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Sugar output falls victim to ethanol...and grain

On September 25 the Sugar Cane Industry Association, a Brazilian trade group, released a report on the cane crush in the center-south region (where 90% of Brazilian sugar is grown). The headline made sugar bears smile – but not for long. Brazilian crushers processed 317 million tonnes of cane, up 8.5% from the same time last year. The allocation, however, reinforces the argument we've been making all along: Sugar output was 16.9 million tonnes, down 4% from last year, while ethanol output was 15.1 billion liters, 15% above last year's level.

Actually, this was not really big news. In fact, as the season progressed, ethanol production as a percentage of the total cane crop slipped from an estimated high of about 62.5%, to the current 59.5%, but that too was expected. The point is that it provides an illustration of the stark reality that output from the single largest supplier of sugar to world trade is in decline. It's been several years since the sugar/ethanol ratio was completely reversed in favor of sugar.

While we haven't written off growth of the corn-based ethanol market in the US, there are certainly challenges. In the US the rate of growth of ethanol production has contracted because of slim profit margins and because consumption is not as well entrenched at the consumer level. Unprofitable ethanol plants are closing, and there is speculation that the USDA has overestimated the portion of the corn crop that will be devoted to ethanol.

In Brazil, on the other hand, the dynamics of the market are far different. Close to 90% of new cars sold are flex-fuel, which allows consumers to use any combination of petroleum and ethanol. The government mandates minimum ethanol consumption that has been fluctuating between 20% and 25% over the past several years. As long as the cost to consumers remains at the present level of roughly 60% to 70% of petroleum, we can be sure that ethanol consumption will continue to grow. Recent press reports quoted local analysts who were throwing around some futuristic forecasts of demand tripling over the next decade. It may be premature for those kinds of predictions, but it is quite clear that ethanol demand in Brazil has yet to plateau, and it will obviously come at the expense of sugar output.

Export demand continues to grow as well. Foreign sales are estimated at 4.2 billion liters in 2008, up 20% from last year.

The effects of low world sugar prices in an environment of high prices for competing cash crops has come full circle in India. As the 2008-09 crushing season begins, estimates for new-crop output have fallen to 20 million tonnes, down from earlier estimates of 22 million tonnes, and down dramatically from 2007-08 output of 27 million tonnes. The government has been quick to repeal the freight subsidy for overseas sales it implemented when inventories were burdensome.

The sugar market in neighboring Pakistan saw the same pattern. It is normally close to self sufficient in sugar and imports only about 100,000 tonnes per year. High grain prices ensured that enough sugar acres were lost for output to drop by close to 1 million tonnes, to 3.7 million tonnes. Several weeks ago analysts were saying that Pakistani stocks were sufficient to carry the country's needs through the year. Now we're hearing that Pakistan may import close to 1 million tonnes.

Chinese output is flat as well, but consumption is estimated to grow by over 1 million tonnes, to 15.4 million tonnes.

The global balance sheet is expected to swing from a 10-million-tonne surplus to a 4-million-tonne deficit. Not that this will make much of a dent in carryover stocks – at least statistically speaking, that is.

