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Copper output inches up, keeping a lid on the bull

From March through August, copper prices tracked stock prices in lock-step. Copper peaked in mid-August, with prices trading in a narrow range of $0.10 to $0.15 per pound. During this consolidation, the bull run in stocks forged ahead, with the DJIA tacking on an additional 5% (Chart 1).

According to the International Copper Study Group (ICSG), the global copper balance sheet at the end of the first half of 2009 showed a deficit of 292,000 tonnes, compared with a deficit of 234,000 tonnes for the same period in 2008. Not too bad for a recession. The ICSG reports are widely watched, but are always three months behind. The somewhat more timely data published by the World Bureau of Metal Statistics (WBMS) paints a similar picture. The WBMS shows a global copper deficit for 2009 through the end of July of 153,000 tonnes, which compares with a 100,000-tonne deficit for the first seven months of 2008.

Why, then, the sharp divergence from the performance of the stock market, which allegedly is foretelling a recovering economy and more demand for copper?

A closer look at some of the data – even those presented in the ICSG report that calculate a startling deficit – provides a clue as to why copper prices have flat-lined over the past couple of months.

There is a lot of focus on mine production in the world's two largest producing nations, Chile and Peru, which, combined, produce more than 40% of the world's copper. A good deal of the recovery in copper prices was attributed to falling production. Since the beginning of the year, Chilean mine output is down 2.3%, compared with the same period in 2008, while Peruvian output has declined by 1.3%.

But the pace of decline has moderated. Chilean output fell 6% in the first quarter of 2009, was down 2% in the second quarter, but actually rose by an average 3.25% for July and August.

Total mine output in any other region is dwarfed by Latin American output, but the output increases seen in Asia have been bigger than the declines in Chilean and Peruvian production. Not only has the jump in Asian production filled in a gap left by slipping output in Latin America in the short term, it may very well portend a new source of alternative supplies. During the first half, combined North and South American output was 103,000 tonnes below the same period in 2008, while total Asian mine production increased by 294,000 tonnes.

Over the past year, Chinese imports have more than compensated for the loss of demand from countries with ailing economies. From mid-2008 through mid-2009, imports skyrocketed. For a good part of 2009, average monthly purchases were more than double the volume before the surge began (Chart 2). That bullish factor has ground to an abrupt halt as well. In July, imports dropped 23% from June, and then again in August, imports fell 24.8%. Analysts contend that it is not an indication of slackening demand for copper in China. Rather, domestic prices were lower, which had end users shifting their purchases away from imports.

Overall, global demand is still contracting, but at a much slower pace than earlier in the year. Usage was estimated at 9.178 million tonnes for the first half of 2009, down 0.5% from 2008, compared with a drop of 4.4% for the first quarter. It is unlikely, however, that even a continuously improving demand side in the US and Europe will compensate for such a sharp drop in Chinese imports.

Warehouse-stock movement is somewhat of a coincident

Inside

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indicator, but at the very least it provides some confirmation that supplies are building. Chart 3 shows that combined LME, COMEX, and Shanghai inventories bottomed at about the same time that prices peaked.

For now, we advise accepting handsome profits on long positions. *[October 1, 2009]*

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

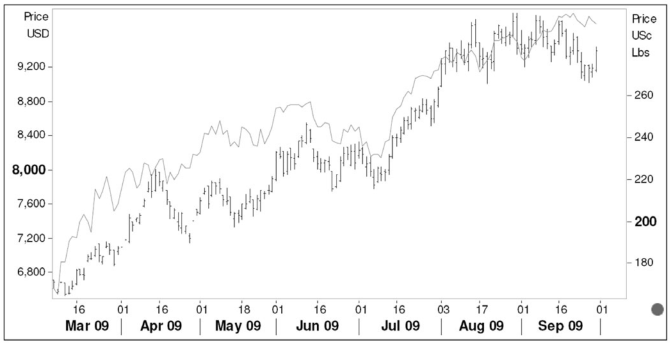

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Chart 2 – Chinese copper imports

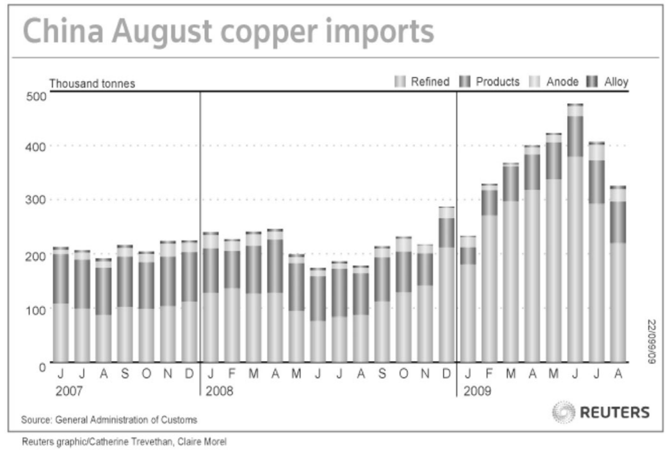

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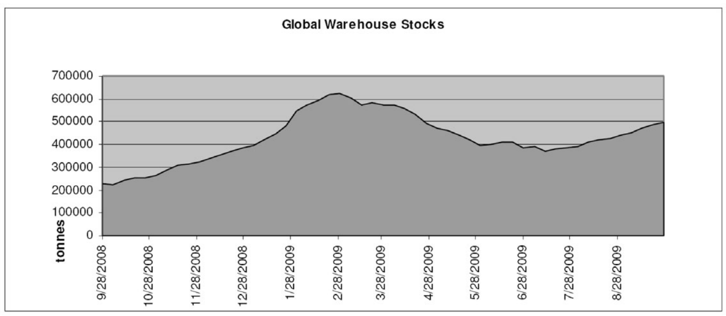
Chart 3 – Warehouse stocks: LME, COMEX, Shanghai



