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Copper: overdone or correction?

On February 15 copper traded at a fresh record high, just a hair's-breadth shy of the $4.65-per-pound level. The market failed to hold the momentum, however, and turned lower to close with an outside-day reversal – a classic bearish signal in the world of technical analysis. Prices continued lower over the next few sessions.

Meanwhile, the stock market continued to make new highs (Chart 1). All this was happening just as the North African crisis was expanding and started attracting serious attention from capital centers abroad. As it turned out, stocks just had a delayed reaction, and the weakness in the copper market was an early warning sign that the euphoric rise in stocks and commodities was about to take a breather. By the time the market showed even a hint of consolidation at the $4.25-per pound level, copper prices had fallen by 40¢ per pound, or 8.5%.

The apparent fundamentals of copper have not changed very much. The most recent International Copper Study Group report shows that the market remains in a significant deficit. For the January through November study period, the global balance showed a deficit of 400,000 tonnes. The growth rates of both refined production and consumption fell from the previous month, but production fell slightly more. Output grew at a rate of 4.2%, down from 4.6%, whereas usage dropped from a 7.5% rate of growth to a still very robust 7.2%.

Chilean output was a dismal disappointment in 2010. At mid-year, Chile was still forecasting that its copper output would grow by 5.5% over 2009, to 5.7 million tonnes. This was based on output rates in the early part of the year that were strong through April. Save for a 6.3% uptick in July, production for the rest of the year was sluggish. Output grew by a scant 0.15% in 2010, to 5.41 million tonnes, no match for the unanticipated continuation of strong Chinese imports and a faster-than expected recovery in Europe.

The primary force in this bull market has been Chinese buying, and for the moment, this indicator shows no sign of letting up. January copper imports reported on February 14 were 363,000 tonnes, up 5.7% from December and 24.7% over January 2010 (Chart 2).

On February 18 the Chinese central bank increased reserve requirements for lenders by 50 basis points. The move, designed to apply some pressure on the red-hot economy, likely exacerbated the selling in copper. However, commodity selloffs triggered by tightening moves by the central bank have historically proven to be nothing more than buying opportunities.

Bulls are looking over their shoulders at the buildup in inventories. Chart 3 shows that combined exchange warehouse stocks at the LME, COMEX, and Shanghai continue to rise. And while unabated Chinese imports seem to be supporting the market, it may not necessarily be as bullish as it appears. In China, copper held in bonded warehouses, and not included in Shanghai warehouse stocks, are said to have increased by 100,000 tonnes, to 500,000 tonnes, over the past couple of months.

When the buildup is viewed in the context of the growth in global consumption in recent years, however, it is not quite that bearish. It is unclear whether exchange or bonded warehouse data are meaningful or accurate – respectively. Even if they gave a fair picture of mobile global copper inventories, consider that in the early 2000s, when exchange warehouse stocks were in excess of 1.5 million tonnes, they represented about 10% of global usage. Now, all the warehouse stocks – exchange and otherwise – total less than 1.2 million tonnes. Global consumption has jumped by about 25% over the past decade, leaving stocks

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as a percentage of consumption at below 6%.

Chinese consumption statistics are generally implied from import data, and if the alleged bonded warehouse stocks fail to work their way into actual industry usage, the bulls would have a problem. A breaking point would eventually be reached, and Chinese buying would dry up. But as long as the Chinese maintain imports at current levels, there is no solid evidence that the copper purchased is not trickling into *bona fide* usage.

