth rate we've seen over the past couple of years, it is at least steady, ensuring that we're looking at a global production/consumption deficit for 2008-09.

Factors that could mitigate the bullish case include a potentially large mid-crop in the Ivory Coast, which is common when the main crop is poor. In addition, in recent articles on cocoa we spoke about Indonesia fading as a major producer because of rampant crop disease issues. But we've seen reports that indicate that this year's crop will not be as bad as previously believed.

Fortis revised its estimate of the global balance on December 22 to a 45,000-tonne deficit, down from its November forecast that called for a 21,000-tonne surplus. If

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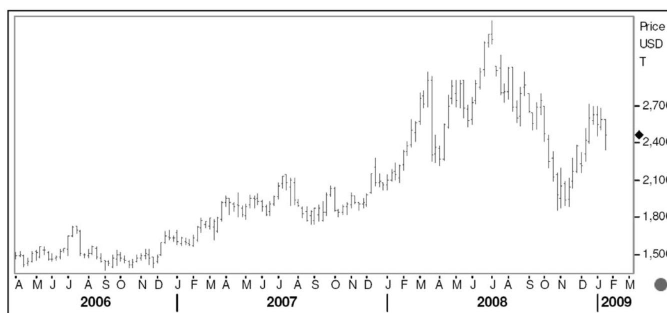
demand remains stable, this is surely a liberal estimate. Given what we know at present, we expect a deficit of at least 100,000 tonnes.

Prices have corrected significantly – by about $300 per tonne from the mid-December high of $2,700 per tonne – which reflects the strong probability that traders overreacted to the weak start to the Ivorian crop. Chart 4 shows that the build in open interest continued to advance after the market peaked on December 18. The fresh buying was weak-handed in that it was not able to propel the market past the $2,700-per-tonne level. Funds and small-specs have a lop-sided net-long position, which is subject to liquidation.

On the other hand, open interest is relatively low, probably as a result of the general climate of reduced market activity. We therefore anticipate that any correction will not be as severe as it might have been in a more speculative environment.

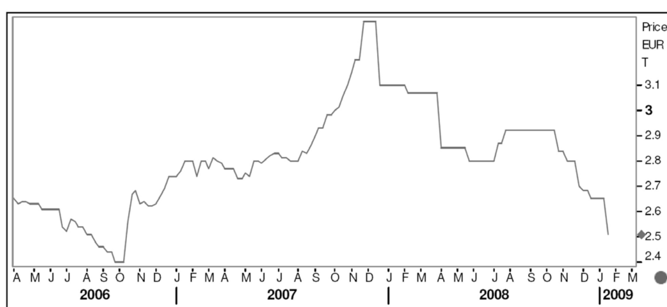
We remain bullish long term, but we would not be surprised to see the market test recent lows to challenge uncommitted bulls. Maintain conservative long positions and feel comfortable to build a larger position on downward spikes. *[January 20, 2009]*

Chart 1 – Weekly cocoa



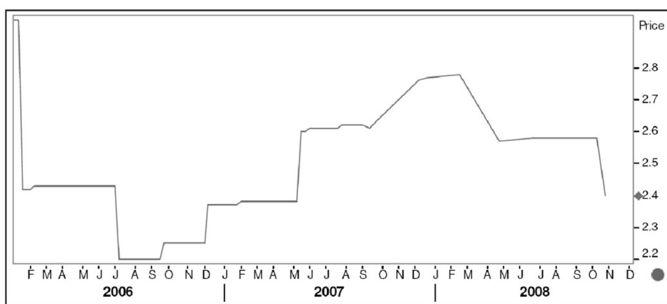
Courtesy Reuters

Chart 2 – European butter ratio



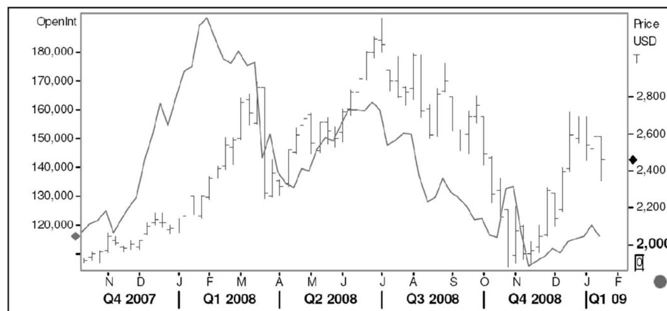
Courtesy Reuters

Chart 3 – Asian butter ratio



Courtesy Reuters

Chart 4 – March cocoa (bar), Total open interest (line)



Courtesy Reuters

WHEAT

Are producing nations underestimating demand?

