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Cotton: a raging bull

Cotton prices have sprinted to near-four-year highs.

The May 11 USDA crop report presented the first comprehensive estimates for the 2018-19 marketing year, which begins on August 1. Global production is expected to fall by 1%, to 121.19 million bales, while consumption is set to grow by close to 4%, to 125.44 million bales. Ending stocks will fall to a post-bubble low of 83.75 million bales, or 66% of consumption. If that still sounds kind of high, recall that at the end of the 2014-15 season, that figure was 100%.

The Chinese government's program of feeding domestic demand by destocking and cutting imports has been effective. Chinese inventories peaked in 2014-15 as well, at 67 million bales, with this year's carryover estimated at only 33 million bales. Imports are slated for their first meaningful increase since they peaked in 2011-12 at 24 million bales, climbing to 7 million bales, up 2 million bales from 2017-18.

The USDA report does not tell the entire story, though. Some output estimates may be too high.

US

The USDA has made adjustments for only one of the three large cotton-producing nations. US cotton area is expected to expand by 6.8% from 2017-18, to 13.47 million acres. However, the weather in Texas, where more than 40% of the nation's cotton is grown, has had very dry weather. The most recent weekly crop progress report shows that only 42% of the crop is in good-to-excellent condition. That compares with 61% last year at this time. The early yield estimate is 841 pounds per acre, down from 905 pounds last year. As a result, despite the higher acreage, the forecast for US output is 19.5 million bales, down from 20.9 million bales last year.

If rain does not arrive in a timely fashion, that estimate may have to be lowered, but at least the USDA has taken a conservative approach in respect of the poor weather.

China

Curiously, the USDA forecasts Chinese output at 27 million bales, just below last year's production of 27.5 million bales. The Xinjiang region, where 60% of China's cotton is grown, is expected to reduce planted area by about 7%. In addition, weather has not been favorable. There is high probability that the June 12 USDA crop report will show a downward revision for Chinese output. This would be particularly bullish in light of the fact that domestic demand is expected to grow by close to 4%.

India

Similar to China, the USDA Indian estimate – at 28.5 million bales, same as last season – seems to be on the high side. There was a serious problem with pink boll worm in some regions, which rendered some cotton unexportable. Over the past few months there has been talk that planted area would be reduced because the worm has developed a resistance even to genetically modified seeds. So here too, we look for the USDA to adjust the crop estimate downwards.

Demand has been strong. The US accounts for about one third of world trade. Export commitments stand at 16.2 million bales, above the USDA target of 15.5 million bales.

The question remains whether it can all be shipped by the end of the marketing year, as there are still roughly 3.5 million bales to be shipped. Shipments have averaged 443,000 bales over the past four weeks, with a particularly strong 576,000 bales in the most recent reporting period. The pace is much stronger for this time of year than is typical. If the momentum can be sustained, we should handily meet the USDA target.

In conclusion, we look for the estimate for global ending stocks to be reduced further. Production estimates should be

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adjusted to reflect lower planted area in China and India and unfriendly weather conditions in China and the US. And with cooperative demand, we look for higher prices.

Remain long December cotton. Raise stops from 73¢ per pound as recommended on April 4, to 87¢, close only.

[By Sholom Sanik, June 10, 2018]

Chart 1 – Weekly nearest contract ICE cotton

Chart courtesy Reuters

SUGAR

Just how bearish is explosive Asian output?

The predominant development for the global sugar market over the past few months has been the unexpected upward revisions to Indian sugar output for the 2017-18 marketing year (October-September). In the early going, estimates called for about 26 million tonnes. As the crush progressed, those estimates moved to 29 million tonnes, then to over 30 million tonnes. Some estimates now put production as high as 34 million tonnes.

To complicate matters for bulls, Thai output will jump by roughly 3 million tonnes, to a record of about 14 million tonnes. The Thai surplus will certainly be targeted for exports.

Indian ending stocks will jump to 10 million tonnes from below 5 million tonnes at the end of the 2016-17 season. The obvious conclusion should be that the large surplus will be exported. Earlier this season the government encouraged mills to export 2 million tonnes. Thus far, only 500,000 tonnes have been sold.