Oil prices are surging, and the stock markets showing signs of concern. Yet the supply/demand fundamentals of copper are still bullish. Production remains sluggish and consumption has not shown much slack. At present, we view the dip in copper prices as a due-course correction. Our January 11 suggestion to use a protective sell stop, basis May, at $4.25 per pound, close only, was triggered. If you were stopped out, re-enter the long side and use the same relatively low-risk stop. *[February 25, 2011]*

Chart 1 – May copper (bar), Dow Jones Industrial Average (line)

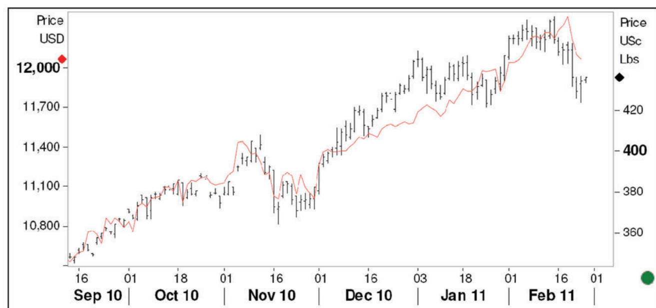

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Chart 2 – Global copper warehouse stocks

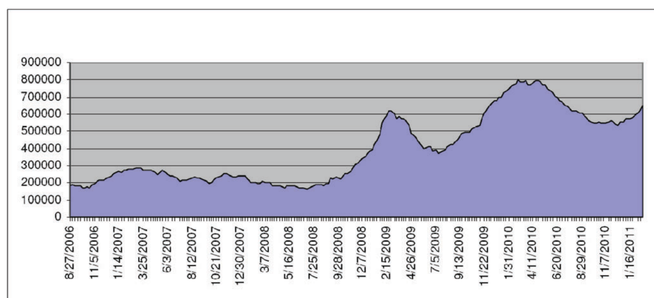
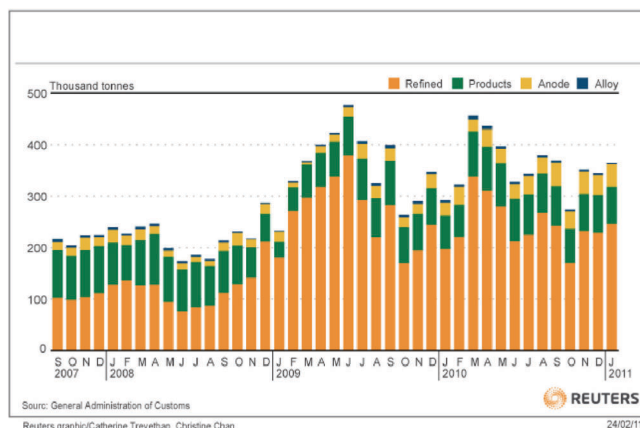


Chart 3 – Chinese copper imports



SUGAR

The bounce in Indian output fails to quell global shortfall

Sugar prices peaked at 35¢ per pound in early February and subsequently shed 15%. The selloff was due partly to a general lull/correction in many commodity markets, but also because of some sugar-specific developments. Support emerged at the 30¢-per-pound level (Chart 4).

The direction of developing fundamentals is somewhat unclear, with uncertainty about the Brazilian crop and the sugar/ethanol ratio. The official start of the Brazilian 2011-12 marketing year is in April, but the harvest in some regions has already begun. Dryness during the growing season last year has lowered yields. Precipitation levels recovered early in 2011, which was beneficial for yields, but will be a drag on the harvest. Estimates vary, but the size of the cane crop will be close to last year's, and any changes in sugar production will be the result in swings in the sugar/ethanol crush ratio.

With sugar prices at multi-decade highs and a tight market abroad, there is obviously a strong incentive to slant the sugar/ethanol ratio in favor of sugar production. The ethanol market in Brazil is far more mature than in any other country in which ethanol blends have made serious inroads – includ-

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ing the US. The government requires gasoline to contain a minimum of 25% ethanol, and it's been that way for years. A significant percentage of the country's cars are flex fuel, which means the consumer can use the government-mandated blend or 100% ethanol. The point is that there is not too much room for consumption growth. Chart 5 shows that the increase in the amount of the sugar-cane crop dedicated to ethanol over sugar plateaued several years ago.

