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Global sugar deficit: how did that happen?

After trading up to fresh multi-decade highs of over 33¢ per pound in mid-November, sugar prices took a steep 8¢-per-pound – or 25%! – two-day dive. The possibility of a top loomed large – at least in chart land.

Although 2010-11 global output is forecast to grow by 7% because of strong crops in Brazil and India, supply/demand developments remain bullish and have powered prices back to and beyond the November highs (Chart 1).

Some dry weather in Brazil towards the end of the primary crushing season had a limited impact on yields. Output should still come in at a record. Despite growing demand for both domestic usage and exports, ethanol output is lower than last year owing to the price advantage of crushing cane for sugar.

With the return of healthy monsoon rains, India will harvest its first normal-size crop in three years. Estimates have not varied much from early-season forecasts of 24.5 million tonnes. That will be up from drought-afflicted 2009-10 output of 18.8 million tonnes. A production/consumption surplus of 2 million tonnes is anticipated – the first in three years – but not all of it will be added to 2010-11 ending stocks, because the government has liberalized export rules. So far, export licenses have been granted for 500,000 tonnes, but that figure is expected to rise. Estimates for exports run as high 2.5 million tonnes.

Large Indian exports may quell some spot shortages but are probably a bad idea for India. Coming into 2007-08 with ending stocks of 10 million tonnes, government planners were complacent with bulging inventories and allowed exports of 5 million tonnes. Then came two consecutive years of drought, and India turned from comfortable net-exporter to desperate net-importer. Domestic demand has grown 3% to 4% per year. The 5 million tonnes of ending stocks that would remain at the end of 2010-11 if all surpluses were sold abroad would be about 20% of usage, compared with 40% of usage in the pre-drought years. We have absolutely no evidence to propose the following, but we'll bet that the Indians can figure this out as well, and export licenses will be on the lower side of estimates.

Australia's rainy season arrived early and has wreaked havoc with crops – mostly for wheat and sugar. In 2009-10, sugar production was 4.5 million tonnes, but the excessive rains have slashed output forecasts down to 3.6 million tonnes. Exports are expected to fall to 2.4 million tonnes from 3.2 million tonnes in 2009-10. Australia is not a huge producer, but it has regular Asian customers for its sugar crop and is now scrambling to meet export commitments by buying from Brazil and Thailand.

We discussed the crop losses in Russia and Pakistan in the October 27 issue of *Focus on Futures*. More recent data indicate the Russian crop will be about 15% below a year earlier, but prospects for Pakistani output have improved.

China has reportedly sold 1.7 million tonnes of sugar from reserves to the domestic market. A production/consumption deficit of 2 million tonnes is expected for 2010-11. Exports of 1.5 million tonnes are factored into the balance sheet.

Sugar analysts have been slashing their surplus forecasts for the global balance sheet. What was first seen as a return to surplus, and then a balanced market, has now turned into a deficit. Czarnikow estimates that the 2010-11 marketing year will show a 2.8-million-tonne deficit, which is amazing if you consider the recovery in output.

Without any doubt, speculation has played a role in some of the wild rides that some commodities have taken. For those who believe that 33¢ sugar has become the exclusive domain of speculative activity, the facts prove otherwise. Open inter-

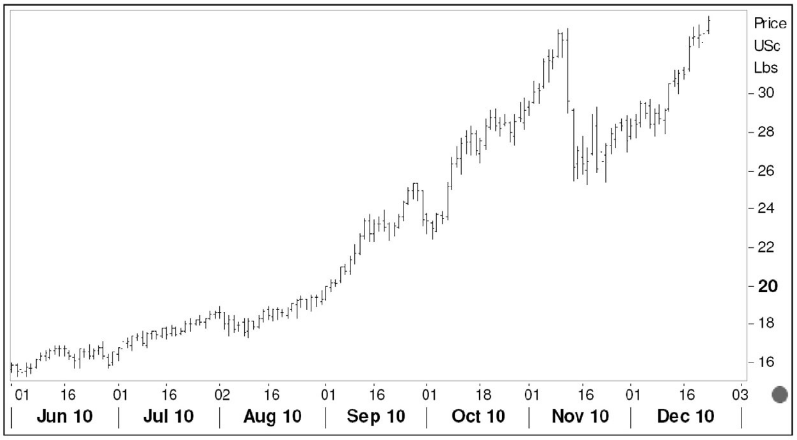
Inside

Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: *ssanik@friedberg.ca*).

est has been in decline since January 2008 (Chart 2), and this latest series of stabs at the 33¢ level has barely attracted a glance, at least in so far as the open interest indicates. Funds hold a large net-long position, but as Chart 3 shows, that position has been stuck in a range for the past two years.