The government also announced that it would force the creation of a 3-million-tonne buffer stock, which would for all practical purposes be untouchable. As a result, when analysts toss around ever-growing estimates for a 2017-18 global surplus, it's a bit misleading because about half of that surplus will head into non-mobile Indian ending stocks. And the government policy to stimulate exports with what is available has not been very effective, as illustrated.

By the same token, explosive Asian output cannot be ignored. It is just that when taken in perspective, the bearish sentiment generated by reports of fantastic surpluses is not necessarily indicative of a period of unmitigated abundance. This is particularly true when we consider what is happening in Brazil.

For starters, forecasts for the size of the 2018-19 cane crop vary widely, but all agree that dry weather will limit the size of the crop. One grim estimate puts the crop at 555 million tonnes, down 7% from the previous season.

Then there is the matter of the ethanol/sugar allocation. At current prices, ethanol is as profitable to produce as sugar would be at 16¢ per pound. Consequently, the ethanol/sugar processing ratio for the marketing year to date stands at 64.98/35.02 compared with 53.67/46.33 last year at this time. Estimates for Centre-South output also have a broad range, but we are definitely looking at a drop of at least 3 to 4 million tonnes from 2017-18.

Arguably, despite the overwhelming output gains in India, the Brazilian situation is far more significant. With both domestic demand and exports of sugar and ethanol, Brazil consumes just about everything it produces. Typically, ending stocks are equal to a scant 3% of usage.

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As illustrated, it is questionable whether India will become an exporter of any meaningful volume. There are no serious suppliers of last resort if tightness emerges in the world sugar market. Were there to be any glitches in world supplies, the estimates for 2018-19 surpluses would contract rapidly.

For example, the monsoon rains in India are critical for sugar production. There was an 11-day stretch this past month that saw no rain in key regions. Forecasts call for the rains to return, but it underscores the reality that vulnerabilities exist.

We cannot say that we are screamingly bullish. However, we do believe that the market is trying to bottom. Prices put in a low in April and have been grinding higher since.

Maintain long positions in March 17¢ calls, first recommended on January 19. March 14 calls are trading at about 60 ticks and represent a low-risk opportunity to participate on the long side.

[By Sholom Sanik, June 27, 2018]

Chart 2 – March ICE sugar

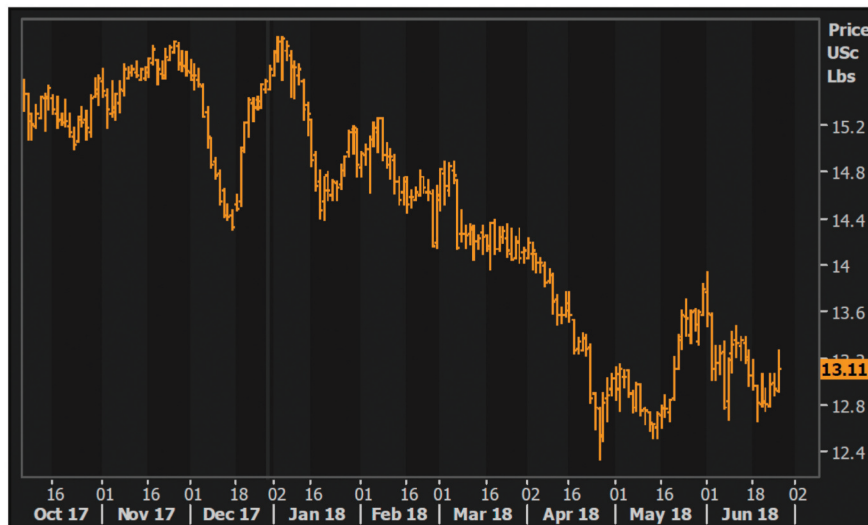

Chart courtesy Reuters

COPPER

Strike fears are fading, and so are prices

In early June, traders turned their attention to labor strife at Escondida, the world's largest copper mine. In the space of just five days, prices rallied by 25¢ per pound. The spike took out the spot high set in late December. The subsequent retreat back to the very bottom of a nine-month range was almost as quick (Chart 3).

Fears of supply disruption caused by work stoppages in Chile are not unfounded. In early 2017 a 44-day strike at Escondida saw total Chilean production fall dramatically. Average output for February and March – the months in which the strike took place – declined by 20%, year-over-year. Output was down 6.75% for the first half of 2017, sparking a 65¢-per-pound rally that lasted through the summer.

