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Cocoa: are supply disruptions in the Ivory Coast temporary?

Last month we presented a series of bearish arguments for the cocoa market: 1) Large crops are expected in West Africa, supplier of about 40% of the world's cocoa beans; 2) quarterly grinding data have shown only moderate increases; 3) and finally, the fear premium attached to prices would fade over time, because two successive bumper crops were produced in the Ivory Coast despite the rampant chaos that has plagued the country. This has inspired some measure of confidence among market participants that cocoa will continue to flow even during flare-ups.

Illogical as it may have seemed at the time, we nevertheless took a long position, because we believe that the spike in cocoa butter prices is a precursor to explosive bean demand.

The confidence acquired over the past six months regarding the situation in the Ivory Coast, however, was short-lived. On November 4 our position got an unexpected boost when Ivorian government forces attacked not only rebel forces, but launched an assault on French government troops as well. The clashes and rioting that followed were arguably the fiercest we've seen since the conflict began in September 2002 and almost certainly has had the most direct impact on supply.

This is the first time that we've actually had a breakdown in the infrastructure that moves beans off the plantations and on to the ports. European grinders shuttered their facilities, and the ports were closed. Virtually all exports ground to a halt and did not resume until November 11, and then only in limited quantities.

Aside from the obvious short-term tightness that was created, beans that linger on farms and trucks easily attract mold when they are not stored properly, thus compromising quality.

The mayhem has died down, but the need for a fear premium has resurfaced. We're smack in the middle of the holiday buying season for European processors, and the availability of fresh bean supplies that they count on at this time of year has – at the very least – been slowed down. It will take several months to see if the pace of port arrival figures will accelerate to achieve the optimistic output that current 2004-05 global supply/demand balance estimates are based on.

The rebels, who control the north of the country, are separated from government forces in the south by a UN ceasefire line. For the most part, the port cities Abidjan and San Pedro, which are in the south, were not involved in the conflict until this latest round of unrest began. Now, citizens loyal to the rebel cause have engaged in rioting in the two port cities, targeting primarily French nationals.

The country is a powder keg, and chocolate manufacturers are now more cognizant than ever that 40% of their supplies could be in jeopardy. Just as a starting point, we expect prices to retain a hefty premium, at least until a significant amount of beans has arrived at one of the two Ivorian ports and is safely out to sea.

Another issue, which has not received much attention but which adds to the uncertainty in the Ivory Coast, is the country's general financial situation. On November 3, the World Bank suspended financial assistance to the Ivory Coast because it has been delinquent in its payments. The Ivorian government does not subsidize cocoa farmers, so this should not immediately affect farmers' ability to purchase fertilizer and other crop maintenance materials. It would be reasonable to assume, however, that the country's transportation infra-

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structure, vital in moving beans from the bush to the ports, will be affected.

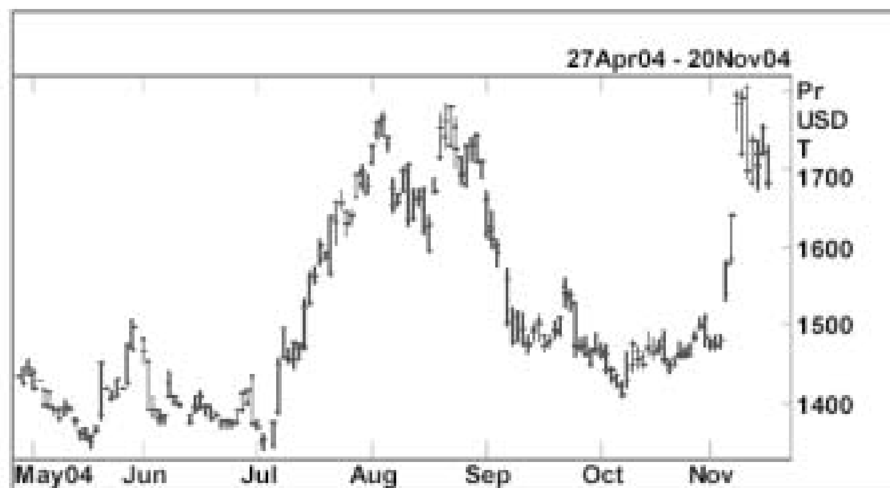
Spot butter ratios in Europe are holding steady at their record highs and were last seen at 3.55 times London, compared with 3 just one month ago.

