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Soybeans: the USDA reverses course

Prior to the October USDA crop report, soybean prices had been moving mostly sideways since early September. Weekly crop progress updates were consistently showing that the good-to-excellent portion of the 2017-18 crop was running more than 10 percentage points behind last year's crop because of poor weather. Despite this, all summer long the USDA had been surprising traders with better-than-expected yield estimates. The street expected more of the same.

The USDA had yet another surprise, but this time in the opposite direction. The average of analysts' guesstimates was 50 bushels per acre (bpa), up just slightly from the September estimate of 49.9 bpa, but the USDA lowered the estimate to 49.5 bpa.

The estimate for planted area was expected to be revised upwards by 286,000 acres, but the USDA number was 740,000 acres higher than September. The net effect to production was therefore virtually unchanged from September. Still, there was a shock value in the headline number of lower yields, which seemed to draw all the attention.

Actually, there was another item that tipped the scales to the bull side. With a series of tweaks to the 2016-17 US balance sheet, the USDA lowered the old-crop carryout by 45 million bushels. So while production, domestic demand, and exports for 2017-18 were all unchanged from the September estimate, the forecast for ending stocks dropped to 9.9% of consumption, down from 10.9% in September. That's higher than the two previous seasons, so the balance sheet still shows a well-supplied US market. However, along with the old-crop stocks revision, the surprise USDA yield revision opened up a new area of concern. In response, soybeans rose by close to 40¢ per bushel over the next two sessions (Chart 1).

The primary issue going forward will be the progress of South American planting. The weather problems we talked about in our last article on soybeans (see *Focus on Futures* September 15) persisted for a while. Brazil had too little rain and Argentina too much. More recently, Brazil received much needed precipitation. An October 16 USDA attaché report said that Argentinean planting would be delayed, but also indicated that it is early enough for late-planted crops to achieve full potential.

The USDA crop report left its forecast for South American crops unchanged from September, at 107 million tonnes for Brazil and 57 million tonnes for Argentina. That compares with 114.1 million tonnes and 57.8 million tonnes in 2016-17, respectively. For Brazil in particular, last year's weather was picture perfect, from planting through harvest – a tough act to follow. The USDA estimates are roughly in line with local private forecasts, so there has been some discounting for a late-planted crop.

Another potentially bullish factor: In our September 15 article we questioned the USDA's optimism regarding US exports. At the time, export commitments were running 28% behind the same time last year, while the USDA estimate for 2017-18 annual sales was 3% larger than final 2016-17 sales.

In the interim, US exporters have chalked up some very impressive overseas sales. Average weekly commitments over the past four weeks have been 1.7 million tonnes, putting exports only 17% behind last year. If the torrid pace continues, that gap will close rapidly.

We're marginally offside on our September 15 short-sale recommendation of January soybeans. Owing to the USDA's change of direction on yield outlook, uncertainty surrounding South American crops, and strong export sales, we advise covering short positions.

[Sholom Sanik, October 19, 2017]

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Chart 1 – January soybeans

Chart courtesy Reuters

COTTON

Burdensome global stockpile is now overstated

The USDA was widely expected to lower the estimate for 2017-18 US cotton output in its October crop report. There was considerable damage caused by Hurricane Harvey in Texas and to a lesser degree by Irma in Georgia. Market participants were waiting for some direction.

The revisions were minimal, though. The national yield was lowered to 889 pounds per acre, down from the September estimate of 908 pounds per acre, but remained higher than last year's 867 pounds per acre.

The harvest-to-planted ratio was lowered as well, to 90.41% from 91.2% in September. That amounted to a crop estimate of 21.12 million bales, down only 640,000 bales, or 3%, from the September estimate. The smaller-than-expected revision to the crop also kept intact the renaissance in US cotton production, which had sunk to 12.89 million bales in 2015-16 and improved to 17.17 million bales last year. Prices continued to droop, falling to two-month lows in the sessions that followed.

In the meantime, the more current weekly crop progress report showed that the good-to-excellent portion of the crop dropped two percentage points from the previous week, falling to a season low of 56%. In addition, with only 35% of the crop harvested, forecasts for cold temperatures in Texas raised fears of an early frost. So the jury is still out on final yields.