Consumption indicators for wheat could not be any more bearish.

On January 12 the USDA released a slew of reports on the wheat market. As of December 1, quarterly stocks in the US stood at 1.422 billion bushels (38.75 million tonnes), 58 million bushels above analysts' estimates and 290 million bushels above the same time last year.

Using this data, the monthly supply/demand situation report slashed its estimate for the feed-and-residual component of US usage by 30 million bushels from the December estimate. This resulted in a sharp increase for 2008-09 ending stocks, to 655 million bushels, 47 million bushels above analysts' guesstimates.

Foreign buying has all but ground to a halt. This past week's sales improved to 410,000 tonnes, but there is a lot of catching up to do. The four-week average going back to mid-December is 200,000 tonnes. Weekly sales would need to average about 520,000 tonnes to meet the USDA target for annual US exports of 27.22 million tonnes. While the USDA estimate for 2008-09 exports is 21% below last year's final sales, export commitment data show that US exporters have contracted to sell only 22.3 million tonnes, which is 26%

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behind last year's pace. Despite this, the USDA maintained its December estimate for exports in the monthly situation report.

In 2007-08, US farmers seeded 46.18 million acres of winter wheat – the largest area planted since the late 1990s. Global supplies were tightening because demand for bread-quality wheat had ballooned and prices were rising. After three consecutive years of production/consumption deficits – from 2005-06 through 2007-08 – the US and other producing/exporting countries finally planted crops that would meet demand. The explosive bull market in wheat that resulted from years of underproduction then collided with the global economic crisis. Prices fell dramatically as traders began pricing in a collapse in demand, and it seems that wheat producers are planning their output accordingly.

Rounding out the January 12 reports was the first look at acreage for the winter wheat crop that was planted back in the fall. The street expected a fairly large drop from last season of about 2 million acres, or 4%, to 44.3 million acres, but the actual figure came in at 42.1 million acres, or 8.8% lower than last year.

Other Northern Hemisphere winter wheat producers followed a similar pattern, although the reduction in acreage was not as drastic. Early estimates put EU and FSU area down by 2% and 4% respectively.

After the release of the January 12 report, traders focused on the bearish demand side, wiping out about 50% of the $1.75-per-bushel rally that started in early December. The potentially bullish impact of smaller acreage was ignored.

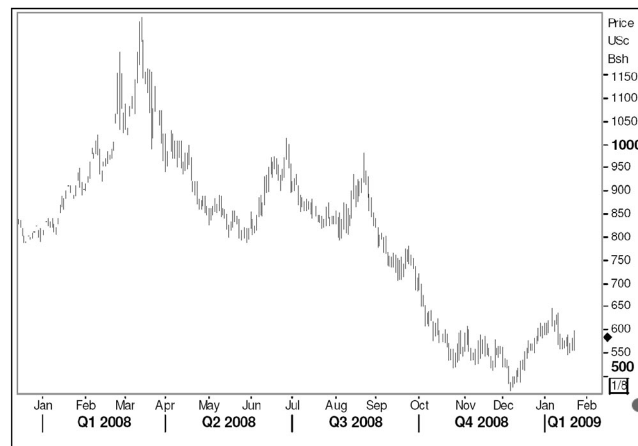
The drop in consumption has shored up the balance sheet to reflect a more comfortable level of inventories. Global stocks at the end of the 2008-09 marketing year are estimated to rise to 148.36 million tonnes, or 22.5% of usage, up from 119.37 million tonnes, or 19.3% of usage in 2007-08.

There are a number of issues that are going to bear watching on the supply side. First, aside from a smaller area for the US winter wheat crop, weather has not been ideal, which means we will probably not see optimum yields.

Chinese carryover stocks are reportedly ample. Ending stocks for 2008-09 are estimated at 45 million tonnes, or 42% of consumption, up from 39% at the end of 2007-08. Drought across 30% of the winter wheat belt has been significant, however, so it's difficult to say that the Chinese won't turn to imports with a smaller-than-expected crop.

Even after tumbling from a peak of over $13 per bushel, wheat prices remain at extremely high prices when viewed in historical perspective. Nevertheless, we do not believe that a short-selling situation is being presented. It is now a certainty that winter wheat output will be returning to the levels that created global tightness in the first place. The assumption that the worldwide economic crisis will keep demand down is indeed reasonable, but the probability that demand for food staples will return to normal levels is at least equally reasonable. Stand aside, but stay tuned. *[January 26, 2009]*

Chart 5 – March wheat



Courtesy Reuters

CORN

Weak demand and prospects for higher acreage

The revisions contained in the USDA's January supply/demand situation report for the corn market left the US balance sheet completely transformed from just a couple of months ago. Falling consumption reflected in the quarterly stocks reported was allocated to the various demand categories.