As far as how this mess is going to affect the global 2004-05 supply/demand balance, it is far too early to talk about numbers. There are many variables. What we do know is that the vulnerability of Ivorian supplies has been exposed. The global output balance could swing by about 100,000 tonnes, wiping out any anticipated surplus. This would be achieved with Ivorian output falling by 5% from last season and our belief that butter demand will ultimately translate into increased grindings, say, growing by a still modest 5% rate instead of the expected 3%.

We took a long position because we expected latent demand for beans to surface. While the initial success of this trade was driven by the outbreak of civil strife, it is not as if this is a wholly unrelated matter. We therefore chose not to treat the sudden spike as a windfall but have merely tightened our stop in the belief that current market conditions could easily drive cocoa prices back to the 2002 highs of $2,400 per tonne. *[Nov. 16, 2004]*

CURRENT STRATEGY: *Remain long March cocoa as per Flash Update of Nov. 23. Raise stops to 1525, close only.*

Chart 1 – March cocoa



SUGAR

Indian buying just around the corner

After touching three-and-half-year highs back in October, sugar prices took a sharp 1¢-per-pound dive. The reasons for the correction were not obvious in terms of any known change in the supply/demand fundamentals. All major analysts were still forecasting a deficit for the 2004-05 marketing year. The selloff in crude oil prices was certainly a potential culprit. With ethanol usage on the rise on the back of skyrocketing petroleum prices, it was not much of a stretch to expect some skepticism about a softening in the ethanol theory. With open interest at record levels and speculators heavily net-long, the story was plausible enough to trigger a setback.

After the fact, all the major sugar analysts revised their forecasts for 2004-05 to reflect a smaller deficit or balanced market, with a larger-than-expected Brazilian crop being the key factor in the change.

The first revision was released by F.O. Licht on October 28 when 60% of the correction had already taken place. Licht changed its estimate from a 2- to 3-million-tonne deficit to a forecast for a balanced market. On November 5, Kingsman slashed its deficit forecast by more than 2 million tonnes, to 4 million tonnes. And on November 12 the International Sugar Organization cut its deficit by 1 million tonnes, to 1.8 million tonnes, while Czarnikow weighed in with a largely insignificant revision for a deficit of 4.78 million tonnes, a tad below its previous forecast of 4.85 million tonnes.

In the September 3 issue of *Focus on Futures*, we outlined the dramatic changes experienced in the Indian sugar market. Reduced planting area and two successive crop failures have left the once amply-supplied country with very serious production/consumption deficits. Output for 2003-04 is now estimated at 13.8 million tonnes, the low end of the

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estimate range. This compares with crops of better than 20 million tonnes in previous years. Forecasts for the 2004-05 crop are even smaller at 13 million tonnes. With consumption in the 19-million-tonne neighborhood (a conservative estimate), the once burdensome stockpile of sugar in India is dwindling.

A recent government estimate puts October 1 stocks – the beginning of the Indian marketing year – at 8 million tonnes. Even if we're to assume that consumption remains steady or that some rationing process were to unfold, inventories will be run down significantly. Press reports have indicated that India has not yet been very active in the import market, because it is looking for prices to fall below 8¢ per pound, but will eventually be looking to purchase 2 million tonnes during the 2004-05 marketing year. If this was the case, and Indian purchasers were indeed to confine themselves to these quantity and price-target parameters, they might muddle through this season and hope for a better crop next year.

We, however, do not believe that this is the most likely scenario. Available supply for 2004-05 will be 21 million tonnes (new crop output of 13 million tonnes and beginning stocks of 8 million tonnes). Consumption of 19 million tonnes would leave ending stocks of 2 million tonnes. We don't know how central planners will decide to deal with the shortfall. They may allow stocks to be drawn down to dangerously low levels. On the other hand, they may not find that to be an acceptable approach, because this would then require substantial purchases, perhaps double the street estimate of 2 million tonnes.