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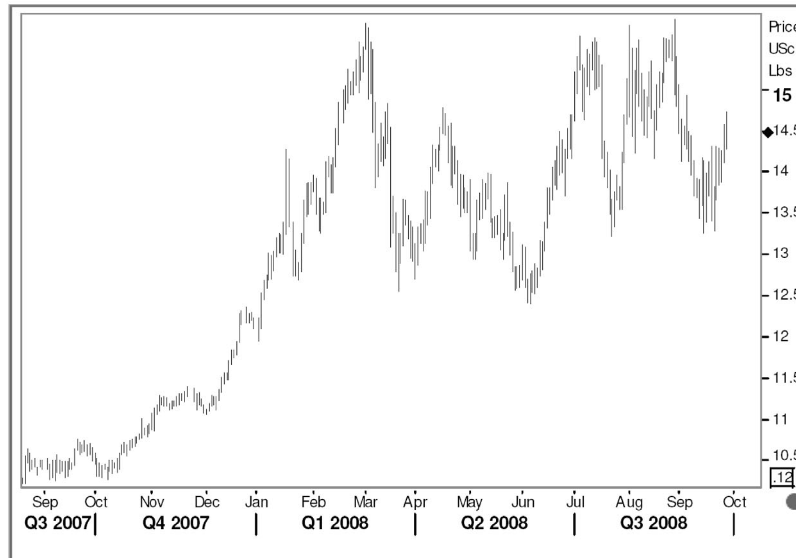
Judging this market by global ending stocks statistics is not very inspiring for bulls, especially when compared with standards of other markets. Estimates of supply and demand published by the few statisticians that cover this market vary, but we calculated that 2007-08 ending stocks were roughly 52% of usage, and with the fresh estimates for the new crops, that number would drop to only 48% because of the already high stocks. However, we believe that the focus should be on which countries can compensate for the large volumes lost by Brazil and India. For example, India exported 4.5 million tonnes in 2007-08, and current estimates are for sales to drop to below 1 million tonnes in 2008-09. Thailand is expected to step in, but it already exports two thirds of its crop, and if it sold all its inventories, it still would not compensate for lost Indian exports.

This market is tightening and when (if?) we get through the random selling of securities tied to the financial mess in the US, we believe that this market will take off and challenge the 19¢-per-pound highs set in February 2006.

Tough it out. Stay long. *[September 29, 2008]*

Chart 1 – March sugar



Courtesy Reuters

COTTON

Is demand really falling as fast as plummeting prices seem to indicate?

Cotton prices have now fallen by more than 50% from their spike top back in March. The powerful bull run that brought prices near $1 per bushel was driven by a slide in global cotton-acreage and was assisted in no small part by the broad bull market in commodities.

The implosion of the sub-prime mortgage market that ensued eventually triggered a collapse of commodity prices, and no market was spared the carnage. Even gold, which – for awhile – appeared to defy the massive onslaught, eventually succumbed to the ravages of the merciless liquidation.

There are two explanations for falling commodity prices. First, to a degree, the reckless selling was not necessarily connected to supply/demand fundamentals of cotton or any other commodity. Individual investors and large funds alike were pressured to sell holdings of any and all classes of investments because they needed to raise cash in a hurry to avoid margin calls.

The first reason may have exaggerated the real underlying cause, but we cannot attribute everything to reckless dumping. Concern over falling consumption of goods and services has become a reality.

Our task, then, is to sift through the data and attempt to ascertain which commodities have fallen "too far" in terms of their cost of production and which may still have further to fall. If profit margins have become too slim or indeed nonexistent, we would be setting the stage for new bull markets. On the other hand, some irrational moves that occurred during the multi-year commodity bull market may have left some

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markets still overvalued and significantly above the cost of production, which would certainly facilitate overproduction and a resulting glut. This should serve as an introduction to our discussion on cotton, as well as for articles to be published over the next few weeks on all the commodities that we follow.

After a surge in production in 2004-05, world output stagnated, hovering between 118 and 122 million bales. This season, mainly because of a steep plunge in US acreage, world production fell to 113.7 million bales. The other major producers, China, India, and Pakistan, did not compensate.

Early in the 2008-09 season, when world demand was forecast to maintain the pace of recent years and after it became clear that US production would be down sharply, global ending stocks were forecast to fall to as low as 42% of usage. This may not seem low, but for cotton, it is bull market territory. The 2003 bull market was achieved with a global carryover of 45% of consumption. But demand estimates have been falling consistently. With the release of the October USDA supply/demand situation report, the forecast for global demand had fallen by 5 million bales, or about 4%, from early-season estimates, bringing the stocks-to-usage ratio back to 45% – still not that bearish in historical terms, but enough to keep the selling pressure on.