On the demand side, the USDA revised its forecast for US exports downwards from the September estimate by 400,000 bales, to 14.5 million bales. That compares with final sales of 14.92 million bales in 2016-17. In its notes accompanying the October crop report, the USDA cited "reduced U.S. production and strong competitor shipments." But we have an issue with this.

Thus far, 2017-18 export commitments stand at 8.09 million bales, compared with 5.85 million bales at this time last year. That's a 38% increase over last year compared with the USDA forecast for a drop of 2.8%. Last year, exports were very strong later in the season, so that gap will narrow. But it is still very impressive. We would have to experience a serious slump in US sales to meet the USDA's pessimism, which looks for no improvement in annual sales.

Furthermore, the USDA has maintained its Chinese ending-stock estimate at about 40 million tonnes for several months now. On the one hand we'll have to live with that massive number on the global balance sheet, which bloats the stocks-as-a-percentage-of-usage figure. On the other hand, though, it means that the government has not been selling cotton out of inventories any longer, most likely because the usable cotton has all been sold. Which brings us to a discussion of what we can expect from imports.

Chinese foreign purchases have tumbled by some 80% from their 24-million-bale peak in 2011-12. The USDA estimate for total Chinese imports from all sources has averaged 5 million bales over the past two seasons, and the forecast for 2017-18 is the same. That figure may be understated.

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Thus far this marketing year, US shipments plus outstanding sales to China stand at 1.566 million bales. That compares with only 697 million bales at this time last year. Final sales for 2016-17 were just over 2 million bales. So it's fair to say that Chinese buying is showing some signs of life.

We may never know how accurate the estimates of the size of the Chinese stockpile are or, for that matter, the quality of its contents. Production and consumption figures are far more concrete. An analysis will show that imports will have to grow.

While imports began to retreat in 2012-13, up until and including the 2014-15 season, a small production/consumption deficit was still handily filled with imports. Average output for the past two seasons was 22.4 million bales against average mill demand of 36.2 million bales. The USDA forecast for the current marketing year calls for production of 24.5 million bales and usage of 38.5 million bales. The government instituted its policy to liquidate the burdensome stockpile, which replaced imports to make up for the deficit. Imports continued to collapse.

So there has now been a production/consumption deficit for three consecutive years. If the remaining inventories are indeed stagnant, as we believe they are, China already has a material supply shortfall of quality cotton that can be used for manufacturing clothing for the export market. Sooner or later, China will have to start importing cotton in larger amounts to meet mill demand.

Maintain long positions as per our September 7 recommendation. Keep stops at 66¢ per pound, basis December, close only.

[By Sholom Sanik, October 27, 2017]

Chart 2 – December cotton

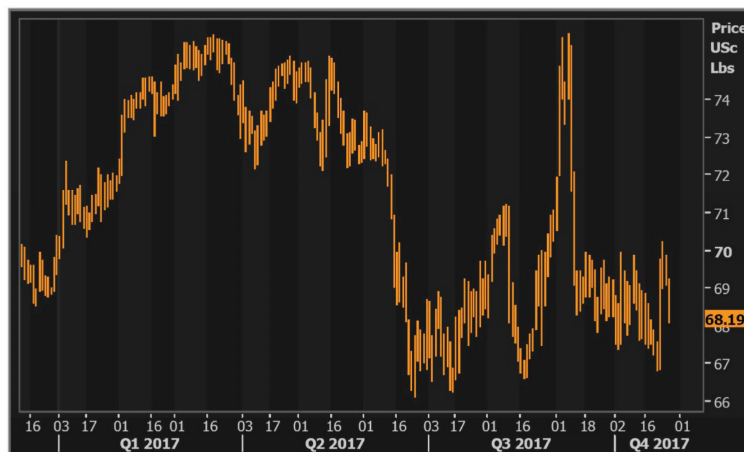

Chart courtesy Reuters

SUGAR

The bull reawakens

The sugar market has been absorbing ostensibly bearish news. Forecasts for a 2017-18 global production/consumption surplus have been swelling. One estimate recently put the surplus at close to 10 million tonnes. That compares with a deficit of about 2 million tonnes for the outgoing 2016-17 marketing year. In addition to the recovery in Indian output, production increases in the EU, Pakistan, and Thailand will account for the surplus.

