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Is weakness in sugar market being driven by fundamentals?

After registering a 9.4¢-per-pound contract high in early March, July sugar tumbled back to just shy of the 8¢-per-pound level. The move was actually a significant technical event in that it broke a long string of counter-trend moves that had formed a pattern of higher lows dating back to early-2004 when the bull market began (Chart 1).

Indeed, the slide could be very much commensurate with bearish fundamental developments that we discussed in the March 30 issue of *Focus on Futures*. India is counting down to the harvest of a new crop that is expected to stage an almost-full recovery to the 20-million-tonne level. In addition, the 2004-05 crop was revised upwards by 1.5 to 2 million tonnes over the past couple of months. Anticipation of large Indian purchases, which underpinned prices on every dip over the past year, is therefore no longer perceived to be a factor.

While the slide in prices may have spoiled a rather handsome uptrend in graphical terms, market action over the past two weeks is reminiscent of the support that would appear whenever the market tried to break during the bull run. Moreover, with the bullish fundamentals supposedly waning, a liquidation of speculative long positions should have been expected to follow. While commodity funds have liquidated, they have also turned around completely and have now established a substantial short position. The fund position has swung from a net-long of 85,000 contracts as recently as early February to a current net-short position of 30,000 contracts.

We continue to believe that the outcome of the Indian situation will prove to be the most important factor for this market. On April 15 The International Sugar Organization (ISO) released a report that indicated that India would remain an active participant in the import market even though its production outlook is set to improve dramatically. The report points out that traders were expecting large, well-publicized purchases. But Indian importers have maintained a low profile with small, inconspicuous purchases, and they are likely to continue this for the foreseeable future, the report predicts.

The report also reminds us that Indian consumption did not drop off during the two years of crop failures. With 2005-06 production forecast at about 18 million tonnes, the Indian balance sheet will still show a production/consumption deficit of 2 million tonnes. So while the situation is not as bleak as it was over the past two seasons when we were looking at deficits of 6 to 7 million tonnes, stocks will remain at critically low levels until India can produce enough sugar to restock inventories.

On May 10, despite the small improvement in the Indian balance sheet for this past season and the much larger improvement to come in 2005-06, the ISO raised its estimate for the 2004-05 global deficit to 1.96 million tonnes from its March 14 estimate of 1.7 million tonnes.

In conclusion, we're retreating somewhat from our bearish views. First, we're not impressed with the quality of the selling that caused the market to drop. The price weakness is directly tied to the boredom the commodity funds have experienced with the long side.

Then, the long-term demand side fundamentals have not changed very much. These include growing demand for ethanol and Chinese production/consumption deficits.

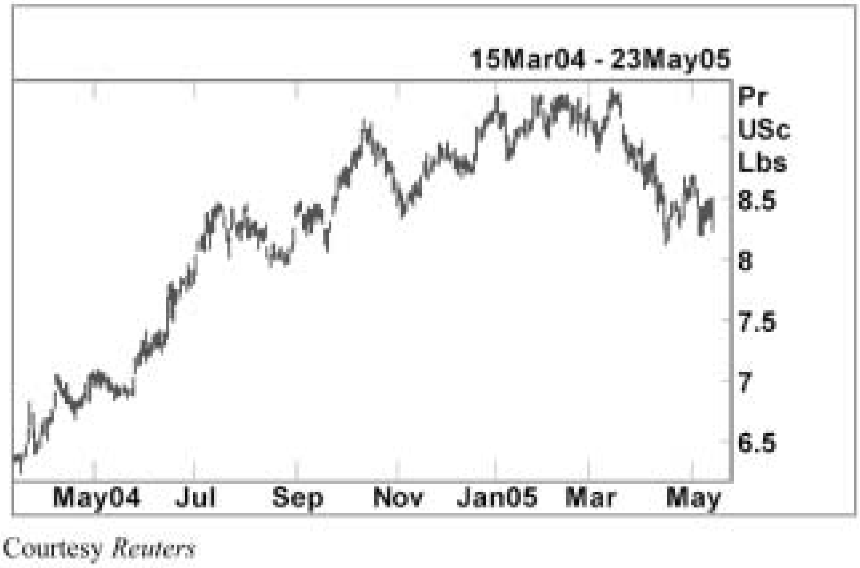
Inside

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

Ethanol demand continues to grow. The ratio of Brazilian sugar that is processed into ethanol *vis-à-vis* sugar for food has grown steadily. Even as Brazilian crops get bigger every year, the day will come when the amount of sugar available for export will become static, despite bountiful crops.