The statistical picture is mixed in terms of supporting ideas that demand will fall. The October estimate for US exports was reduced by a rather significant 1.5 million bales from the September estimate, to 13 million bales, down from 13.65 million bales exported in 2007-08. Weekly export commitment figures, however, show that with sales-to-date of 6.5 million bales, we are still 8% out in front of last year's pace. While the last few weeks had very respectable average new sales of about 300,000 bales, the most recent report may have indicated that the buying has dried up, with a paltry 58,000 bales sold. Actual shipments are lagging last season by 12%.

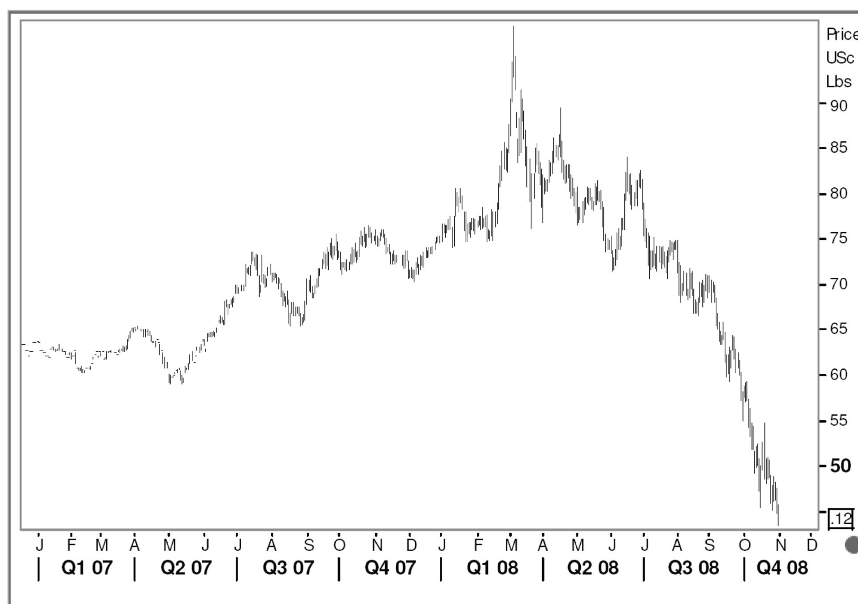
US domestic demand is estimated to fall 4% from last year. The monthly average for the Census Bureau figure for factory consumption over the past 6 months is perfectly consistent with this forecast. This, however, is not a bearish indicator. US cotton consumption has been falling for many years, because the manufacturing base has shifted to lower-cost regions in developing nations. The lost consumption has shifted to the export side, and the cotton comes back to the US in the form of finished goods. As a matter of fact, this year's drop in mill demand is rather modest when compared with the previous two seasons.

The only real issue that supports falling demand is the slowdown in shipments. It is possible that financing is an issue, and when credit begins to flow through the system again, the shipment pace will pick up. After all, for the most part, the commitment data indicate that interested buyers do exist.

As prices continue to make new lows, we are only perpetuating the supply problem that caused acreage to shrink in the first place. While the prices of many competing crops have fallen dramatically, they still remain at levels above historical norm, which continues to make them far more profitable to grow than cotton.

Try to hang on if you're long. *[October 31, 2008]*

Chart 2 – December cotton



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SOYBEANS

Prices find support in foreign buying

The soybean market has followed the pattern of most other commodities. Plunge, plunge, plunge, with the fantastic bull market gains all but gone. Prices have moved back into the pre-bull market range, but we're still on the high side in terms of modern-historical ranges (Chart 3).