So while the analysts have indeed revised their estimates to reflect an improvement in the global balance sheet, their forecasts are based on the assumption of a limited Indian presence in world trade.

The extent of the impact of ethanol consumption on the market is not clear. Despite a sharp drop, petroleum prices are well above historical norms and, very likely, still make ethanol a competitive alternative, perhaps even with crude oil at $40 per barrel.

The market has held extremely well and for the moment seems to be in the process of working off a very overbought situation without a further plunge in price. We remain comfortably long. *[Nov. 26, 2004]*

STRATEGY: *Remain long March sugar as per Flash Update of November 12. Maintain initial stops at 815, close only.*

SOYBEANS

Soybean rust invades the US. Should we be concerned?

In recent weeks, the attention of soybean traders has been concentrated on the first incidence of soybean rust to reach the US. The powerful winds of this year's hurricanes blew spores northward from Latin America. Before the news broke, January beans were struggling to stay above the $5-per-bushel mark. As the rust story developed, the market rallied 60¢ per bushel, but has now retraced half the move. How serious is the threat from rust, and what other issues can drive this market in the coming months?

To be sure, when rust does strike, it is devastating. Yields can be reduced by as much as 80%. After the initial news reports broke – and indeed, it was news – the rationalization process began. Both government and private groups made statements assuring the public that ample supplies of fungicide are available to combat the disease. In addition, there was talk about the spores not being able to survive the freezing temperatures of a Midwestern winter, where a vast majority of US soybeans are grown.

In fact, less than 10% of the soybean crop grows in the southern-most states, where crops would be most vulnerable. A serious outbreak resulting in substantial losses only in the south would create a noticeable – but not an overwhelming – dent in the total US supply/demand balance. For example, just using the 2004-05 crop loosely as a base, a 25% yield loss in the south – which is not unrealistic if the disease is not controlled – would trim the total crop by about 2% and ending stocks by about 60 million bushels. If all else goes right with the 2005-06 crop and demand remains fairly steady, a loss of this magnitude is not serious.

While we don't want to be alarmists, the matter should not be easily dismissed either. If there were an outbreak of rust, and it did move into the primary growing areas further north, the example we presented would be a best-case scenario.

Most intriguing though, is that the scare is likely to manifest itself in a bullish way even if there is not a single US soybean farm affected by rust. It is almost a given that farmers will be exercising caution in situations where they can plant corn or cotton as an alternative to soybeans.

It will be several months before we get anything close to an accurate estimate of how much acreage will be affected, but we have seen some predictions. The range of estimates is fairly wide, with analysts looking for anywhere from 1 to 5 million fewer acres planted than in 2004-05. A 5-million-acre reduction would lower the total US crop by close to 7%.

Aside from the rust scare and the fact that prices have fallen by more than $5 per bushel from their $10-per-bushel highs, there is not very much else we can point to on the bullish side. In the November supply/demand situation report, the USDA lowered its forecast for US exports by 410,000 tonnes from last month's report, to 27.49 million tonnes. As a result of this revision and some other changes from last month's report, the estimate for global ending stocks will grow to

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61.4 million tonnes (29.6% of consumption), compared with the October estimate of 59.25 million tonnes (28.5% of consumption) and 2003-04 ending stocks of 39.11 million tonnes (20.5% of consumption).

