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Cocoa: the deficit grows

Spot cocoa prices sprinted to four-year highs this week. The key supply/demand fundamental issue driving the market is the disappointing performance of West African crops.

As of the March 31 official close of the Ivorian main crop, arrivals totaled 905,000 tonnes, about 10,000 tonnes below arrivals at the same time last year. Mid-crop arrivals as of June 25 stand at 224,000 tonnes, for a total of 1.129 million tonnes, 106,000 tonnes below last year's arrivals. We've known for some time that this year's mid-crop had absolutely no chance of reaching last year's record levels. Still, arrival rates have nosedived, and we expect the gap between this season and last to continue to widen. In the most recent reporting period, only 13,000 tonnes arrived at port, compared with just less than 20,000 tonnes in the comparable period one year ago.

Not surprisingly, the situation is similar in the other major West African producing countries. Nigerian production was originally expected at about 200,000 tonnes. Arrivals to date total just over 100,000 tonnes. The mid-crop is usually about 60,000 tonnes, but the recent arrival pace is about half of last year's. So even if the situation improves with the recent rains, it will be near impossible for the crop to exceed 140,000 tonnes.

Ghanian output in 2006-07 was forecast at 700,000, down from 740,000 tonnes the previous season. Analysts' estimates for the main crop – which ended on May 31 – stand at 570,000 tonnes. Here too, it is anticipated that the optimum mid-crop size of 90,000 tonnes cannot be achieved. Current forecasts are for a mid-crop of no larger than 60,000 tonnes.

The supply problems are not limited to West Africa. Indonesia, the world's third largest producer, experienced heavy flooding. This delayed the start of the main crop by one month, to May. Bean size has been below average. The most recent estimate puts the total crop – which will not be fully harvested until February – at 540,000 tonnes, down from 580,000 in 2005-06.

It has therefore been somewhat puzzling to us that the International Cocoa Organization (ICCO) has been narrowing its deficit forecast over the past few weeks, but comforting that the most recent update from a private forecaster swung the other way.

As recently as June 27, the ICCO revised its forecast for the 2006-07 global balance to a smaller deficit, moving to a range of between 100,000 and 125,000 tonnes, from its previous estimate, for a shortfall of between 125,000 and 150,000 tonnes.

On June 28, however, Fortis Investment Bank increased its estimate for the 2006-07 deficit to 236,000 tonnes from its May estimate of 202,000 tonnes, probably to reflect the deteriorating state of the West African mid crops.

The demand side is not clear. Grind results for the first quarter were disappointing. The EU grind was up 4.4% over first quarter 2005-06, but the US grind was 6.8% lower. On the other hand, butter ratios in Europe remain very strong at 2.89 times the London spot price for beans.

As has increasingly been the case in recent years, it is difficult to know if a quarter with poor grinding results in Western countries is the result of slack end-user demand or the gradual shift to origin-country grindings. Indonesia and Malaysia, for example, each have grinding capacity of close to 300,000 tonnes. The fact that butter demand is strong – a statistic that is based on actual market data – leads us to believe that we don't have an accurate picture of grinding statistics, and that ultimately we will discover that they are better than indicated by the US and European figures.

While the global cocoa market still carries inventories that would be considered burdensome for most other

Inside

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commodities when measured as a percentage of usage, we are headed towards a stock level that has been bullish for the cocoa market in the past. With the mid crops in West Africa likely to be very small, we believe that we will find the stocks-to-consumption ratio below 40%, compared to over 50% at the end of 2005-06.

Commitment of Traders data show very clearly that the bull run is being driven – almost exclusively – by speculative interests, while commercials are taking the short side. Both commodity funds and small-speculators have lopsided net-long positions. Typically, bulls should be quite worried about such a composition in the open interest. We are confident of our understanding of the fundamentals, however, and we believe that a faulty signal from the usually reliable indicator of commercial activity is a distinct possibility.

Remain long. *[June 29, 2007]*

Chart 1 – Weekly nearest contract cocoa

Courtesy Reuters

WHEAT

Global output disappoints

"With very small potential for a supply-side surprise at this point, we would need a demand surprise, which, as illustrated, is possible. We find the balance of evidence to be inconclusive, with somewhat of a bearish bias. Remain sidelined, but stay tuned."

That was the summary of our May 29 issue of *Focus on Futures* regarding wheat. Boy, were we ever wrong! Starting with the US, with about one third of the crop harvested, the condition of the winter wheat crop has deteriorated steadily since the end of May. The good-to-excellent portion of the crop has fallen from a peak of 59% on May 28 to the most recent reading of 48%.

The monthly USDA supply/demand situation report released on June 11 revised its estimate for the total US crop to 59 million tonnes, down just a smidgeon from its May estimate of 59.16 million tonnes, which certainly does not yet reflect the poor conditions experienced as the crop matured.