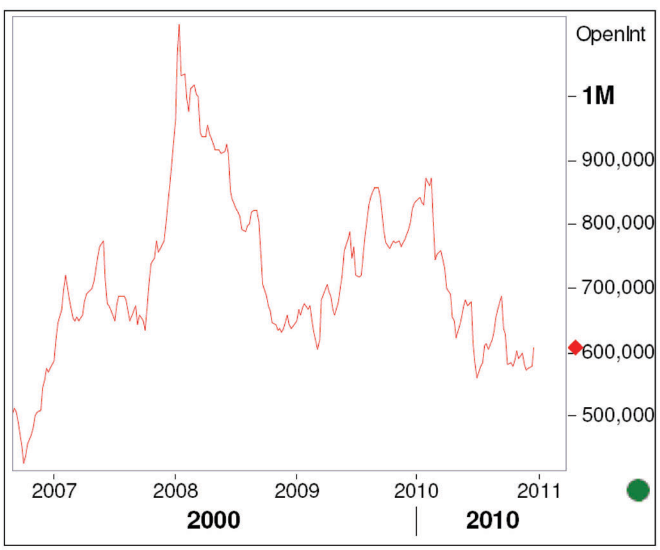
Our most recent recommendation was issued on October 27 when the market was rising. The placing of a 26.5¢ sell stop seemed awfully liberal at the time. The two-day mid-November massacre, however, took us out. The market is very volatile and should provide opportunities to re-establish long positions. Specifically, buy March sugar on any 150 basis point dip. *[December 24, 2010]*

Chart 1 – March sugar



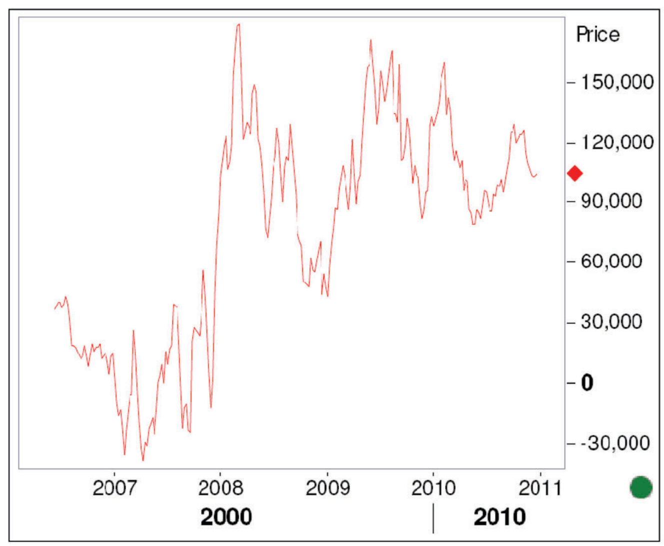
Courtesy Reuters

Chart 2 – ICE sugar open interest



Courtesy Reuters

Chart 3 – Funds net-long position



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COTTON

Have we run out?

Limit-up cotton days became a way of life as March cotton moved from $1.08 per pound in late November until the market peaked at $1.59 in mid-December. A classic reversal then ensued. On December 21 unsuspecting bulls left for home with a settlement at session highs, but were greeted in the morning with a gap down below the previous session's low. Over the next week the market shed 20¢ per pound. Prices have since consolidated, but the island left behind certainly makes it look like cotton may have put in a top.

The US is by far the world's largest exporter of cotton, and in historical terms, it's all but sold out. Ending stocks are projected at 1.9 million bales, or 9.8% of usage.