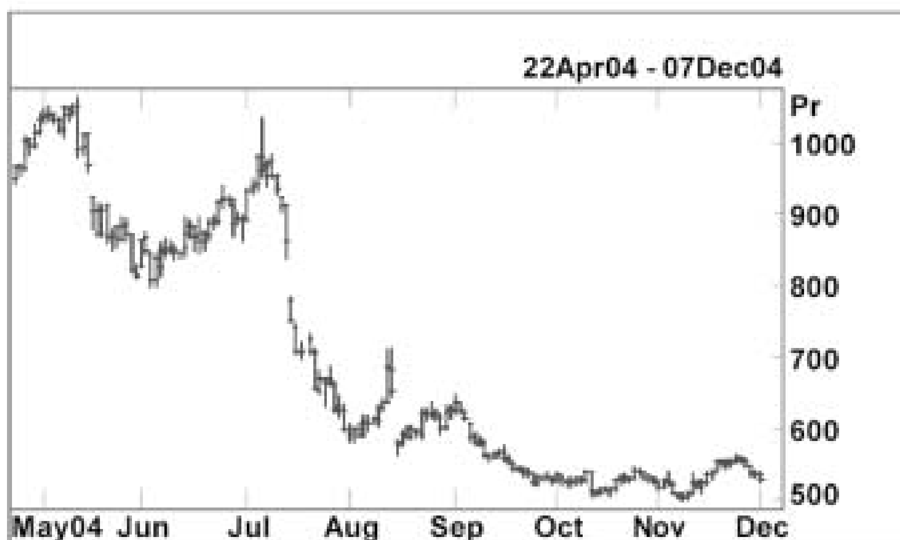
Even with the downward revision to US exports, the USDA estimate is looking for exports to grow by close to 3.5 million tonnes over 2003-04. While it is early in the season, a glance at the current pace of export commitments shows that the feat of achieving the USDA target will be a formidable challenge. As of the most recent weekly export report, US farmers have contracted to sell only 15.7 million tonnes of beans, compared with 18.7 million tonnes at this point last season.

Still, there's a good possibility that the strong demand we saw over the past several years will return and that lost ground will be quickly recovered. Consumption ground to a halt when credit conditions in China tightened near the end of the 2003-04 marketing year, but growing hog and broiler populations in Asia need to be fed. As such, purchasing from China and other Asian countries cannot remain stagnant for too much longer.

We anticipate that prices will be contained in the $5- to $6-per-bushel range for the moment. Certainly, the way the balance sheet looks now, we cannot see the market building very much on the "rust rally." On the other hand, we also believe that the market has set its lows at $5 per bushel when considering that the market has already fallen substantially, the chance that rust will bring smaller crops in 2005-06, and the possibility of a recovery in demand. We'd rather be long than short, but only at the right price. *[Dec. 2, 2004]*

STRATEGY: *Remain sidelined.*

Chart 2 – Nearest contract soybeans



COTTON

Record US and Chinese crops can't seem to break the market, for now

We happen to be long cotton. After absorbing the bearish case we're about to present, some readers may be confused. Rightfully so, but it isn't really much of an enigma.

The direction of this market has tracked the changes in supply/demand fundamentals rather closely. First, there was the monstrous bull run to 85¢ per pound on the 2003-04 Chinese crop failure, which was accompanied by record demand for US exports. Then, farmers in the US and China, enticed by the profitability offered by those high prices, planted enormous crops. To be sure, many hedged their planting intentions at very favorable prices, but the large crops have caused prices to plunge.

While usage is expected to continue to rise, it will be dwarfed by the increase in output. The hurricane scare in the southern US states was just that – a scare. In its November supply/demand situation report, the USDA *raised* its estimate for the 2004-05 US crop unexpectedly by1 million bales, to a record 22.54 million bales, blowing it right past the previous record crop of 20.3 million bales we saw in 2001-02.

The jump in global output over last season is extraordi-

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nary. The leap in US production combined with small increases in virtually all major exporting countries pushed the estimate for global production up by 2.05 million bales from the October report, to 111.72 million bales. This compares with 94.72 million bales in 2003-04, a 17-million-bale, or 18%, increase! Global consumption was increased from the previous estimate by 1.53 million bales to 102.93 million bales, a substantial 4.42-million-bale, or 4.5%, increase over 2003-04 usage, but pales when compared with the explosion in output.

Global ending stocks for 2004-5 will climb to 44.95 million bales, or 43.28% of consumption, up from 41.95 million bales, or 41.4% of consumption in October. This compares with last year's ending stocks of 35.49 million bales, or 36% of consumption.