While market activity seems to be much the same as it is in many of the other markets that we trade, closer inspection shows a slight nuance that sets soybeans apart. The past two weeks or so have seen a bit of stability in the form of some consolidation for many commodities. The CRB was up on the week for the first time since the end of September (Chart 4). The difference that we noticed for soybeans is that the market has not made a new low since October 16, even while open interest continued to fall, an indication, perhaps, that the long liquidation has not let up but no longer has the strength to push prices lower. The pattern is identical for soymeal (Chart 5). Funds are still net long 20,000 contracts of beans, but this past week's CFTC data show that they continued to liquidate over the period that the market has been inching up off the recent low.

While this is hardly enough to formulate a solid bullish case in what has turned into a bear market for commodities, it does draw our attention.

Aside from the heavy liquidation that has plagued every market, the soybean market certainly has undergone sufficient developments to warrant the perception that the historic rise to $16.50 per bushel was ridiculous. The 2008-09 US crop is almost completely harvested. It is far from a record, but is over 10% larger than last season. Both Brazil and Argentina are slated to grow record crops. Early estimates are for Brazilian output of 62.5 million tonnes, compared with 61 million tonnes this past season, and a huge jump for Argentina, from 46.5 million tonnes to 50.5 million tonnes. All told, the global crop is forecast to reach a record 239.43 million tonnes, compared with 220.39 million tonnes in 2007-08, and breaking the previous record of 236.56 million tonnes in 2005-06.

Global consumption is forecast to jump to 236.76 million tonnes, which would be a record as well. On the surface it would seem that after last year's production/consumption deficit, the large increase in supplies is accomplishing little to replenish world inventories. Prices are falling nonetheless, because the market is very skeptical about achieving these demand numbers.

On October 28 the USDA took the unprecedented step of revising its monthly crop report in between reports to correct faulty corn and soybean data that were the result of a computer related issue. The USDA lowered output estimates, so that at first glance, the revisions were bullish. But the USDA mitigated the bullish impact by also revising demand estimates downwards.

The estimate for harvested soybean acreage was lowered by 1.1 million acres, to 74.4 million acres, which will bring production down by 45 million bushels, to 3.15 million bushels. Exports were cut by 30 million bushels, with the net effect of ending stocks falling back to 205 million bushels from the original October estimate of 220 million bushels. On the morning of the release of the special report, the market opened 50¢ to 60¢ per bushel higher, but after digesting the export revision, the market sold off and closed down on the day.

This brings us to our next point. US exports are forecast to drop sharply, to 27.8 million tonnes, down from 31.5 million tonnes last year. The downward revision to exports in the special report only reinforced waning demand. But even before the special report, commitments were running well ahead of last year's pace. We believe the market has moved higher since the disappointing export revision, because the weekly commitment report was expecting strong sales of between 800,000 and 1 million tonnes, but the figure came in at 1.45 million tonnes. Commitments for the marketing year now stand at 14.2 million tonnes, compared with 12.5 million tonnes at this time last season. Shipments have been running behind last year, but the past two weeks saw well above average shipments, particularly this past week, when US exporters reported shipments of 1.35 million tonnes, well above the weekly norm for this time of year of between 600,000 and 800,000 tonnes per week.

The monthly Census Bureau crush data are running well behind last year and support the USDA's forecast that US domestic demand will falter. The export data, however, show that foreign demand remains alive, and with the USDA forecasting falling demand across the board, it's hard not to wonder whether all the bad news is not already in the market. The USDA seems to have been overly pessimistic with foreign demand. Any improvement in the US domestic side of the balance sheet would be surprisingly bullish in a market that is wearing very bearish glasses.