Estimates for crop performance in the other significant exporting regions are available, however, and any notion of a recovery in the global wheat market's inventory situation has been quashed.

The USDA's estimate for FSU output was slashed from the May report by 7.3 million tonnes, to 64.59 million tonnes. The two largest producers, Russia and the Ukraine, are still suffering from drought in key areas.

On June 26 the supply side was dealt a further blow when Statistics Canada released its acreage report. Canadian farmers planted only 21.7 million acres of wheat, 11% less than the 24.25 million acres planted for the 2006-07 crop year. This was down from 23.8 million acres forecast in the March intentions report, and more significantly, well below the average of analysts' estimates of 23.4 million acres. This alone would reduce the Canadian crop by at least 2.5 million tonnes from the June estimate of 24.5 million tonnes.

On July 2, The Canadian Wheat Board released an estimate for the 2007-08 crop of 20 million tonnes that obviously accounts not only for reduced acreage, but for poor weather as well.

The estimate for the Chinese crop was actually upgraded by 2 million tonnes by the China National Grain and Oils Information Centre, offsetting some of the losses in other areas. Chinese imports have been negligible in recent years, but it could beef up its exports, which have been climbing.

Hanging in the balance is the Australian crop, which is not harvested until late in the year. After this past season's disastrous crop of 10.5 million tonnes, expectations are for a return to a normal crop size – an average of 24 million tonnes over the past several years. The USDA is currently using an estimate of 22 million tonnes.

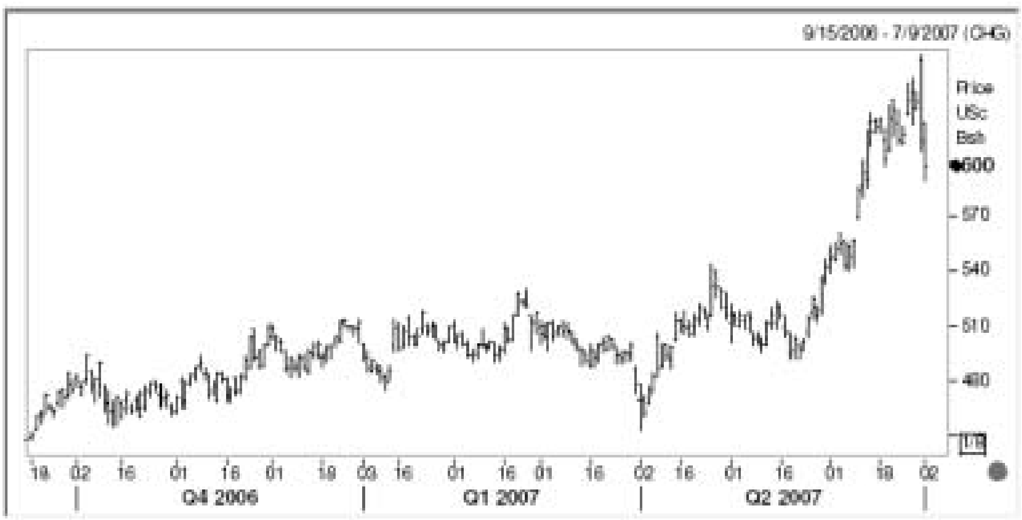
Putting it all together, the estimate for global ending stocks, already at record lows, should be revised down even further in the July 12 supply/demand situation report. A rough calculation that incorporates the above developments would put ending stocks at about 109.5 million tonnes, or 18% of consumption, down from 20% of consumption at the end of 2006-07.

Global inventories peaked in 2000-01 at 35% of consumption. Despite the best efforts of farmers in producing nations, output seems to be in a perpetual decline, and stocks are reaching dangerously low levels. Consumption is growing along with the growth in world population. Even after including the 2004-05 season, when production jumped 15% to 555 million tonnes over the previous year, world inventories have been drawn down by an average of 15 million tonnes over the past five years. With current estimates, we're going to lop off yet another 10 million tonnes.

Having missed the boat, we're not going to make any specific recommendation at this time. Large setbacks, however, should be viewed as buying opportunities.

[July 3, 2007]

Chart 2 – Daily December wheat



Courtesy Reuters

SOYBEANS

US acreage shrinks and shocks

The June 29 USDA acreage report for 2007-08 US soybean planting was truly a shock. The March 30 estimate of 67.14 million acres was revised downwards by 5%, to 64.08 million acres. Analysts' estimates ranged from 66 million to 69 million acres. Well-regarded forecasters that we follow believed that $8-per-bushel-and-higher bean prices would surely reverse a good chunk of the soybean-to-corn switching, and just within the past two weeks at least two of these analysts issued estimates of just less than 69 million acres.