Several developments lead us to believe that the anticipation of gargantuan surpluses are at least somewhat overstated.

Brazil

The ethanol/sugar ratio in Brazil has shifted towards ethanol. Earlier this season (see *Focus on Futures*, August 31) Brazil implemented a 20% tax on ethanol imports, which gave Brazilian cane-based ethanol production an immediate boost.

Furthermore, while it may take a bit longer to work its way through the system, crude oil prices have spiked to a two-and-a-half-year high. Crude prices are now trading at their highest level of the post bear market era, making ethanol more competitive as a motor fuel.

The ethanol/sugar ratio thus far this crushing season, which began in April, is still smaller than last year at this time. The most recent estimate puts the ratio at 52.08%/47.92%, compared with 53.49%/46.51% last year. However, consider the change from earlier in the season when the ratio was closer to 40%/60% in favor of sugar.

OPEC meets later this month in a bid to extend oil supply cuts through the end of 2018. If higher oil prices are the

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new paradigm for the energy markets, we could see the ratio swing all the way back to the 60%/40% levels we've seen in previous years. Expect 2017-18 Brazilian sugar output estimates to be revised lower in the coming months.

India

While there is nothing new here, we reiterate that the market is focusing on the 20% jump in Indian sugar output for 2017-18, but ignoring the production/consumption deficit of about 1 million tonnes. We've seen a wide range of estimates for 2016-17 ending stocks, but any way you look at it, inventories should be at modern-history lows. The deficit will only exacerbate the low inventory situation. This completely eliminates India as an exporter over the next 12 months. We've already seen the government relax import tariffs for a limited amount of sugar, and we're betting that this will continue throughout 2018 until the government is satisfied that stocks have reached a comfortable level.

China

Chinese imports have slowed down to a trickle as the government continues its destocking program. According to a recent USDA estimate, output will rise for a second consecutive season, to 10.5 million tonnes. The problem is that demand has grown to 15.8 million tonnes. The mammoth production/consumption deficit can be filled from inventories to a point. Eventually Chinese imports will need to increase.

Summary

Prices have been moving mostly sideways since June. As depicted in Chart 4, commodity funds have been unwinding their long positions for a year now, but more recently have been hopping on to the short side.

We believe that market participants have been working on the assumption that the fundamental picture is bearish because of the looming 2017-18 global surplus and that the surplus does not have a home.

However, as illustrated, the surplus should be considerably smaller than current estimates mainly because of diversion of more Brazilian cane to ethanol. In addition, both India and China will almost certainly import more sugar than the market believes they will. A short-covering rally is just around the corner.

Remain long March 16¢ calls.

[By Sholom Sanik, November 8, 2017]