As the 2011-12 crop enters the harvest season, forecasts for the key ratio vary. According to one estimate, the sugar portion will rise sharply to 47%, up from 44.7% in 2010-11, which translates roughly into an additional 1.5 million tonnes of sugar available for export. A more recent estimate by sugar analyst Kingsman SA, however, puts the ratio much closer to 2010-11 levels, at 45% sugar and 55% ethanol.

India is expected to have a surplus for its 2010-11 marketing year, which runs from October through September. This is a dramatic reversal from the previous two deficit seasons which turned the selfsufficient and well-stocked country into an importer. Most production estimates hover around 24.5 million tonnes, up from 18.8 million tonnes in 2009-10. A recent estimate puts consumption at 22.5 million tonnes. A 500,000-tonne export license has been bandied about over the past few months, and the government is procrastinating over the move. A decision was expected in December.

We've pointed out in past articles on sugar that even with the surplus, Indian ending stocks will be half – or less – of what the heavy sugar-consuming nation was accustomed to before the two consecutive drought-plagued seasons in 2008-09 and 2009-10. We find the 22.5-million-tonne usage figure that has been appearing in press reports recently to be somewhat on the low side. Average consumption in the past three years has been about 24 million tonnes, and we don't know any rationale for a such a sharp drop. If consumption is actually in line with the past few years, then the surplus is minuscule and it would explain why the government has been dragging its feet on issuing export licences.

Indian exports would be bearish in the near term. Australian exporters saw their exportable surplus slashed by about 35%, or 1.2 million tonnes. Indian exports would provide significant compensation. Lower ethanol production in Brazil and the threat of Indian exports could pressure prices. Still, the pool of available sugar for world trade is tight and makes prices vulnerable to further rallies. Despite the potential for slightly bearish fundamentals on the horizon, sugar statistician Czarnikow on March 1 increased its deficit forecast for the global balance sheet, to 3.7 million tonnes, from 2.8 million tonnes.

Remain long. Raise sell stops to 26.50, basis May, close only. *[March 2, 2011]*

Chart 4 – March sugar

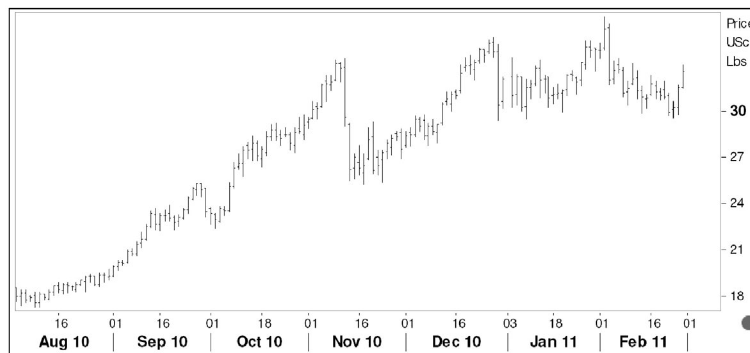

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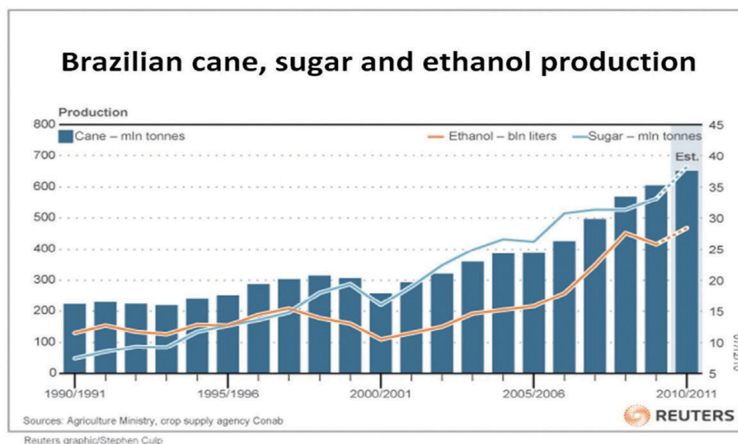
Chart 5 – Brazilian cane, sugar and ethanol production



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COTTON

Asian buying, new autumn crops. Mind the gap!