As of December 1, US inventories stood at 10.084 billion bushels, which was actually below the comparable period in 2007, but – where it counts – 252 million bushels above the average of guesstimates.

Exports and feed-and-residual were cut by 50 million bushels each. The big one was a 100-million-bushel slash to ethanol usage. The estimate for the 2008-09 crop, which was harvested in the fall, was increased by 80 million bushels, to 12.1 billion bushels.

All told, the estimate for 2008-09 ending stocks was increased to 1.79 billion bushels, or 14.9% of consumption, up from 12.1% in December, and substantially higher than 8.9% in November. This compares with carryover of 12.7% of usage in 2007-08 and 11.6% in 2006-07.

So while the balance sheet still appeared to be that of a bull market over the past few months, it turns out that fear of a sharp drop in demand was well founded.

The release of the January 12 reports quashed the December rally with a two-day 60¢-per-bushel selloff (Chart 6). Prices have since stabilized, but we're skeptical about the market's ability to hold, because the supply-side news is turn-

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ing bearish as well.

Early acreage forecasts for the US 2009-10 crop are surfacing. For the most part, soybean prices have outperformed corn prices over the past few months, which prompted analysts to predict a sharp drop in corn area from 2008-09 plantings. Informa Economics' first estimate in December called for 82.29 million corn acres to be planted, down from 86 million acres in 2008-09. On January 16, Informa increased the estimate for corn acres to 82.7 million.

Over the past two weeks, new-crop corn prices have outperformed new-crop beans, so we're likely to see a further shift in favor of corn acres (Chart 7). But the real driver of increased acreage estimates may be natural-gas-based fertilizer, which is applied intensively to corn crops. Unlike most other commodities, natural gas prices have not seen any recovery (Chart 8). Since the beginning of January alone, natural gas prices have fallen another 25%, which leaves the cost of any fertilizer that's been produced recently at a fraction of what farmers paid a year ago.

When the fertilizer factor is combined with the improvement in prices relative to soybeans, profitability of corn planting has upticked significantly. We expect acreage estimates to continue to favor corn.

Back to the demand side: We've been making the case that as credit markets slowly come back to life, demand – particularly for food staples – is unlikely to remain this anemic for much longer. The export market for corn is so depressed, however, that it is difficult to imagine an improvement that will make a large enough dent in ending stocks to change the picture very much. Consider that as of the most recent weekly export report, US exporters have contracted to sell only 23.7 million tonnes of corn abroad, only 51% of the 46.32 million tonnes sold at this time last year. This means that last year, commitments were already 75% of final shipments, but this year US exporters have commitments of only 53.3% of the USDA's projection for the already-reduced forecast for final sales of 44.45 million tonnes for the 2008-09 marketing year.

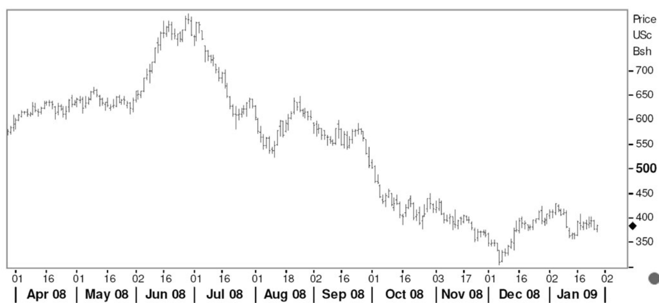
Actually, the past two weeks was the first time in quite some time in which we saw two consecutive decent sales figures, with net new commitments of 1.1 million tonnes in each period. This compares with the average of the previous four weeks of only 324,000 tonnes. There are 31 weeks left in the marketing year. Weekly new commitments would have to average just under 700,000 tonnes to meet the USDA estimate, which based on historical norm, is not at all an insurmountable feat.

Technically speaking, the market is in strong hands. Open interest has fallen precipitously, even while the market rallied by over $1 per bushel in December (Chart 9). The liquidation of long speculative positions continues, but has been unable to break prices below the early December low.

