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Cocoa: output is disappointing, but so is demand

The Ivory Coast harvested a record cocoa crop of 1.5 million tonnes in the 2010-11 season. Early in the 2011-12 crop year, main-crop arrivals were well out in front of the previous year. Precipitation seemed adequate. A decent April-through-September mid-crop was expected. Another bumper crop was a given.

As recently as early June, port arrivals for the 2011-12 harvest were still running slightly ahead of last year's pace. A prolonged dry period, however, has dampened any hopes for a repeat of the 2010-11 performance. The most recent tally shows arrivals at 1.259 million tonnes, down 50,000 tonnes from last year at this time. In years of healthy mid-crops, weekly arrivals in July still run at 30,000 tonnes per week, but that figure has tapered off to 20,000 tonnes per week and is expected to dwindle. The International Cocoa Organization estimates the crop at 1.35 million tonnes.

The anticipation of a strong crop in the Ivory Coast, as well as another 1-million-tonne harvest for neighboring Ghana, drove prices down to the $2,000-per-tonne level several times this year. But as discussed above, hopes for a bumper crop in the Ivory Coast have faded. And in Ghana, the main crop is reported to have reached just under 800,000 tonnes. Dry weather will limit the mid-crop to 40,000 tonnes, less than half of last year's total, which reached 107,000 tonnes.

The other West African producing nations are not expected to meet early-season goals either. Key Nigerian growing regions suffered from excessive rains and have lost about 30% of their crops. Cameroon was on track for yet another record crop of about 250,000 tonnes, but dry weather limited yields. Arrivals are down 10% from a year earlier, which would put output at about 215,000 tonnes.

Despite the disappointing West African crops, the outlook for demand is weak and has led cocoa analysts to revise their forecasts for the 2011-12 global production/consumption balance to show a shrinking deficit. Estimates for the deficit hover around 50,000 tonnes, down from 100,000 tonnes earlier in the year. This compares with a massive surplus of 343,000 tonnes in 2010-11.

Butter ratios in Europe have improved to 1.15 times the London spot price, up from lows that touched 1 times the London price several months ago. In Asia, the ratio remains stuck at the lows. Powder prices, which kept grinding profitability afloat, have been slipping as well. Chart 1 shows the combined butter/powder ratio falling to 15-month lows.

After dismal results for the European and the North American first-quarter grind helped push prices lower, the second quarter looks even worse. Analysts were expecting the European grind to be about 5% below the second quarter of 2011, but the grind – reported on July 12 – came in at 17.8% below the same period a year ago. This would seem to be a clear indication that soft product prices have been a disincentive for processors. Traders responded in kind to the news with a $110-per-tonne, or close to 5%, selloff (Chart 2).

Bulls are bracing themselves for the North American grind to be released on July 19.

We've been long for some time and just missed being hit on our $2,050-per-tonne stop in early June. Considering the bearish demand case, it would seem expeditious to count our blessings and just get out now at the $2,200 per tonne level.

Taking a step back, though, we should remember the 2010 civil war in the Ivory Coast that kept 500,000 tonnes of cocoa beans off the global market for months. The beans

Inside

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were shipped eventually, but the market's vulnerability to the Ivory Coast, which is the source of 40% of the market's supply, was exposed. In June the government put down an attempted coup by former military officers loyal to past President Gbagbo.

The bullish supply side has been mitigated by anemic consumption. Having come this far, though, and still always worried about the long-term potential for large-scale supply disruptions, we'll take our chances with the stop.

[July 12, 2012]