The removal of that much copper from the market certainly put pressure on mines to compensate. It took a while for production to resume to normal levels once the strike was settled. Output was up 18.9% for the first quarter of 2018, year-over-year. Obviously, that is not as exciting as it first sounds because it is in comparison with strike-truncated production. Output for April, the most recent month for which statistics are available, was up 6.4% compared with a post-strike April 2017. First-quarter global output was 7% higher, but again, after last year's sharp drawndown in Chile, it just means that the market has returned to trendline growth rates for production.

On the demand side, the Chinese government's ban on scrap imports has resulted in strong imports of other categories. Although the ban does not kick in until next year, there already has been a noticeable shift in the type of imports coming into the country. Overall, Chinese imports of all categories have been climbing steadily (Chart 4).

The only two supply/demand fundamentals that matter for this market are in the bullish camp: the recovery period for Chilean mining from last year's strike and the maintenance of Chinese imports. However, neither factor has been

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extraordinary. In fact, according to the International Copper Study's most recent report that covers the first quarter of 2018, total refined production grew by 2.9%, while demand grew by only 1.7%. The market was in a 150,000-tonne production/consumption surplus, compared with an 85,000-tonne surplus for the first quarter of 2017.

Last year's standoff in Chile ended with a one-year extension of the existing arrangement, but the July 24 deadline is nearing. There have not been too many press reports regarding the progress of the talks, but judging by market action, traders are assuming that a resolution is near.

The loss of output caused by the 2017 strike debacle inspired commodity funds to build their largest net-long position since the CFTC has been collecting the data. That position was unwound earlier this year, but then, with fears of a *déja vu* performance, they piled back onto the long side (Chart 5).

The recent pullback to the low of the range has sparked a liquidation of the new long position. We believe that we are in the throes of a much larger liquidation, particularly if news emerges that there will be no strike.

Our generous protective buy stop at $3.35 per pound, basis July, suggested on March 6, kept us alive on the short side. At this point, roll July shorts to September, but lower buy stops to $3.20, close only.

[By Sholom Sanik, June 29, 2018]