Having painted a bearish picture from both the supply and demand sides, we are hesitant to recommend a short position. Prices have fallen so much already, and the market remains vulnerable to a sudden increase in demand. However, considering the relative strength of soybean exports (see *Focus on Futures*, December 26) and the fact that soybean ending stocks have not improved the way inventories of many commodities have, we believe that a spread of long soybeans and short corn will prove to be a profitable trade.

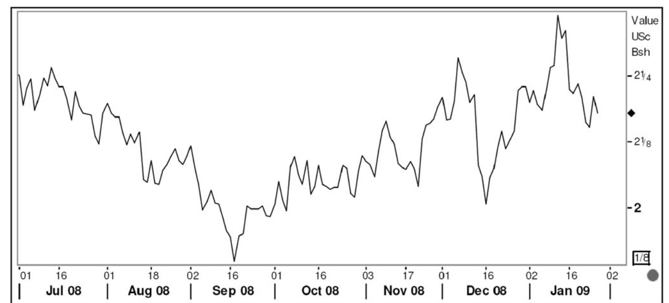
[January 29, 2009]

Chart 6 – March corn



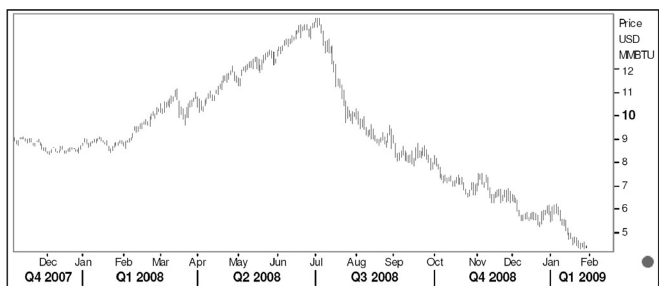
Courtesy Reuters

Chart 7 – Ratio of November soybeans/December corn



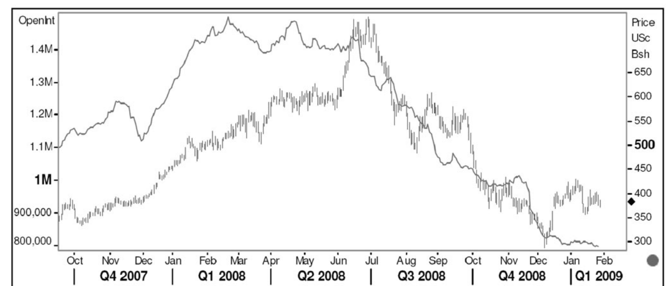
Courtesy Reuters

Chart 8 – March natural gas



Courtesy Reuters

Chart 9 – Nearest contract corn (bar), Open interest (line)



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COTTON

Looking beyond tumbling US domestic demand

Many commodity markets are following a template of sorts. Prices have sprung off the bottom – in some cases quite sharply – but quite clearly, not as a result of speculative activity. These rallies have come against a backdrop of headlines documenting demand in a very clear downward spiral. Finally, to balance falling consumption, producers are cutting back output.

A strong case in point is cotton. The March contract has rallied by as much as 12¢ per pound over the past two months. US domestic demand is moving in the same direction of the bleak economic data we see crossing the wire on a daily basis. On January 29 the US Census Bureau released December mill consumption figures, which showed December usage at 223,646 bales, down from the already depressed November number of 285,167 and dramatically below December 2007 usage of 361,779.

The USDA began the 2008-09 marketing year with an estimate for US consumption at 4.4 million bales, down from 4.61 million bales in 2007-08, and 4.94 million bales in 2006-07. Although the estimate has been revised downwards, the USDA's conservative approach is something of an enigma. The January supply/demand report brought the estimate down another notch, to 4.2 million bales, but an examination of the marketing year to date shows that at current usage rates, this forecast seems quite ambitious.

Since the start of the marketing year in August, average monthly mill usage has been 320,120 million bales, down from 379,075 million bales in the comparable period the previous season. That's down 15.5%, which would put annual usage at just over 3.9 million bales. The USDA is obviously making the assumption that the economic situation will stabilize.

On the export front, weekly sales on the whole have been limp, but the occasional burst of sales has kept the market on pace for reaching the USDA target of 12 million bales. Actually, at 8.7 million bales, commitments and shipments are only 3% and 6%, respectively, behind last year at this time, compared with the USDA forecast for a 11.8% drop from last year.

Global output declined sharply in 2008-09, to 110 million bales, compared with 2007-08 production of 122 million bales. There have not been many estimates for spring planting, so it's hard to say what the future holds. Consider, however, Charts 10 and 11, which show the long-term historical relationship between the price of soybeans or corn *vis-à-vis* the price of cotton, and it becomes clear that where the choice exists, cotton will not be the farmer's crop of choice.