We are going to be patient, though. The market is testing the bottom of the range, and we will be monitoring the ability of commodity funds to break prices into new low ground. If they are not successful and commercial support emerges, we will become far more interested in exploring the long side. *[May 13, 2005]*

Chart 1 – July sugar



COCOA

Fund liquidation distorts fundamentals

Cocoa prices have been sliding. The 2004 lows of $1,300 per tonne are within sight. A series of negotiations between the quarreling factions in the Ivory Coast has yielded peaceful headlines and perhaps a truce as well. At the moment this development is irrelevant, to a degree. We're between main crops, and only the mid-crop – about 15% of the total crop – still needs to make it to port. While it's certainly good news that hostilities are on hold, the need for a fear premium has not disappeared.

While prices were falling, traders believed that a robust mid-crop would compensate for a disappointing 2004-05 main crop, which – based on port arrival data – was 13% smaller than the previous season's. To date, however, there is no evidence that the mid-crop is any better than average. Combined arrivals of main- and mid-crop beans as of May 12 stand at 1.028 million tonnes, down 125,000 tonnes from the same time last year. At the current pace, total output will still be about 11% below last year's.

Neighboring Ghana, the world's second largest producer, is also harvesting a sub par crop, which will yield roughly 20% less than 2003-04 output.

Number-three producer, Indonesia, was expected to grow an average-size crop, but arrival levels have been lagging there as well.

With 2004-05 global production down between 10% and 15%, the supply side is definitely bullish. But the bullish case we've been promoting over the past several months was rooted in our expectations for improved consumption. We reasoned that with butter ratios holding steady at close to historical highs of 2.8 times the London spot price, it wouldn't be long before processors would ramp up grinding activity to take advantage of the profitable spread between beans and butter. Thus far, we've been wrong. Both US and European first-quarter grind data were flat. Nonetheless, the mere fact that butter has maintained strong price levels is an indication that there is underlying demand lurking somewhere in the system.

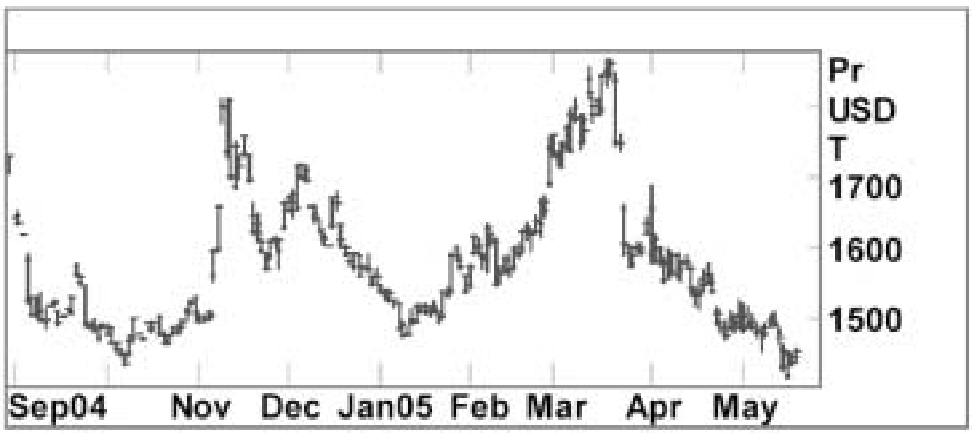
While butter stocks are clearly tight, one factor that is probably holding back growth in grindings is the fact that powder supplies are ample and processors must be enticed by the profit margin on a combined package of butter and powder.