Inventories have been slipping each year since mid-decade, when carryover stocks peaked at 55.1% of usage in 2007-08. There is virtually no precedent with which to compare US stocks below 10% of usage. The closest was in the mid 1990s, when ending stocks fell to 12.9% of usage, which saw cotton prices spike to $1.15 per pound.

For the bull market to continue, however, a number of hurdles must be overcome.

Agricultural bull markets should not last longer than one growing season. The rationing process should push prices high enough to provide incentive for farmers to overplant the following season and create enough supply to meet demand. The market is anticipating that this will occur. New-crop December 2011 is trading at a 45¢ per pound discount to old-crop March. Farmers depress new-crop prices by selling forward, locking in what by historical standards are still fantastic profits.

There is no question that acreage will expand, but there are two significant variables that will determine how much more cotton the US actually grows. First, West Texas, the principal US cotton growing region is extremely dry. If these conditions do not improve in time for spring planting, yields will be poor. Second, although these prices should be a powerful incentive for farmers to plant a lot of cotton, corn and soybeans will be competing with cotton for acreage.

According to an associate of ours, John Bondurant, a Southern farmer and sophisticated agriculture analyst, at current levels of new-crop prices, assuming average costs and optimum yields, soybeans would net a profit of $424 per acre, cotton would earn $400 per acre, and corn would fetch only $377 per acre. So while cotton would win out over corn where substitution is possible, soybean planting would be far more attractive.

Brazil is set to become a bigger player in the cotton export market. By some accounts, acreage has been expanded by 65% in the key growing region. Last year Brazilian production was 5.45 million bales. The USDA has been raising the estimate for Brazilian output, with the most recent figure at 8.1 million bales.

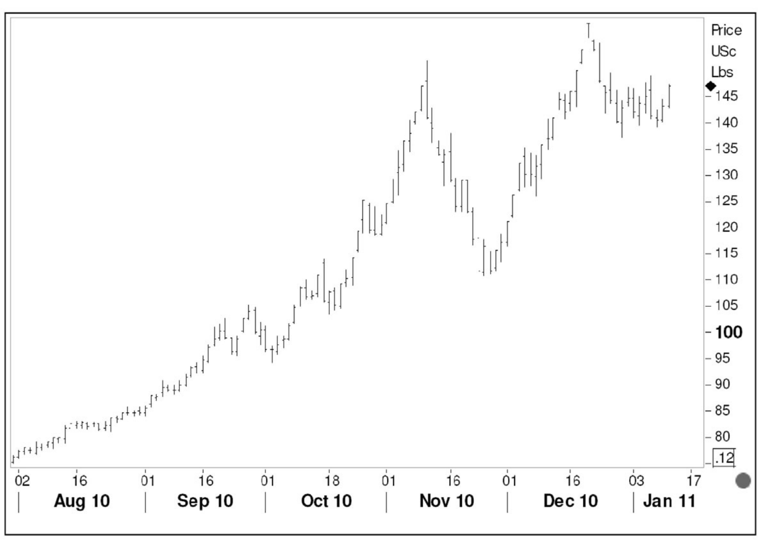
US exports can only be described as awesome. Thus far, US exporters have contracted to sell just under 14 million bales since the marketing year began on August 1, more than double sales of 6.3 million bales at this point of the 2009-10 season.

Here's the potential catch, though. Shipments for 2010-11 stand at 4.2 million bales, compared with 3.1 million bales at same time in 2009-10. That's nowhere near the ratio of export commitments in 2010-11 over 2009-10. There is no evidence to suggest that shipments will not catch up, but if prices start to come off and importers can re-book purchases at lower prices, you can bet there will be cancellations. The record shipment target of 15.75 million bales will start fading. In fact, this week's commitment report showed net old-crop cancellations of 40,000 bales, the first such occurrence this season. The impact of the cancellations was mitigated by new-crop 2011-12 sales of just under 200,000 bales.

Chinese mill consumption has been rising while crops have been falling, which is the biggest dynamic in this bull market. Output has dropped from 36.7 million bales in 2008-09 to 30 million bales for the current crop. Usage has increased from 44 million bales to 47 million bales in the same period. Obviously, China will ramp up acreage this spring as well. Official statistics notwithstanding, Chinese imports indicate that it has bled its inventories dry.