Although the soybean-to-corn price ratio (Chart 3) is still below historical norms, it had rallied substantially, and we reasoned (*Focus on Futures*, May 29) – as many must have – that traditional soybean farmers would feel quite comfortable locking in soybean crops at $8 per bushel. Obviously not.

The implications for US inventories are dire. Based on the new acreage yield and the USDA's yield estimate of 41.5 bushels per acre, the 2007-08 US crop would be 2.62 billion bushels (71.4 million tonnes), down from the June estimate of 2.75 billion bushels (74.71 million tonnes). Ending stocks would fall to 195 million bushels (5.31 million tonnes), or 6.4% of consumption. This compares with 20% in 2006-07 and 15% in 2005-06.

Global ending stocks would fall to 50.6 million tonnes. While this will still be the third highest ending stock level on record, the USDA is forecasting a steep increase in usage. As a percentage of consumption, ending stocks would fall to 21.5%, about the same level that facilitated a massive bull market that pushed soybean prices over $10 per bushel in 2004. Ending stocks for the past two seasons were 28% in 2006-07 and 23% the previous year.

The USDA estimate for US exports for the new marketing year is 29.39 million tonnes, virtually the same number as 2006-07. US export activity in soybeans has been extremely strong, and it is not a stretch to assume that the USDA estimate is just a plug-in figure and that we can expect sales abroad to be even larger than this year's, if we were to continue at the current pace. With 10 weeks left to the marketing year, commitments stand at 29.8 million tonnes and have met and exceeded the USDA estimate. What's more, 27.74 million tonnes have been shipped. Actually, some analysts are puzzled as to why the USDA maintained its 29.39-million-tonne estimate in the monthly supply/demand report when it is very clear that we are going to exceed that amount.

The acreage report was one of the more stark instances of analysts being significantly off the mark, and frankly, we're puzzled over the wide disparity between the street's impressions and the USDA figure. It was very clear that the market was betting on a higher estimate because prices had dropped by as much as 75¢ per bushel in the days leading up to the report.

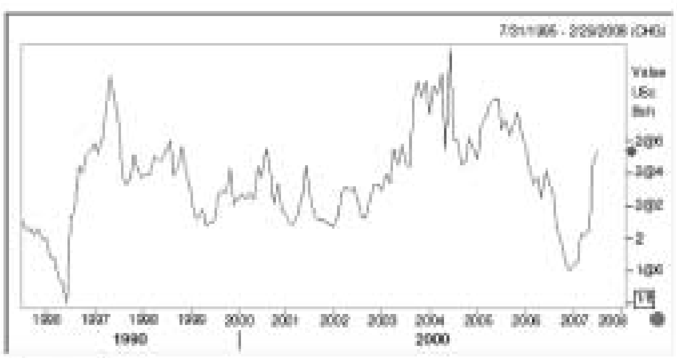
The market's initial response was the obvious one – a 50¢-per-bushel limit-up opening in soybeans. The meaning of events subsequent to that initial reaction is less clear. The market came off the limit on the day of the report, with November beans closing up 39.5¢ on the session. Not too shabby for bulls, but the market failed to surpass the level that was set 10 days before the release of the report. The market did close at a new high after traders had a chance to think about it over the weekend, but we're still in the zone, so to speak. Of course, that could change in a flash, but it is interesting to note that the market did not push into new territory to reflect the revisions in the extraordinarily bullish report (Chart 4).

Another interesting aspect of the trading activity in this market is that commercials are heavily net short this market, which means that commodity funds were the driving force behind the rally. Should commercials not have had a better handle on the acreage situation? How could the farmers who grow the soybeans (as well as the private industry analysts who conduct their own surveys) be so wrong?

The facts paint a bullish picture – a much smaller US crop than anticipated with strong demand. Having been caught totally off guard with the acreage estimate headed in the completely opposite direction from our mindset, we feel that we must remain sidelined until we can understand how so many sophisticated analysts could have been so wrong.

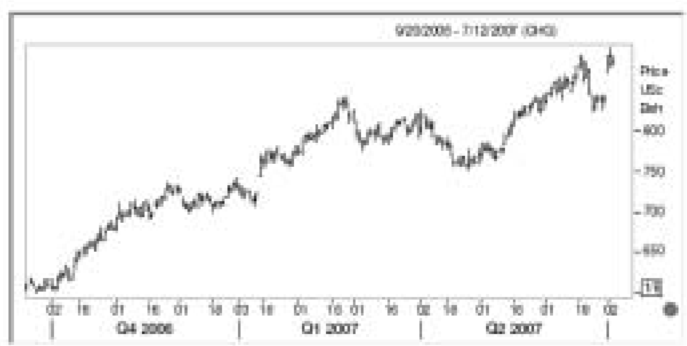
Remain sidelined. *[July 3, 2007]*

Chart 3 – Monthly soybean/corn ratio



Courtesy Reuters

Chart 4 – Daily November soybeans



Courtesy Reuters

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