Even with flat consumption, the International Cocoa Organization (ICCO) forecasts that the drop in global output will yield a 50,000-tonne stock drawdown for 2004-05, which compares with a 233,000-tonne surplus in 2003-04. While poor grind data certainly seemed to put the dramatic, 3-month, $400-per-tonne slide into proper perspective, we should not forget that the influence of large commodity funds on volatility has at times come to play an equal or greater role in moving markets than do the underlying fundamentals, at least in the short term. The peak of the market in mid-March (Chart 2) coincided almost to the minute with the high in the fund's net-long position (Chart 3). In fact, that net-long position was by far the largest ever held by funds. Even when measured as a percentage of total open interest, fund managers have not been this excited about the long side of cocoa since 1994. When they decided to exit collectively, the move was quick and merciless.

We therefore do not believe that there has been any material change in the supply/demand fundamentals. Whatever disappointment there was for the poor grind data is probably compensated for by the disappointment over the (so far) weak showing for Ivorian mid-crop arrivals.

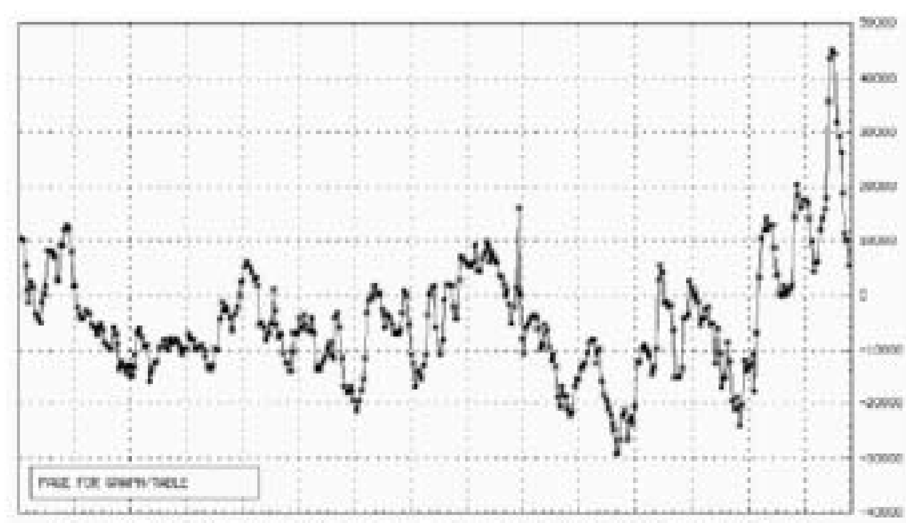
We remain friendly to the bullish case. With the sharp drop in the open interest, the massive bout of selling has probably ended. A reasonable, low-risk buying opportunity has emerged. *[May 19, 2005]*

Chart 2 – July cocoa



Courtesy *Reuters*

Chart 3 – Large speculators' net position



Courtesy Bloomberg

SOYBEANS

Prices consolidate. Where to from here?

The $2-per-bushel rally in soybean prices this past February reflected a second consecutive crop failure in Brazil. The May USDA supply/demand situation report estimates 2004-05 Brazilian output at 53 million tonnes, down 1 million tonnes from the April estimate, and dramatically below early-season estimates that reached 66 million tonnes when the crop was first planted last fall. Some forecasters are talking about lower numbers yet – as low as 50 million tonnes. But considering that the crop is mostly harvested, it is fair to assume that the market has a pretty good idea how big the Brazilian crop will be.

Traders will now focus their attention on the progress of the 2005-06 US crop. As of the May 23 weekly crop progress report, 65% of the crop has been planted, which is equal to last year's pace of 51% at this point of the season, and is above the 5-year average of 39%.

As is the case with all US agricultural products, the USDA is assuming that we will not repeat the record yields of 2004-05. The very preliminary May estimate was 39.9 bushels per acre (bpa), down from 42.5 bpa the previous season. Based on the March 31 planting intentions report, which estimated plantings at 73.9 million acres, 2005-06 US soybean output will be 78.9 million tonnes, down from 85.5 million tonnes in 2004-05.

It is very early in the season, and as evidenced from the reaction to this past weekend's forecast for a cold snap in the Midwest, yields are very much vulnerable. November beans rallied 8¢ per bushel to close out the session at 10-week high.