We've played devil's advocate and presented the potential bearish case. In the meantime, we continue to draw down global inventories, and until next fall's harvest, the pool of cotton available for world trade is as small as it's been in modern history. We continue to recommend maintaining long positions, but advise moving up sell stops to 129, basis May, close only. *[January 6, 2011]*

Chart 4 – March cotton



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COPPER

The bull clings to Chinese imports

In mid-December copper prices cruised through the previous record high of $4.27 per pound, set in May 2008 (Chart 5). The market added 22¢ per pound and subsequently pulled back to the breakout. Was the market merely taking out the last batch of shorts that hung on with stops at the 2008 highs? Or have we still not reached a price level that will bring production growth in line with growing demand?

According to The International Copper Study Group's (ICSG) most recent report, the global production/consumption deficit widened to 436,000 tonnes in its January-through-September study period. That's up from a 363,000-tonne deficit at the end of August. Global demand continued to grow, by 8% over the comparable period in 2009, a somewhat slower pace than the 8.3% in the previous month's report. Refined output, however, grew at an even slower pace of 5.2%, compared with the previous month's 5.8%, which accounts for the larger deficit.

Economies around the globe are ticking up, albeit slowly. Copper demand is growing – slowly as well – but growing nonetheless. Consider that in the ICSG study period for the first three quarters of 2010, Japanese, EU, and US usage grew by 27%, 11%, and 7%, respectively, over the same period in 2009. In the first three quarters of 2009, consumption in these regions had fallen by 32%, 22%, and 32%, respectively, over the comparable period in 2008. Which means, of course, that the current growth rates are just clawing their way back to usage levels of 2008.

Prices began their ascent at the beginning of 2009, despite the worldwide recession that saw demand plummet in most consuming countries. Chinese imports skyrocketed in the first half of both 2009 and 2010 and singlehandedly compensated for falling consumption in all industrialized regions (Chart 6).

And China remains the big variable. While it's comforting to see consumption rising in the other regions, it is near impossible to expect prices to hold up at current levels without substantial Chinese imports.

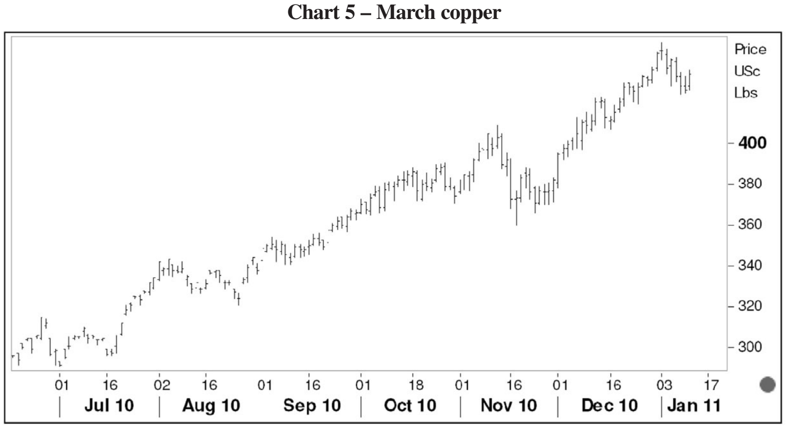
Market participants have been concerned about the longevity of the massive Chinese imports we've become accustomed to. Newswire stories have attributed the 25¢ sell-off from the fresh record high of $4.49 per pound to fears that Chinese imports for December would be weak. On January 9 the data were released and showed that imports had fallen by 2% from November, to 344,000 tonnes. For the year, China imported 4.29 million tonnes, which was slightly above 2009 imports.

There is evidence to suggest that these import levels are, indeed, unsustainable. First, warehouse stocks have stopped falling and have begun to creep up. Chart 7 shows combined LME, COMEX, and Shanghai warehouse stock movements. It does not seem like much from looking at this chart, and indeed it is not much. More significantly, though, there is strong anecdotal evidence of a growing stockpile of copper building up in China, estimated at 400,000 tonnes and not included in the 132,166 tonnes found in the Shanghai Exchange warehouse system. The copper, held in bonded warehouses, has been imported and is available for sale to end users. If domestic demand slackens, this stockpile will grow and immediately affect the volume of imports.