None of the major commodity markets can lay claim to the cotton market's feat – a two-year, 5.5-fold price increase (Chart 6). Is there any evidence of a rationing process? Are we near the end of the meteoric rise?

There are many potential factors to consider. The spread between cotton and synthetic materials has ballooned, which many market participants argue will ultimately shift some demand. Most significant on the supply side: All major producers are going to plant larger crops. The spread between new- and old-crop prices reflects this – the price difference between the two crops recently traded at a record high of over $1 per pound (Chart 7).

Old-crop prices have kept rising because cotton-importing countries have shown no letup in their purchases. We keep waiting for the shoe to drop every Thursday morning when the USDA releases its weekly export data, but it hasn't happened – yet. To date, 2010-11 US export commitments stand at just over 15 million bales. The USDA target is 15.75 million bales, and the marketing year runs until the end of July. US exporters have shipped about half of their booked sales, which is the same commitment/shipment ratio as previous years at this point of the season, so there's no indication that we won't be able to meet the target. To meet the target, weekly shipments have to be just under 350,000 bales per week.

Is this pace of export sales sustainable though? Chinese purchases account for a formidable one third of the 15 million bales of 2010-11 commitments. Since January, just under 1 million bales of old-crop cotton have been sold abroad. Chinese purchases during this period have slowed markedly, to less than 20% of new sales. Other Asian manufacturing-center countries, such as Bangladesh and Turkey, have picked up the slack with some decently sized purchases.

The Chinese have not stopped buying. They've merely filled their needs for the 2010-11 marketing year and have shifted their buying to next year. Last year at this time, new-crop sales (2010-11) were a paltry 400,000 bales. This year, as of the most recent USDA report, new-crop sales (2011-12) have reached 3.7 million bales. In our study period from January onward when Chinese old-crop sales tapered off, 43% of new-crop sales have been to the Chinese. So, little has changed in terms of the principal driver of this bull market.

Looking ahead, the early USDA forecast for 2011-12 US plantings is 13 million acres, up from 2010-11 planted area of 10.97 million acres. That's an 18.5% increase, but output is projected at only 19.5 million bales, a 6.5% increase over 2010-11. At 97.6%, the planted-to-harvested ratio was exceptionally high in 2010-11, and that is obviously not expected to be repeated. The average ratio over the previous 10 years was 88.5%.

It is interesting to note that planted cotton acreage was over 15 million acres at mid-decade. The cotton market has twisted itself into a bit of a bind. The infrastructure for growing a 15-million-acre crop no longer exists. Farmers, frustrated over low cotton prices, shifted their attention to crops that were far more profitable before the explosive move in cotton prices. As a result, they simply don't own enough cotton-specific machinery, such as pickers. Apparently the confidence among farmers regarding the longevity of this bull market was too low to allow for long-term capital investment.

In China, the situation may be somewhat reversed. In 2010-11 Chinese output reached only 30 million bales because of poor weather, down from 32 and 36 million bales in 2009-10 and 2008-09, respectively. With an expected 10% increase in acreage and no serious weather problems, production should return to the 35-million-bale level.

The International Cotton Advisory Committee recently estimated that 2011-12 global output would increase by 10.8%, while consumption would expand by only 2.8%. Using a rough estimate, that would put global ending stocks at about 50 million bales, or 42% of usage, up from 36.7% in 2010-11. That's still a bullish number in historical terms, particularly if we consider that 25% of global ending stocks are those listed as Chinese stocks, which never made sense, given how much they've been buying. So actual pertinent ending stocks that are mobile and available for world trade are really much lower.

We'll have a much better idea of the size of the US crop when the USDA releases its planting intentions report on March 31.