This week's export commitments of 220,000 bales came in at the high end of analysts' expectations, but overall we're behind last year's pace. The USDA is forecasting annual sales of 12.5 million bales, down 9.2% from 2003-04. Commitments to date are running 11.3% behind this time last year.

True, it's early enough in the marketing year for exports to improve, but we can't think of any reason why exports would rebound enough to create a material change in the global supply/demand balance.

China is the single largest customer for imported cotton. In 2003-04 it had a 10-million-bale production/consumption deficit. For this season, the USDA estimates a 4-million-bale increase in Chinese consumption, but a 7.2-million-bale increase in output. While it will still run a deficit, the gap will shrink to 6.5 million bales. The USDA has adjusted Chinese import needs down by only 1.08 million bales from last year, but current data support the modest revision.

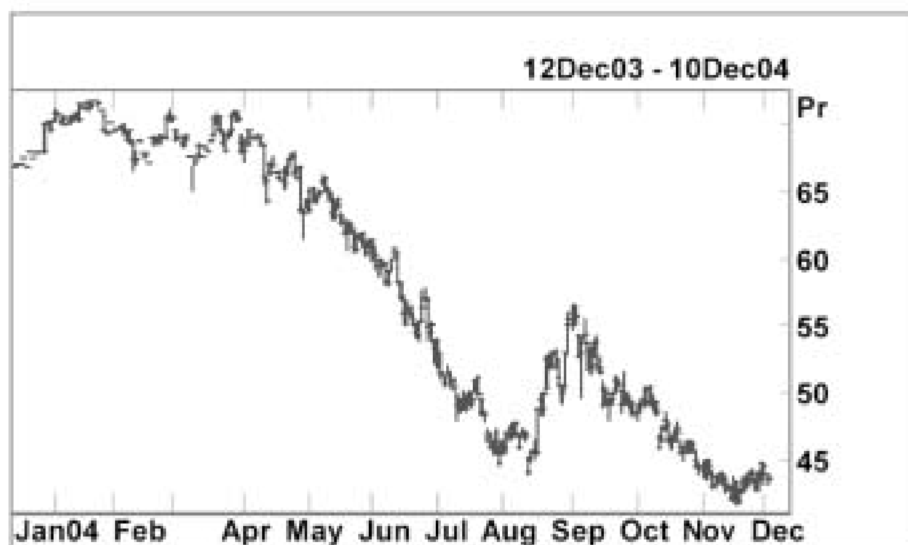
The Chinese have bought 592,000 bales so far this year from the US, compared with 365,000 bales at this time last year. Last year China bought 4.6 million bales from the US, and the comparison with last year shows that most of the buying comes later in the season. Still, it is unlikely for Chinese purchases to surprise on the upside, given the availability of their record 29.5-million-bale crop.

So why are we long? The lows in March cotton were made in the days following the release of the very bearish November USDA report. Although the USDA data were clearly a surprise to traders, it seems that the news was "in the market."

Speculators are heavily short. Typically, we like to follow the activity of the allegedly knowledgeable commercial traders. Well, this has not been a winning formula over the past year or so for cotton bulls. For the most part, commercials have been long while speculators have been short, at least according to the CFTC data. Following commercial activity during this period could only have shown disastrous trading results. Nevertheless, there should be a point at which there is a significant short-covering rally. Recent market action in conjunction with a careful reading of the open interest seems to indicate that we're right around the corner from such an event. *[Dec. 3, 2004]*

STRATEGY: *Remain long March cotton as per Flash Update of November 23. Maintain stops at 41.50, close only.*

Chart 3 – March cotton



Courtesy Reuters

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HOTLINE UPDATE

***Flash Update* – Thursday, November 4, 2004:**
Good afternoon for Thursday, November 4, 1:00 pm. This is a Flash Update. We have sold short March silver at 7.42, placing our initial stop at 7.55, close only.

Friday, November 5, 2004:
Good afternoon for Friday, November 5, 4:50 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On November 4, we sold short March silver at 7.42.

We are currently long December corn at 203.75, with our stop at 196; long March cocoa at 1472, with our stop revised to 1542; short March sugar at 8.72, with our stop at 9.08; and short March silver at 7.42, with our initial stop at 7.55. All stops are close only.