The supply side is clearly bullish. Production remains sluggish. Average output from Chile over the past three months has been down 3.8%. Production costs among the major producers have increased and are expected to continue to rise. However, even with costs rising to an average of $1 per pound, net of gold or silver credits, the distance between prices and costs is so gapingly wide, that there is nothing to deter overproduction.

The performance of Chinese imports will tell us everything. Remain long, but raise protective sell stops to $4.25 per pound, basis May. *[January 11, 2011]*

Chart 5 – March copper



Courtesy Reuters

Chart 6 – China copper imports

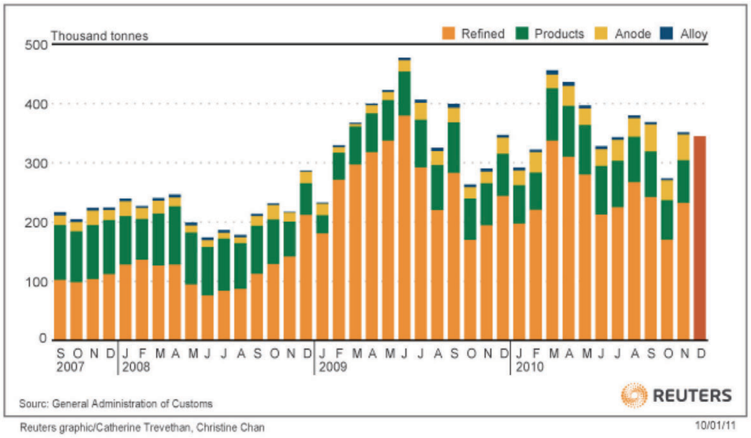


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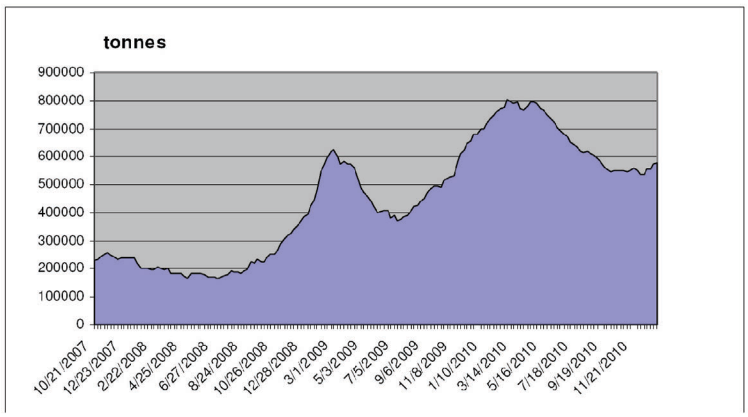
Chart 7 – LME, Comex, and Shanghai copper warehouse stocks



COCOA

Civil war or social harmony, cocoa grinds higher

The Ivory Coast is in turmoil. After a disputed presidential election, the United Nations has declared its choice for president. The disputant is not ready to throw in the towel, though. There's talk of a military coup. Ethnic violence has led to civilian deaths. Since civil unrest first surfaced in the early 2000s, we have maintained that the bulk of the cocoa crop will make it from the bush to ports, and it always has. Ivorian agriculture comprises 28% of the economy, with cocoa being the single largest crop. It seems that whoever is in power makes sure that the jewel of the economy is not compromised.

That's not to say that this fragile assumption will not be compromised some day. Indeed, global cocoa prices have a fear premium attached that will exist for the foreseeable future. After all, the country grows a little over a third of the world's cocoa beans. But the beans are making it to port and arriving in Europe and other destinations. We believe that if there is a problem associated with the country's seemingly perpetual political uncertainty, it is the neglect of investment in pesticides and other crop enhancement tools.

As we have discussed many times, Ivorian cocoa crops have stagnated. Crop size has floated between 1.2 and 1.4 million tonnes for years. Beans grown in neighboring Ghana routinely command higher prices than Ivorian beans. Fighting Black Pod disease requires a concerted effort. True, the ruling parties over the years have ensured safe movement of beans from plantations to the ports, but it also seems that more energy is required to solidify the future of this vital industry.