Chart 1 – Combined cocoa butter/powder ratio

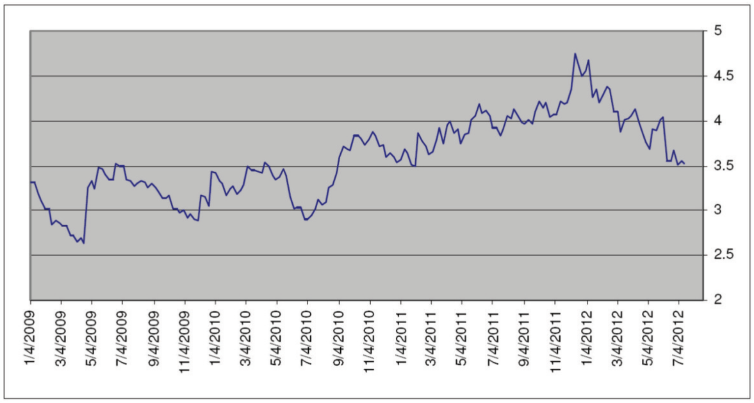
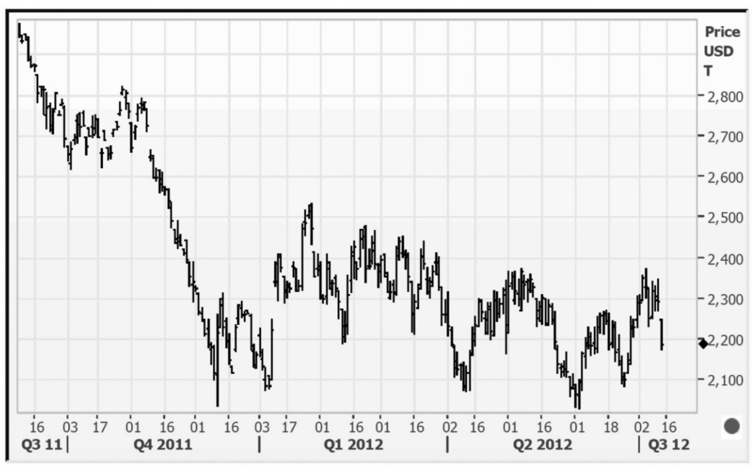


Chart 2 – September cocoa



Courtesy Reuters

SUGAR

India joins Brazil with a compromised crop

October sugar is trading close to 5¢ per pound, or almost 25%, above its early June lows (Chart 3). Developing bullish supply-side fundamentals have overpowered both a strong dollar and worries about demand destruction that would result from the bleak global economic outlook.

Indian crops rely heavily on the amount of precipitation received from the June-through-September monsoon rains. From June 1 through July 23 the rains were 22% below average. On July 23, the government released its forecast for the whole season, revising its estimate downward to 92% of normal from 96% in June. The forecast is a bit optimistic in light of the performance of the monsoon thus far.

For sugar in particular, rainfall in two out of the three largest producing regions was significantly below normal, while the other had excellent precipitation. Estimates for 2012-13 output range between 25 million and 26 million tonnes. That range of estimates, however, is virtually the same as it was before the monsoon season began, when there was no way of knowing how the monsoon would pan out. Again, it's a tad optimistic to maintain early-season estimates when it's doubtful that precipitation levels will be up to par.

Analysts keep talking about a 2012-13 surplus and inventory building. If the monsoon snaps back, perhaps. If it does not, output estimates will be reduced.

Conservative estimates put consumption at 23 million tonnes, which would leave only a small surplus. Indian exports for the current 2011-12 marketing year will reach 3 million tonnes, so there was not much inventory building this year either.

Excessive rains in Brazil that have lowered sucrose content are not news, but estimates for 2011-12 output are dropping. At present, production is running close to 30% below last year. That number is likely to improve, however, but not enough for Brazil to meet the needs of its traditional overseas customers. When we last wrote about sugar on June 7 we said, "Some estimates put export availability as low as 20 million tonnes, down from estimates for 2011-12 that according to some analysts were as high as 24 million tonnes." At the time, that estimate was a bit of a stretch. Now, 20 million tonnes could very well be on the high side of the estimate range.

Another factor that will put a strain on Brazilian sugar output, is that US ethanol prices will soar with the price of corn, because of the oppressive drought in the US Midwest. US ethanol production without the crutch of generous government subsidies has yet to be proven. This will put further pressure on the Brazilian sugar/ethanol ratio. Both the sugar and ethanol industries will be competing for a larger share of the cane crop.

China is not quite the wild card in the sugar market as it is for other commodity markets. Still, analysts say that consumption growth has not tapered off with the slowdown in its economy. Estimates for both production and consumption can be fairly erratic, but customs data show that imports of 1.4 million tonnes for 2011-12 to date are more than double the previous season's.

None of the major sugar analysts have changed their forecasts for global production/consumption surpluses for 2011-12 and 2012-13. (The last round of revisions was actually revised to show larger surpluses.) But they will.

The balance of evidence suggests overwhelmingly that the supply/demand fundamentals are bullish. In addition, as we've pointed out in previous articles, the cost of production has risen substantially, particularly in Brazil.