Anyone who has had the temerity to stay with our January 11 recommendation to maintain long positions, with a $1.29-per-pound stop, basis May, should raise that stop to $1.75, basis May, close only. Although December cotton is pricing a return to normal conditions, there is no way of knowing whether the crops will pan out. The dryness in Texas is already problematic for vital sub-soil moisture. Buying the dramatic discount to cash is a relatively low-risk trade. New long positions in December should use a $1.10 stop, close only. *[March 9, 2011]*

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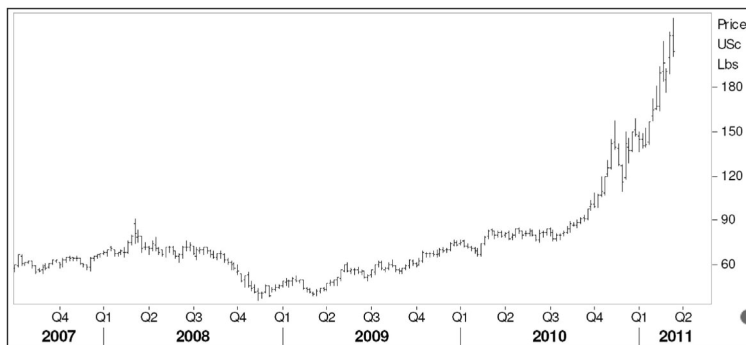
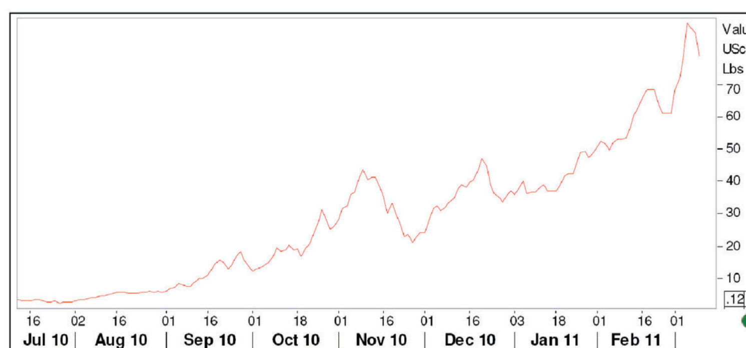
Chart 6 – Weekly nearest contract cotton



Courtesy Reuters

Chart 7 – May/December cotton spread



Courtesy Reuters

COCOA

No end in sight for Ivorian political stalemate

Cocoa prices have shed over $500 per tonne since sprinting to a modern-day record of $3,775 per tonne earlier this month (Chart 8). Looks like a top, feels like a top...but it's not. The political standoff in the Ivory Coast has broadened, and we believe that the potential for short-term – and possibly long-term – restriction on the free flow of cocoa production and exports is a reality.

A brief summary of recent events indicates quite clearly that the incumbent candidate, Mr. Laurent Gbabgo, has no plans for ceding his office to Mr. Alassane Ouattara who is recognized by the international community as the rightful president. By the same token, Mr. Ouattara is doing everything he can to ensure that the cocoa industry – the prize of the Ivorian economy – fails.

The export ban ordered by Mr. Ouattara is now near the end of its second month and has been extended through to the end of March. Despite the fact that Mr. Ouattara is operating from the sidelines, the industry has largely adhered to the ban. The purpose of the ban was to starve the sitting government of export taxes. The industry's motivation to comply with the ban is twofold. First, Mr. Ouattara said that if he recaptures power, his government would ignore any taxes paid and recollect them. Second, going through the process is an exercise in futility, because most of the cocoa will not be accepted for shipment. The majority of the parties involved will abide by the UN embargo. European trade houses will not risk violating international law.

Mr. Gbabgo has struck back. He has dangled the threat of seizing the 475,000 tonnes of beans that have been sitting in warehouses if they are not exported. The government then retracted somewhat, clarifying that it would not actually seize the beans, but transfer them to the state. Whatever.

The UN Security Council has come up with a plan that is similar to the 1995 "oil-for-food" concept employed in Iraq. Under this program, beans would be exported, and any funds collected would be placed in an escrow account for the eventual use by an Ouattara-controlled government.