Chart 3 – March sugar

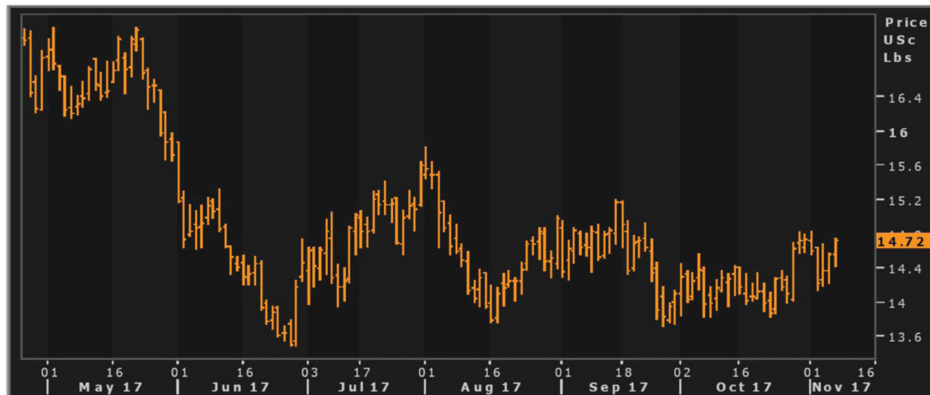

Chart courtesy Reuters

Chart 4 – Sugar: Commodity fund net position

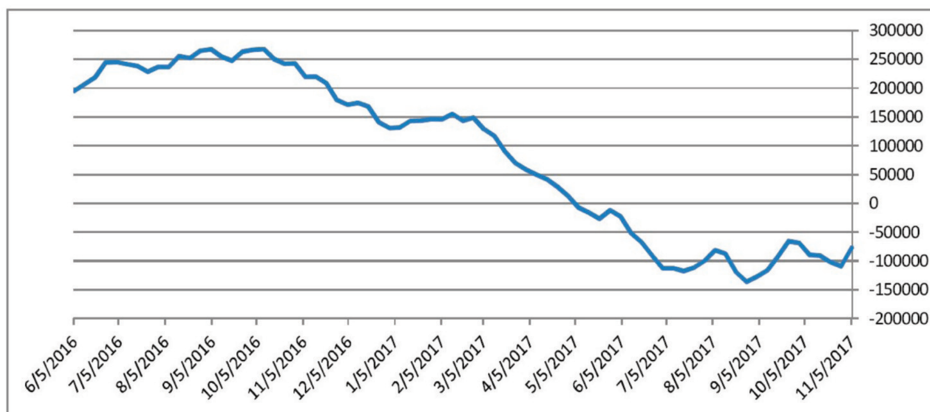

Chart source: Reuters

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COCOA

The bear gives way to the bull

Cocoa prices peaked at over $3,400 per tonne two years ago. By the time the market bottomed this past summer, prices had shed half their value -- a justified bear market from both the supply and demand sides. The Ivory Coast, the world's top producer, grew a record 2 million tonnes of beans in the just-ended 2016-17 marketing year, surpassing the previous record by 10%. Furthermore, product prices followed bean prices lower, leaving processors with little incentive to increase bean purchases.

As we look forward, those dynamics are now ancient history.

It is very early in the season, but port arrivals in the Ivory Coast are already lagging last year's pace. As of the most recent figures available, arrivals were 283,000 tonnes compared with 311,000 last year at this time. Although it's premature to draw any conclusions, one analyst points out that at the current pace, arrivals should reach 830,000 tonnes by the end of the calendar year, down from 938,000 last year.

It's important to get a good start on the crop in terms of building subsoil moisture before dry weather that results from the Harmattan winds sets in. The dry season extends from the end of November through mid-March and can determine the health of the tail end of the maincrop and the subsequent mid-crop. Weather reports thus far have been mixed, but if the budding rally is any indication, we'd say the weather has not been ideal.

One fallout of a bumper crop is that the resulting low prices leave farmers with smaller incomes and with less money and incentive to apply fertilizer. So a smaller crop in 2017-18 is a near certainty.

With a global production/consumption surplus of about 300,000 tonnes and a carryover equal to 41% of usage, there should be no immediate threat of sharply rising prices from a supply-side glitch. *However*, for the first time in the longest time, demand-side diagnostics are looking healthier.

The latest set of grinding statistics released in October for the third-quarter continued to show sluggish demand for beans by processors. European grindings were up 3% year-over-year. North America eked out a small gain of 0.68%. Asia was up 12.9%, but that was not a surprise, because it is part of the pattern of a shift of grinding to origin countries.

What is new is that product prices have shown some signs of life. The butter ratio has jumped to 3.45 times the price of London spot prices. We have not seen the ratio that high since 2007 (Chart 6). Powder prices are still depressed in historical terms, but have moved off their lows as well. The combined butter-powder ratio has moved to multi-year highs (Chart 7). If these ratios hold up, we can expect to see a material increase in processing, which would lower the current burdensome global stockpile.