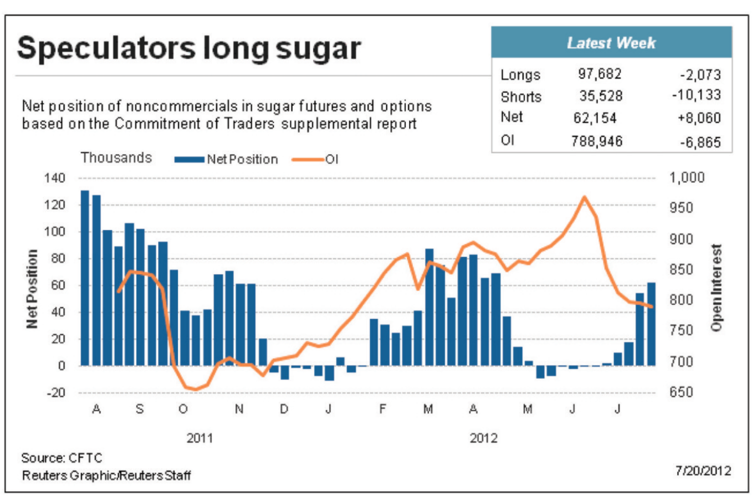
The rally has not gone unnoticed. The most recent CFTC data show that fund net-long positions have moved from a small net-short position as recently as mid-June to a net-long position of over 60,000 contracts (Chart 4). Expect volatility.

We recommend maintaining long positions in October sugar. Raise the 19¢-per-pound stop, suggested on June 7, to 22¢, close only. *[July 25, 2012]*

Chart 3 – October ICE sugar

Courtesy Reuters

Chart 4 – Net fund position



Courtesy Reuters

COPPER

A bearish combo: Chilean output creeps up, while Chinese demand slips

Copper prices have dropped substantially since the beginning of the year, failing at the $4-per-pound level and sliding all the way down to $3.25 per pound. In early June, the market found support at about the same time that the stock market bottomed (Chart 5). We've been bearish, but our trading has been a bit sloppy. Our April 24, $3.75-per-pound stop was triggered just ahead of the May selloff.

According to the International Copper Study Group (ICSG), the global balance sheet for refined copper has been building a deficit since the beginning of the year. Through the end of April, the deficit stands at 384,000 tonnes, sharply higher than in the same period a year earlier, when the market was in near balance with a deficit of only 26,000 tonnes.

Although the global economy has been sluggish, the deficit was generated by improved demand. During the ICSG's study period, usage of refined copper grew by 10% over a year earlier, while total refined production rose by just 4.4%.

ICSG data are dated, though, and are a reflection of the tail-end of the recovery, which has since sputtered. More current statistics indicate that the key drivers of the global copper market have turned bearish, for both the supply and demand sides.

Chilean output for 2011 was 3.2% lower than in 2010. So far this year, average monthly output is up 1.18%, but the trend may be moving towards more significant production growth. In the second quarter, average monthly output was 3.6% above the same period in 2011. Estimates for 2012 call for growth of between 6% and 10%. If the current trend can continue even while being affected by the ever-present issues that hamper Chilean mining, such as weather and labor strife, those estimates are achievable.

Chinese imports – the single most important factor in the copper bull market – have been in decline. Imports reached a monthly record in December of last year, but have been trending down since (Chart 6).

To put this in perspective, although month-over-month numbers are falling, imports are still above year-ago levels. While the dropoff in imports seems to be consistent with the slowdown in the growth rate of the Chinese economy, imports are still substantial. June imports of refined copper were 250,000 tonnes, 40% higher than in June 2011. Each month's data will have to be scrutinized.

Global warehouse stocks peaked in mid-2010 and have been falling since. Inventories began to rise a bit in June (Chart 7), however, which might prove to be consistent with weaker Chinese imports and increased supply coming out of Chile.

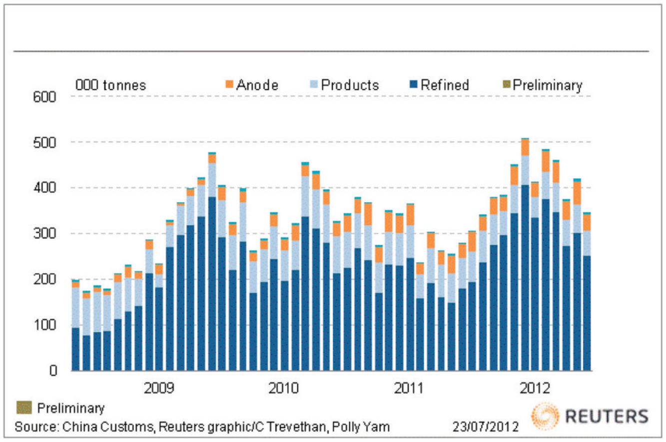
In conclusion, if the two principal fundamental factors that guide this market – Chilean production and Chinese imports – continue to develop in the direction they've been moving over the past several months, even a strong US stock market will not be able to keep copper prices above $3 per pound. The Chinese market has proven to be resilient, however, and Chilean output growth has many challenges to deal with.