***Flash Update* – Monday, November 8, 2004:**
Good morning for Monday, November 8, 10:35 am. This is a Flash Update. We have covered our short March silver position at 7.56.

***Flash Update* – Tuesday, November 9, 2004:**
Good morning for Monday, November 9, 10:35 am. This is a Flash Update. We have covered our short March sugar position at 8.56.

Friday, November 12, 2004:
Good morning for Friday, November 12, 9:20 am. This is a Flash Update. We have purchased March sugar at 8.60, placing our initial stop at 8.15.

Friday, November 12, 2004:
Good afternoon for Friday, November 12, 4:50 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On November 8, we covered our short March silver position at 7.56. On November 9, we covered our short March sugar position at 8.56. On November 12, we purchased March sugar at 8.60.

We are currently long December corn at 203.75, with our stop at 196; long March cocoa at 1472, with our stop at 1542; and long March sugar at 8.60, with our initial stop at 8.15. All stops are close only.

***Flash Update* – Wednesday, November 17, 2004:**
Good morning for Wednesday, November 17, 9:20 am. This is a Flash Update. We have liquidated our long March cocoa position at 1647.

Friday, November 19, 2004:
Good afternoon for Friday, November 19, 4:10 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On November 17, we liquidated our long March cocoa position at 1647.

We are currently long December corn at 203.75, with our stop at 196, and long March sugar at 8.60, with our stop at 8.15. All stops are close only.

***Flash Update* – Monday, November 22, 2004:**
Good morning for Monday, November 22, 9:45 am. This is a Flash Update. We have sold short December mini S&P at 1171.50, placing our initial stop at 1190, close only.

***Flash Update* – Monday, November 22, 2004:**
Good afternoon for Monday, November 22, 12:05 pm. This is a Flash Update. We have sold short December T-bonds at 111-30, placing our initial stop at 113-03. We repeat our Flash Update from earlier today where we sold short December mini S&P at 1171.50, placing our initial stop at 1190, close only.

***Flash Update* – Tuesday, November 23, 2004:**
Good morning for Tuesday, November 23, 9:05 am. This is a Flash Update. We have purchased March cocoa at 1586, placing our initial stop at 1450, close only.

***Flash Update* – Tuesday, November 23, 2004:**
Good morning for Tuesday, November 23, 10:45 am. This is a Flash Update. We have purchased March cotton at 44.15, placing our initial stop at 41.50, close only. We repeat our Flash Update from earlier today where we purchased March cocoa at 1586, placing our initial stop at 1450, close only.

Friday, November 26, 2004:
Good afternoon for Friday, November 26, 2:05 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On November 22, we sold short December mini S&P at 1171.50, and sold short March T-bonds at 111-30. On November 23, we purchased March cocoa at 1586, and purchased March cotton at 44.15.

We are currently long December corn at 203.75, with our stop at 196; long March sugar at 8.60, with our stop at 8.15; short December mini S&P at 1171.50, with our initial stop at 1190; short US T-bonds at 111-30, with our initial stop at 113-03; long March cocoa at 1586, with our initial stop at 1450; and long March cotton at 44.15, with our initial stop at 41.50. All stops are close only.

***Flash Update* – Monday, November 29, 2004:**
Good morning for Monday, November 29, 10:45 am. This is a Flash Update. We have liquidated our long December corn position at 195.

***Flash Update* – Wednesday, December 1, 2004:**
Good afternoon for Wednesday, December 1, 12:45 pm. This is a Flash Update. We have covered our short December mini S&P position at 1190.

Friday, December 3, 2004:
Good afternoon for Friday, December 3, 4:05 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On November 29, we liquidated our long December corn position at 195. On December 1, we covered our short December mini S&P position at 1190.

We are currently long March sugar at 8.60, with our stop at 8.15; short US T-bonds at 111-30, with our stop at 113-03; long March cocoa at 1586, with our stop revised to 1525; and long March cotton at 44.15, with our stop at 41.50. All stops are close only.

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