Chart 3 – March COMEX copper

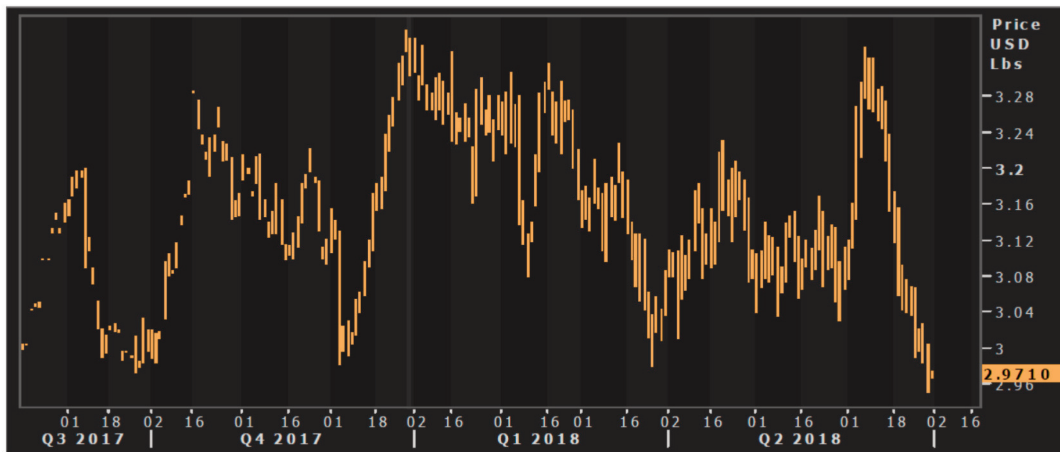

Chart courtesy Reuters

Chart 4 – Chinese copper imports

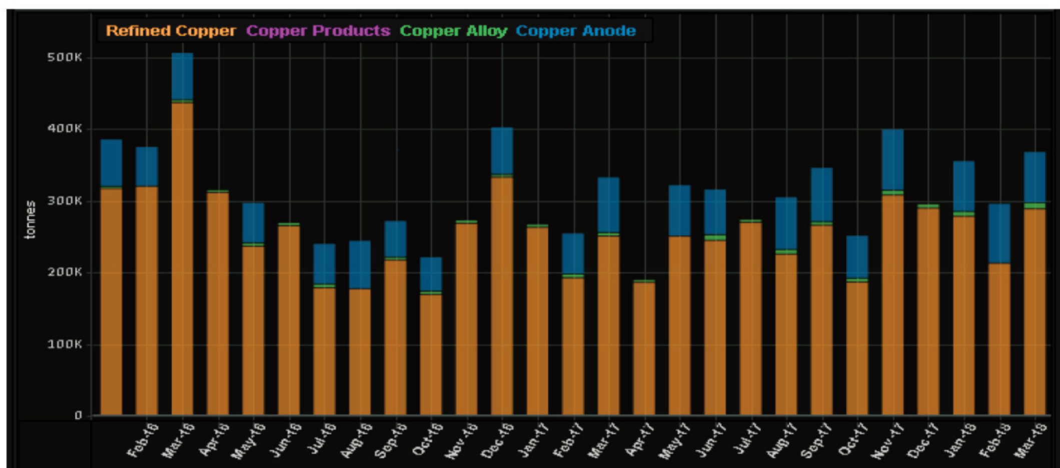

Chart courtesy Reuters

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Chart 5 – Copper: CFTC net-long commodity fund position

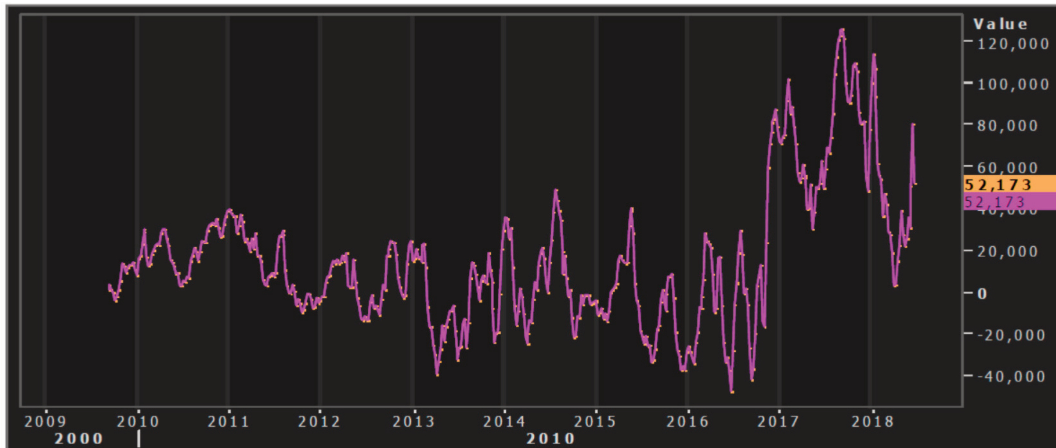

Chart courtesy Reuters

CORN

Are collapsing prices warranted?

The trigger for the spike in 2018-19 new-crop corn prices we saw this spring can be traced to US acreage estimates. The March 29 USDA planting intentions report set the market on a bullish course with a forecast for a 2.14-million-acre, or 2.4%, reduction in corn area, to 88.026 million acres. While the street expected a smaller number than in 2017-18, the actual figure was 1.4 million acres below the average of traders' guesstimates. Quite a miss.

Swift planting progress and excellent early season weather then quashed the rally, with December corn setting fresh contract lows (Chart 6).

Then came the June 29 acreage update. Again, analysts correctly anticipated the direction of the move – an increase in area – but were off the mark. The USDA estimate jumped to 89.13 million acres, higher than the average guestimate of 88.56 million acres. More selling followed.

Thus far, crops in most US growing regions have fared well despite the hot summer we're experiencing. As of the most recent weekly crop progress report, 75% of the crop is in good-to-excellent condition, compared with 65% at this time last year. But there's a long summer ahead, and as we head into the key pollination period, the crops remain vulnerable.