Although Commitment of Trader data show that there has been some increase in fund buying over the past week, for the most part, it was not the result of speculative activity. Chart 12 shows that while most of the rally took place, open interest has not increased much since it bottomed in late December. Chart 13 shows that the net-long position of the funds still remains relatively modest when compared with where it's been in the past year. This means there is ample purchasing power among trend-following systems waiting on the sidelines.

The current estimate for 2008-09 global ending stocks stands at 59 million bales, or 51.5 % of consumption. Although this seems high, it is not high for cotton. Ending stocks were 50.8% of usage and 50.7% in 2006-07 and 2007-08, respectively. These ending stocks are a bit deceptive, because *official* Chinese ending stocks comprise about 35% of the world total, yet China remains the largest buyer of US cotton, with last year's sales totaling about 35% of all US exports.

There is no question that if demand does not improve, there would be no reason to think that cotton prices could move much higher than they are right now. If, however, acreage drops again – as we expect it will – the market is left highly vulnerable to an increase in demand.

Remain long cotton. Keep position size commensurate with your emotional and financial ability to tolerate significant volatility. *[January 5, 2009]*

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Chart 10 – Soybean/cotton ratio

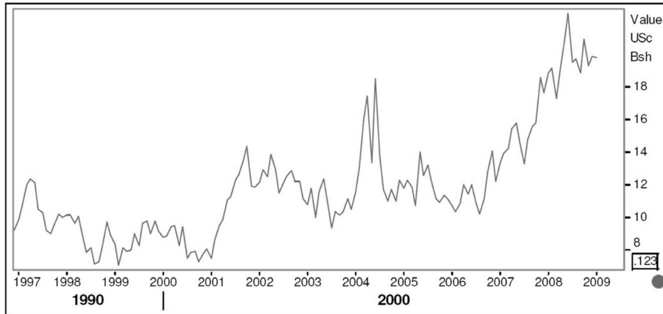

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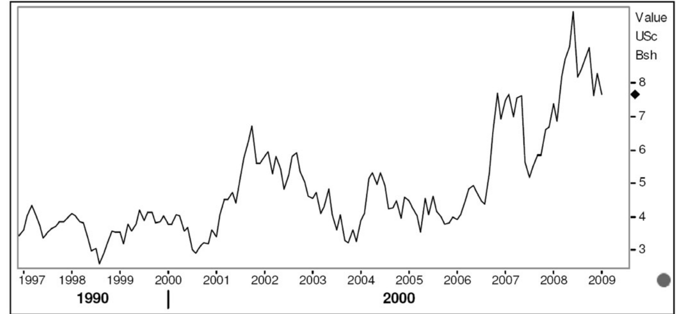
Chart 11 – Corn/cotton ratio



Courtesy Reuters

Chart 12 – March cotton (bar), Total open interest (line)

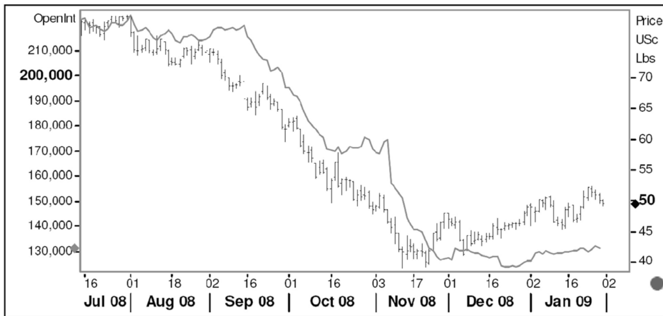


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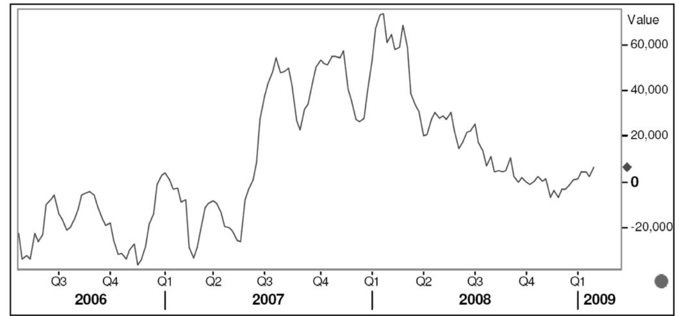
Chart 13 – Commodity fund net-long position



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