The arrival of rust in the US seems to have taken a back seat for the moment. It is likely to become a more influential factor as the plants begin to grow. Weather plays a direct role, because the spores die when exposed to direct sunlight and spread only in wet or cloudy conditions. Thus far, the fungus has been confined to the few places in which it was originally discovered.

While the constantly dwindling Brazilian production estimates caused prices to rally to these levels, it is fair to say that strong demand has assisted in maintaining those gains. The USDA continues to revise upwards its monthly forecast for annual US soybean exports. The estimate now stands at 29.94 million tonnes, up 550,000 tonnes from the April report. US export commitments stand at 28.8 million tonnes, well within reach of the USDA target.

In 2003-04 there were enough cancellations after the Chinese government tightened credit conditions to alter the complexion of the entire market for many months. Significant cancellations are not a risk this season, because the US has already shipped over 27 million tonnes. Weekly shipments would need to average about 200,000 tonnes to meet the USDA forecast.

To illustrate how Chinese demand has recovered, consider that Chinese imports for all of 2003-04 were 8.2 million tonnes. As of the most recent weekly USDA export report, China had committed to buy 11.87 million tonnes, of which 11.77 million tonnes have already been shipped. We can't predict the future from these statistics, but they certainly provide some evidence that demand has been strong.

For the moment, we believe that most fundamental indicators are constructive for the bull case. The Brazilian crop is a disappointment, the size of the US crop is uncertain, and demand is steady.

Any purchase inside the recent range of $6.20 to $6.40 per bushel for November beans represents a very reasonable risk considering the potential of a serious weather rally for this extremely volatile market. *[May 24, 2005]*

Chart 4 – November soybeans

Courtesy Reuters

COTTON

Bullish data, weak market

All recently released data for the cotton market – short- and long-term – have been bullish. Yet the market couldn't possibly be behaving worse for bulls. July cotton has plummeted 7.5¢ per pound since the beginning of the month (Chart 5). The old crop/new crop spreads have gone into a tailspin as well (Chart 6), an indication that supplies are ample to carry the market through the old crop marketing year, which winds up at the end of July. Does the recommendation to buy cotton on a test of the 49¢-per-pound level we issued at the conclusion of our last discussion on cotton (*Focus on Futures*, April 19) still stand?

The May 5 weekly USDA US export report delivered quite a shock to the market. Typically, a 250,000-bale weekly sales tally would be considered a very decent number. Although the street was expecting a fairly good number, the actual number – 1.032 million bales – was an eye popper. That 90% of the sales were for old crop and that China had purchased 664,000 bales of the total made the data even more startling. After all, China grew a record crop; why would it need to come in late in the season with a large purchase? Just a few months ago the USDA estimate for 2004-05 US exports was 1.5 million bales below the record sales of 13.76 million bales we saw in 2003-04. Commitments are now ahead of last year by about 500,000 bales.

The USDA's first 2005-06 forecast is for a 10% drop in global output, to 107 million bales, most of which comes from a call for a return to average-size crops in the US and China after last year's record production. Consumption is forecast to rise by 3.2%, to 111.5 million bales. Chinese imports are estimated to almost double to 15 million bales.

Some of these forecasts are bold, but if they turn out to be accurate, we will see global ending stocks fall to 45.17 million bales, or 40.5% of consumption, compared with last year's 45.4% of consumption. While a 40% carryout doesn't sound that ominous, the bull market that drove prices to 85¢ per pound in 2003 happened with a carryout of 38% of usage.

There was one development, however, that mitigated the bullish data, which explains in part why the market stumbled when both the near-term (the huge Chinese purchase) and the future (smaller crops and growing demand) looked fairly bullish.

On May 18 The US Commerce Department slapped import quotas on certain Chinese textile products, the second such move in a week. It is difficult to dismiss this news as mere political saber rattling, particularly in light of the fact that – as mentioned above – the USDA is looking for import demand from China to grow even stronger.