This marketing year is progressing no better or worse than previous ones. Up until a few weeks ago port arrivals were running ahead of last year. According to the most recent data, however, we've slipped behind last year's pace. As of January 9, arrivals reached 684,765 tonnes, down from 702,061 tonnes at this time last year.

For the first time since Ghana began trumpeting its plans to produce 1 million tonnes annually a few years ago, the arrival data are actually indicating a strong jump in output. After several 700,000-tonne crops, last year's crop slumped to 650,000 tonnes. This year, however, arrivals are way out in front of last year's. As of December 30, arrivals sprung up to 600,000 tonnes, compared to only 393,483 tonnes at this time last year. This torrid pace cannot continue, especially with the dry Saharan Harmattan wind season in full force. Analysts estimate that Ghana is on track for a record 800,000-tonne crop.

The overall supply picture will not get much of a boost from Ghana, though, because Indonesian output is expected to fall. The Indonesian harvest normally begins in April, but heavy rains will delay the harvest to July. Analysts say that the crop will be about 5%, or about 50,000 tonnes, below 2009-10 output.

Fourth quarter Western European and North American cocoa grinds will be released in the coming days. After a dismal third quarter, bulls are hoping for better news.

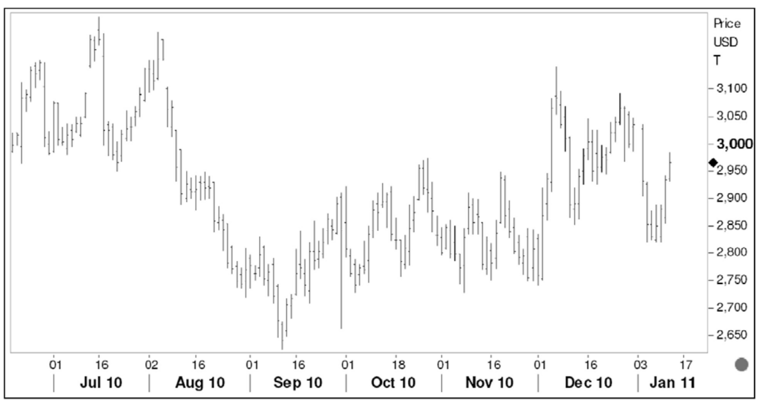
High cocoa prices have inspired something of a push towards alternate vegetable fat substitution, which explains why butter prices have been sluggish for so long. More significantly, usage of less-expensive cocoa powder has been on the upswing and has been reflected in a sharp upswing in prices (Chart 9). Butter stocks are ample, but then ultimately, grinders will be forced to focus bean-purchase decisions on falling powder inventories and improved margins.

The ICCO forecasts that the 2010-11 global balance sheet will move into surplus, with production exceeding consumption by 70,000 tonnes. The estimate is based on a 6% to 8% jump in output, but a mere 2.9% increase in consumption. We expect to see grinding activity improve at a considerably higher rate, and as a result, we believe that the market will be balanced at best.

Cocoa is an undervalued commodity, both in relation to other commodity markets and in relation to its supply/demand fundamentals. Production growth is stagnant with little prospect for any major improvement. Consumption growth has been stagnant but will not remain that way forever.

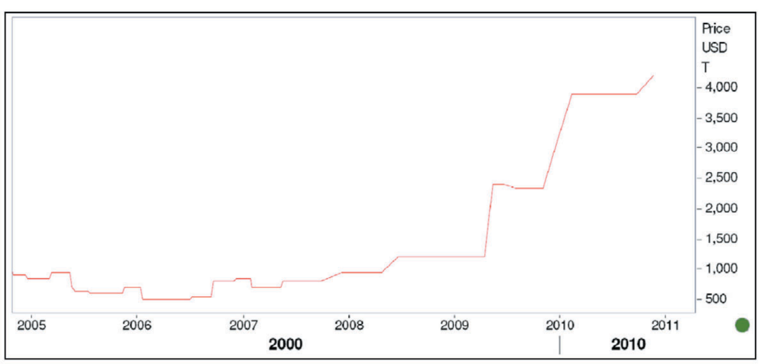
Maintain long positions. *[January 12, 2011]*

Chart 8 – March cocoa



Courtesy Reuters

Chart 9 – Spot cocoa powder



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