If you were fortunate enough not to abide by our stop and are still short, remain short, but lower stops to $3.56 per pound, basis September, close only. Otherwise remain sidelined, but stay tuned. *[August 2, 2012]*

Chart 5 – September COMEX copper

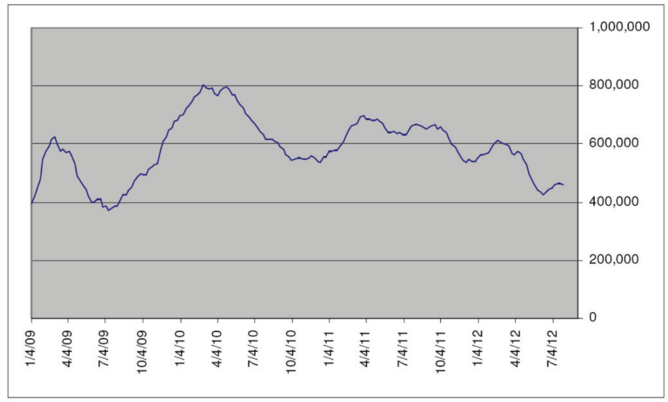
Courtesy Reuters

Chart 6 – Chinese imports



Courtesy Reuters

Chart 7 – Global warehouse stocks



COTTON

The sleeper, for now

In past US droughts, cotton crops were damaged by the hot and dry weather alongside grain crops. While the entire US has been affected by well-above-normal temperatures this summer, cotton crops have largely been spared the worst of the devastating drought that has slashed estimates for what was expected to be a blockbuster corn crop and a very decent-size soybean crop.

The most recent weekly progress report shows that 41% of the crop is in the good-to-excellent category, down from 44% a week earlier, but still up significantly from last year at this time when only 30% of the crop had the top rating.

To illustrate how much worse the effects of the drought have been on corn crops, consider that in mid-June, just before ratings began to reflect the hot and dry weather, 53% of the cotton crop was in the good-to-excellent category, which as mentioned above, is currently at 41%. Corn, on the other hand, has fallen from 63% to a meager 23%. Traders have therefore not focused much on cotton – certainly not from a weather angle.

Chinese output may prove to be somewhat of a bearish influence as well. Although 2012-13 planted cotton area was close to 10% below the previous year's, favorable weather and better disease control seem to have improved yields in some areas. The current USDA estimate for Chinese output – based loosely on the drop in planted area – calls for a 30.5-million-bale crop, 3 million tonnes smaller than in 2011-12. Chinese analysts have been raising their estimates for the crop. The USDA will almost certainly raise its estimate for the Chinese crop in the August 10 crop report, but it will be very interesting to see if it will be by a substantial amount.

The Indian monsoon was late for cotton-growing regions this year, and as a result, actual planted area will likely be smaller than earlier estimates. Once the monsoon did arrive, the rains were below average. The USDA has already been trimming its estimate for Indian output. The July crop report revised the 2012-13 crop down from the June estimate, by 1 million bales, to 24 million bales, substantially below output of the previous two seasons of 26.5 million bales. We're guessing that there will be further downward revisions to the Indian crop, because all recent revisions for the monsoon have been down. The extent of the weak monsoon was not yet known at the time the last crop estimate was prepared.

The 2011-12 marketing year ended on August 1. The late-June cancellation by China of 600,000 bales of old-crop cotton put a damper on the export picture. The final tally for commitments was over 12 million bales, leaving about 1 million bales of unshipped old crop to be carried forward to the new marketing year.

The USDA has been persistent in revising down its estimate for Chinese domestic usage to a multi-year low. It now stands at 39.5 million bales. This is the single most important demand-side issue for the international price of cotton, because it determines the size of Chinese imports. The pessimism is consistent with the gloomy forecasts for anemic economic growth rates around the globe and particularly in China.

The most bullish aspect of this market relates indirectly to US grain crops. US farmers will be taking advantage of the rally in next season's crops by selling forward to lock in historically high prices. December 2013 corn and

November 2013 soybeans are trading well below spot prices, but also well above the historical norm for new crop prices that won't be planted for eight or nine months. While December 2013 cotton is trading at a small premium to spot prices, corn and soybean prices for the 2013-14 crop year have risen far more dramatically (Chart 9) and will be far more profitable to plant at these prices. The next crop year should therefore see many cotton acres shifted to corn and soybeans where viable. To balance the acreage distribution, cotton prices must rise.

Raise stops on long December cotton positions to 69¢ per pound basis December, close only. *[June 29, 2012]*

Chart 8 – December cotton

Courtesy Reuters

Chart 9 – November 2013 soybeans/December 2013 cotton ratio (top) December 2013 corn/December 2013 cotton (bottom)

Courtesy Reuters

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