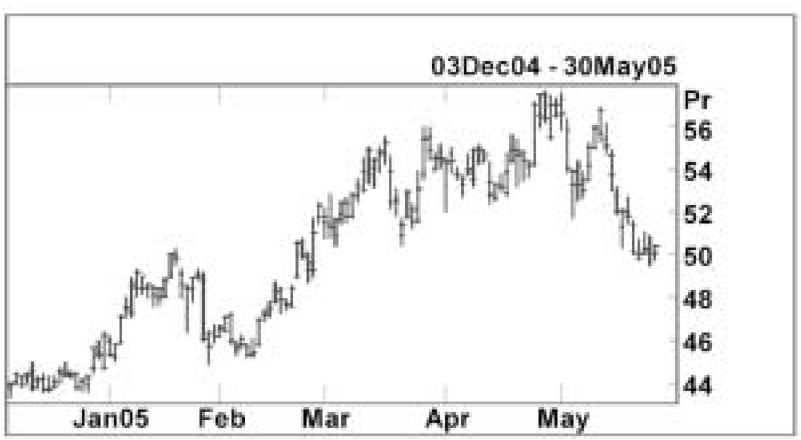
In addition, commodity funds were holding a net-long position of 35,000 contracts at the end of April. They've been liquidating that position, and as of the most recent weekly CFTC report were net-long only 15,000 contracts. Open interest has continued to decline since the end of that reporting period, which means that the funds continue to abandon the long side.

It is especially difficult to understand why the spreads became so weak even while the large export sales we saw should tighten up old crop supplies.

In conclusion, we believe the price weakness has more connection to fund liquidation than it does to anything in the more permanent supply and demand issues. The US/China quota squabble may restrict some US sales, but ultimately it is not likely to alter net global demand. It is early in the growing season for all major producing countries, and the crops therefore remain vulnerable. Prices are low in historical terms if demand continues at its recent torrid pace.

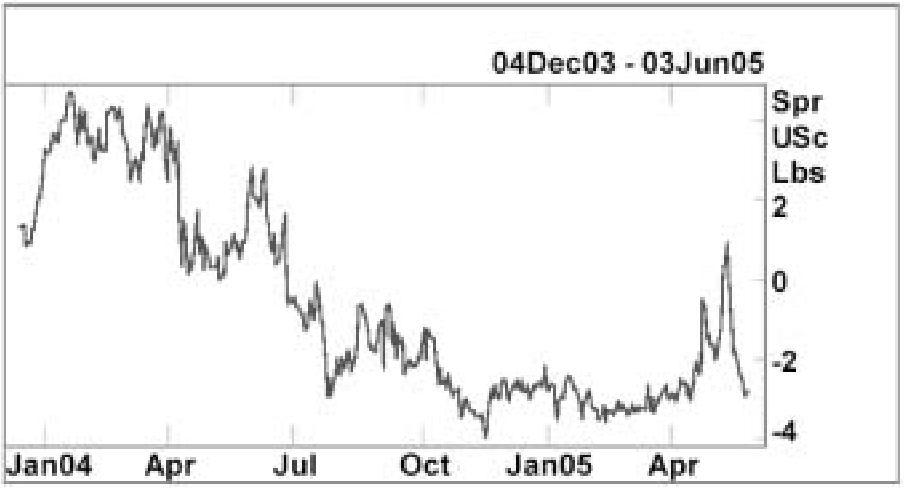
So yes, we're still bullish. July cotton did not quite make it down to the 49¢-per-pound level, but the market has held the 50¢-per-pound level for a week now, so perhaps the bulk of the selling is over. We're ready to probe the long side. Bulls should recognize, however, that this marketing might still be in a liquidation mode, so be prepared with reasonable sell stops and to make several attempts to establish a long position. *[May 25, 2005]*

Chart 5 – July cotton



Courtesy Reuters

Chart 6 – July/December cotton spread



Courtesy Reuters

HOTLINE UPDATE

Friday, May 6, 2005:
Good afternoon for Friday, May 6, 5:15 pm. We are currently holding no positions.

Friday, May 13, 2005:
Good afternoon for Friday, May 13, 4:25 pm. We are currently holding no positions.

Friday, May 20, 2005:
Good afternoon for Friday, May 20, 4:35 pm. We are currently holding no positions.

Friday, May 27, 2005:
Good afternoon for Friday, May 27, 5:05 pm. We are currently holding no positions.

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