We recommend a relatively low risk trade. Buy March soybeans with a stop below the recent low of $8.50 per bushel, close only. *[November 2, 2008]*

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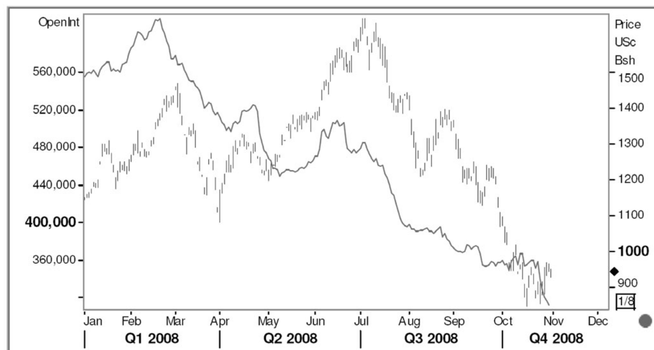
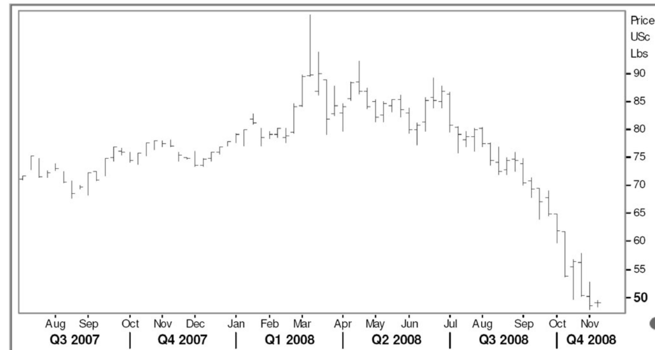
Chart 3 – March soybeans (bar), open interest (line)



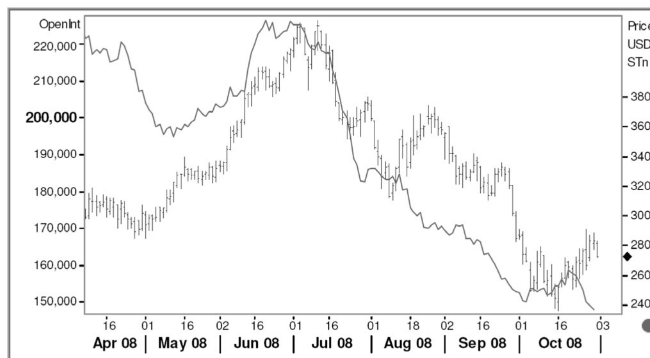
Courtesy Reuters

Chart 4 – CRB weekly



Courtesy Reuters

Chart 5 – December soybean meal (bar), open interest (line)



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CORN

Prices hit by the energy market and foreign sales

The dramatic drop in corn prices over the past few months can be associated with the broad decline in commodity prices, but there are potential developments that leave the corn market bereft of the extraordinary supply/demand fundamentals that triggered the bull market that drove prices to $8 per bushel (Chart 6). There are two primary issues, and they both involve the energy market.

First, the US ethanol market continues to grow, certainly in terms of production. Distilling capacity is up 60% from one year ago, to 11.2 billion gallons. After completion of all distilleries currently under construction, that figure will jump to 13.8 billion gallons.

The general problem is that the enthusiasm for both consumers and policy makers is not quite the same at $70 per barrel of crude as it was when $120 seemed to be here to stay.

More specifically, distilleries may be popping up in record number, but if they are not economically viable, the mothball rate will rise just as quickly as the plants sprang up. Ethanol prices have not been spared in the commodity sell-off, and profit margins have become very slim for producers.

The other side of that argument is that prices for the main production inputs – corn and natural gas – have also fallen, and as the lower prices work their way through the system, profitability will improve for ethanol producers.

In addition, there are areas in the US that are still largely untapped markets, and the industry is moving full steam ahead in introducing ethanol. The industry took root in the Midwest, where the feedstock is grown, but the Southeast and Southwest are just now starting to see ethanol production and consumption proliferate.

Ever since the USDA began ramping up estimates for the portion of the corn crop that is used for ethanol, many analysts have been skeptical, citing the disappointing pace of demand at the consumer level. With several years of data

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behind us now, and even with some relatively small downward revisions, the USDA had it basically right. At present, the USDA is estimating that 33% of the crop will be used for ethanol in 2008-09, up from 23% last year. The USDA made a minor adjustment in the October supply/demand situation report, lowering the estimate of corn used for ethanol by 100 million bushels, to 4 billion bushels. But overall, if the estimate turns out to be anywhere near accurate, the ethanol factor still plays an ever-increasing role in compromising supply to the feed side of the market.