Chart 8 shows that commodity funds built the largest short position in over a decade and that they are now in the process of unwinding that position. That's the first leg of this rally. If West African weather is not cooperative and our assumption that we should see a noticeable uptick in grindings is accurate, a bull market is born.

Establish long positions in ICE March cocoa. Place initial stops at $1,950 per tonne, close only.

[By Sholom Sanik, November 14, 2017]

Chart 5 – Weekly nearest contract ICE cocoa

Chart: courtesy Reuters

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Chart 6 – Butter ratio

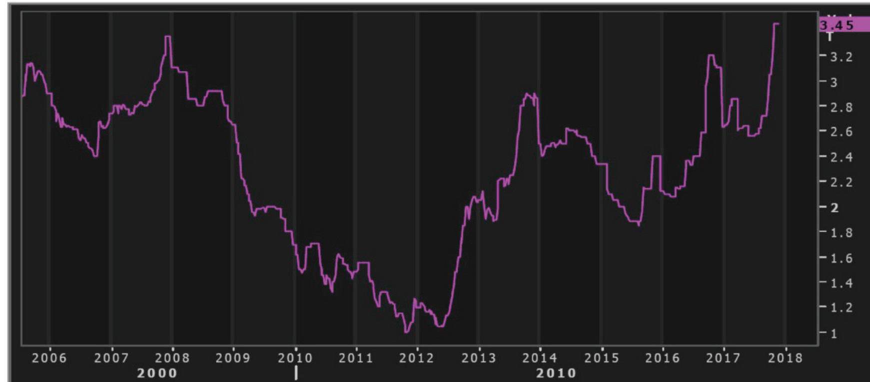

Chart: courtesy Reuters

Chart 7 – Combined cocoa butter/powder ratio

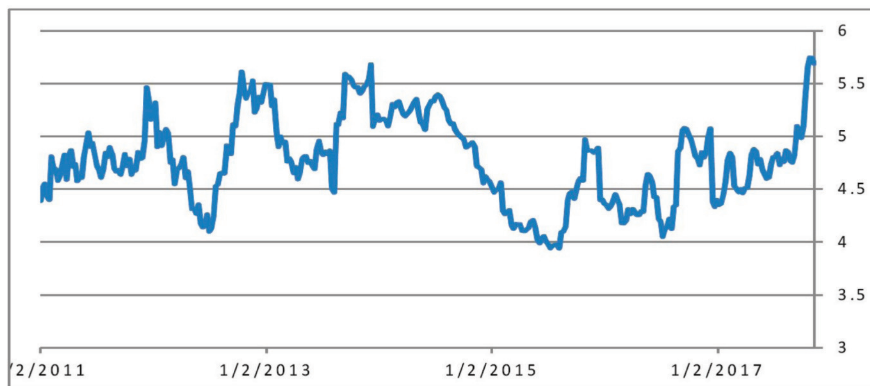

Chart source: Reuters

Chart 8 – Cocoa: CFTC commodity fund net position

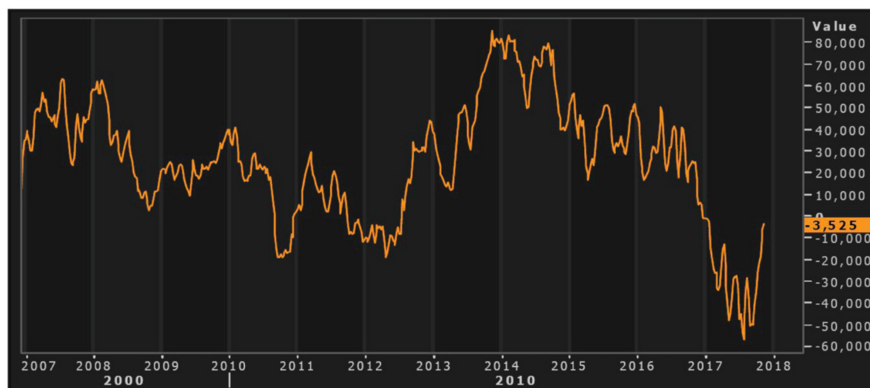

Chart: courtesy Reuters

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