In any case, nobody's budging. The real issue that pertains to the outlook for cocoa prices is that the strong arrival pace that had been the basis for the estimate of a global

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cocoa market surplus in 2010-11 has evaporated. Even if everybody kissed and made up today, the quality of the huge stockpile has been compromised.

The facilities where the beans are being held were designed for brief storage as they arrive from the bush and are prepared for shipment. Whatever ventilation exists was not designed for keeping beans there for extended periods. Analysts warn that they can rot completely, which would of course render them useless.

Even in a best case scenario, a quick resolution to the crisis, we're talking about 40% of the entire crop being of sub-par quality. European chocolate manufacturers may not even want to buy them. That's the short-term problem.

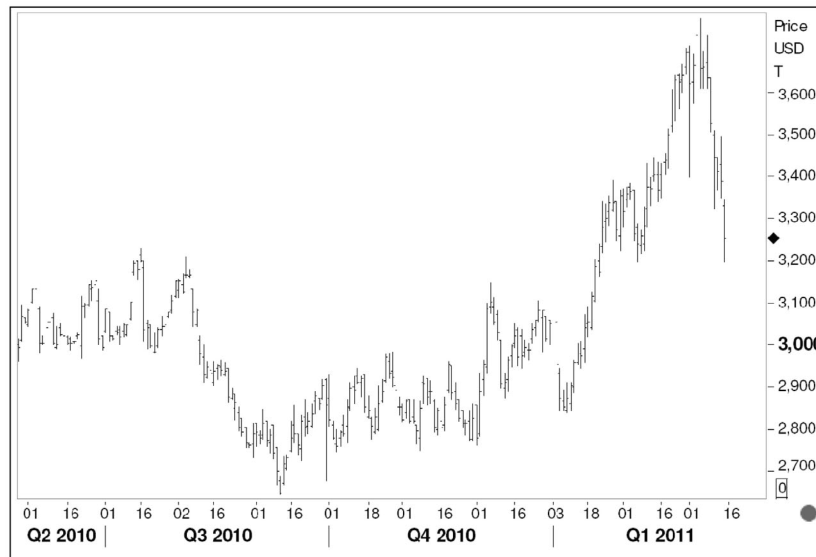
For the future, the issues become more complicated. As it is, lackluster investment in crop control, such as pesticide and fertilizer use, has been a problem – and has kept the size of the Ivorian crop stuck between 1.2 million tonnes and 1.3 million tonnes for several years. It is certainly not going to get any boost from this mess. On the contrary, the foreign capital that would be required to stabilize the industry and help it grow is not going to find its way to a country torn apart by civil strife of the magnitude that we are witnessing.

On March 1, The International Cocoa Organization (ICCO) forecast that the 2010-11 global balance sheet would show a surplus of 119,000 tonnes, up sharply from a 2009-10 deficit of 66,000 tonnes. Even assuming the ICCO arithmetic is accurate, the figure is bogus, because it would have to include a significant amount of beans that have either limited or no marketability. And that's if cooler heads prevail. If the struggle between Mr. Gbabgo and Mr. Ouattara persists and the 475,000-tonnes-and-growing stockpile rots completely, we could be looking at a deficit of several hundred thousand tonnes.

The saving grace comes from Ghana, which is finally showing signs of realizing its long-standing predictions to expand its crop substantially. Output is expected to grow to 850,000 tonnes this season, up from a dismal 2009-10, when only 632,000 tonnes were harvested. The average crop size in recent years has been about 700,000-tonnes. While the jump in Ghanaian supply will certainly mitigate the potential loss from the Ivory Coast and provide a measure of price stability, it is no match for the looming disaster brewing across the border.

Cocoa prices were not spared from the massive commodity liquidation that resulted from the Japanese earthquake, tsunami, and nuclear tragedies. We maintain our recommendation to hold conservative-sized long positions. *[March 16, 2011]*

Chart 8 – May cocoa



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