The second direct impact that the energy market may hold for the near future of corn prices is the plunge in natural gas prices. Corn farmers use natural-gas-based fertilizers almost exclusively. When gas prices were way up at $13 per MBTU in the summer, $8 corn may still have been overpriced but did not seem nearly as absurd as it does now. The cost of production of corn soared with the rise in fertilizer prices, and corn prices would have to remain high to provide any incentive for farmers to plant corn instead of soybeans or cotton, which do not have the same fertilization costs.

Now, however, fertilizer prices have collapsed, and if they remain at reasonable prices long enough for farmers to stock up before spring planting, the dynamics of corn profitability will shift. We presented a bullish case for soybeans, but at these levels, corn still remains relatively strong versus soybeans in historical terms (Chart 7).

The heavy selling experienced in virtually all commodity markets was the result of recessionary fears that would see demand fall. For the corn market, at the moment anyway, this is more of a reality than a fear. The USDA estimates that US exports will fall by 20% from 2007-08. Indeed, export commitments are downright dismal. As of the most recent export report, US exporters have booked sales of only 16.6 million tonnes, down from 27.8 million tonnes at this time last season.

Having presented a mostly bearish case, we qualify the arguments by invoking that any and all of the bearish fundamentals factors can turn on a dime if the credit markets start to operate properly. Foreign purchasers will feel more comfortable buying grain if they know they'll be able to pay for it. Ethanol producers will regain confidence that need for competition with traditional energy sources still exists. And so forth.

We therefore have little interest in becoming short a market in which we clearly missed the trade. Besides, for the very long term, we do not believe that it is possible for corn prices to return to the old ranges, where the $2-per-bushel level was the floor.

The rate of growth of the ethanol industry will fluctuate, but ethanol is here to stay, and it will be grabbing an increasing share of the corn crop for the foreseeable future. Until ethanol growth plateaus *and* the US farmer finds a way to grow enough corn for both the feed and fuel markets, the corn market remains vulnerable to higher prices.

Stand aside. *[November 2, 2008]*

Chart 6 – December corn

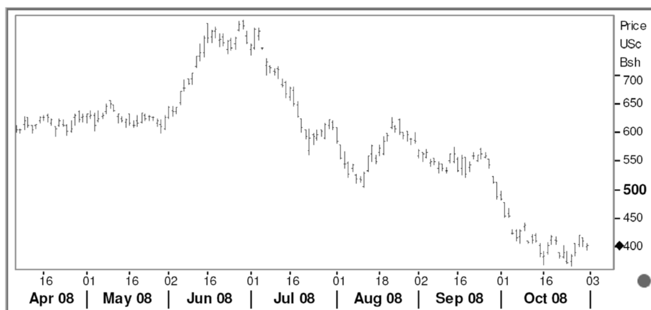

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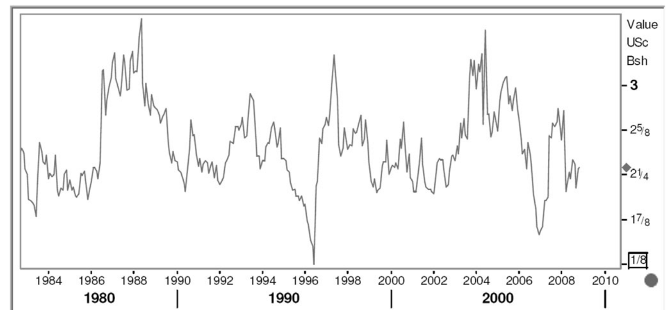
Chart 7 – Weekly soybean/corn ratio



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