At the moment, actual output is still forecast to be below the previous two seasons because the USDA has still been running with a 174 bushel-per-acre (bpa) yield, below last year's 176.6 bpa. Unless the weather acts up, that estimate is likely to be raised, if not in the July crop report, then in the August report.

The supply side took a hit from South America. Brazilian and Argentinean crops harvested this spring and summer were plagued by drought, resulting in lower output. Both countries were coming off record output in the 2016-17 season. Production dropped from 98.5 million tonnes and 41 million tonnes, to 85 million tonnes and 33 million tonnes, for Brazil and Argentina, respectively. Estimates that are more current than that contained in the USDA July crop report suggest that Brazilian output is closer to 82 million tonnes.

It has been dry in European corn regions, which could translate into lower export availability in the Ukraine, an important exporter, and higher imports for the EU.

China is hardly a factor in the global corn market. Although imports have inched up over the past two years, the USDA forecast of 5 million tonnes represents only 2% of total Chinese consumption. In any case, unlike soybeans, the ongoing trade war has absolutely no bearing on the corn market. Year to date, China has purchased only 515,000 tonnes (shipped and unshipped) from the US. That's less than 1% of total US sales.

Global demand continues to rise faster than output. The USDA estimates that consumption rose by just less than 1% in 2017-18, but output fell by 4%. That production/consumption gap drew ending stocks down from 21.48% of usage in 2016-17, to 18% at the end of the current marketing year. With a further drawdown expected in 2018-19, inventories are expected to dive to 14.15% of consumption.

Although we expect to see upward revisions to the US

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2018-19 yields, as noted above, the reality is that in an age in which global wheat and soybean ending stocks are serving to buffer short-term supply shocks, corn demand is growing at a pace for which there is little insulation – if any – against surprise supply problems.

The US, still the supplier of last resort in the corn market, will see a second consecutive year of stock drawdowns. With the July USDA estimate, ending stocks will fall to 10.8% of consumption in 2018-19, compared with 15.6% in 2016-17. South America, which has made some inroads in competing with the US, suffered its setback, as illustrated above, so any reliance on Brazil and Argentina has been delayed until mid-2019.

We were stopped out of our long position in July corn at $3.85 per bushel, as per our May 25 recommendation. We believe that ultimately corn prices will stabilize and recover. However, we're not about to expose ourselves to the hazards of "catching a falling knife." So we remain sidelined for the moment. Stay tuned.

[By Sholom Sanik, July 11, 2018]

Chart 6 – December corn

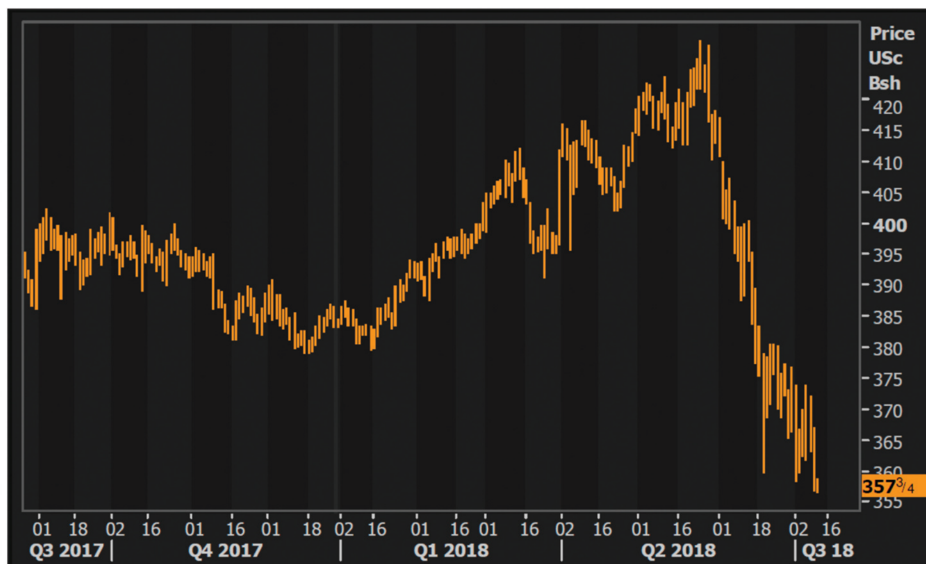

Chart courtesy Reuters

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