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WHEAT

Is there much left for the bear?

Wheat prices have been tumbling since their $13-per-bushel peak was set in early-2008. The bullish fundamentals warranted that explosive bull market. Growing global demand finally caught up with years of declining output by major producer/exporter nations. Then, high prices certainly accomplished the task of making wheat farming profitable and increasing world supplies. Global wheat output for 2008-09 jumped to 682 million tonnes, an 11.6% increase over 2007-08.

Global demand continued to grow for this basic staple, even during the global economic downturn, but at a dramatically lower pace than the jump in world production. The mammoth, 70-million-tonne jump in 2008-09 output was met by a tepid 20-million increase in usage, which has left burdensome inventories to be carried forward to 2009-10, which explains why prices collapsed. Global ending stocks jumped to 26% of consumption in 2008-09, up from 20% in 2007-08.

Because of expectations for slack demand, acreage for 2009-10 Northern Hemisphere wheat crops was reduced as far back as autumn 2008, when the 2009-10 winter wheat crops were planted. This occurred despite the fact that historically high prices could still have been locked in at the time. The USDA's September estimate for 2009-10 global output is 664 million tonnes, down 18 million tonnes, or 2.7%. Even after accounting for the drop in output, global ending stocks for 2009-10 are estimated to rise again, to 28.8% of usage, their highest level in eight years. A very bearish picture.

As illustrated, the exuberant-production-stage of the cycle has already ended for wheat. A look ahead at crop yet to be harvested and Northern Hemisphere winter wheat plantings for 2010-11 confirm that the drop in output is likely to continue.

The Southern Hemisphere crops are just entering their harvest seasons and are still included in the 2009-10 marketing year. Australia is still having weather problems in some regions, but the most recent reports seem to indicate that the USDA estimate for a 22-million-tonne crop will be achieved, with 14 million tonnes available for export. Argentina's crop, on the other hand, suffered from drought for the second consecutive season, and will fall to 8 million tonnes, down from 8.4 million tonnes in 2008-09. That's sharply below 2007-08 output of 18 million tonnes, with a scant 2.5 million tonnes available for export, compared with 11 million tonnes in 2007-08.

So there is some vulnerability. Brazil typically buys its wheat from Argentina – about 6 million tonnes – and it will obviously have to look elsewhere this season for 2 to 3 million tonnes.

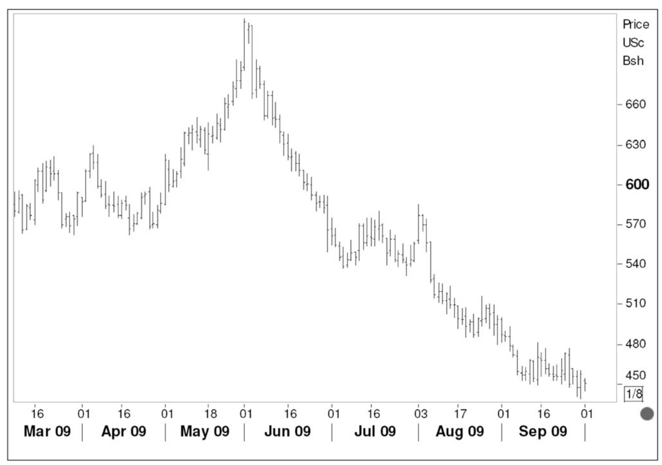
More significantly though, it seems that US winter wheat planting is slated to fall by a fair chunk, partly because planting conditions are not favorable, but mostly because prices are uninspiring. In the FSU – a key exporter and competitor of the US – planting conditions are poor as well. So unless prices recover over the next six weeks when the planting window closes, we're likely to see a sharp drop in Northern Hemisphere winter wheat production.

The market registered a rather strange performance this week. After making new lows dating back to spring 2007, prices reversed on a pair of bearish reports. First, on September 30, the total US 2009-10 crop was revised upwards by 36 million bushels from the USDA's September estimate. Then the quarterly stocks report showed that September 1 US stocks stood at 2.215 billion bushels, 81 million bushels above guesstimates. Not that the data were that terribly bearish, but the market's reaction was a signal that prices are oversold.

There is no apparent evidence that demand will improve. For that matter, US export commitments are down 37% from last year at this time, but the USDA estimates a drop of only 6.5% from 2008-09.

Our recommendation is to stand aside at this time. The market should work its way lower based on the appearance of the global balance sheet. But with output almost certain to start slipping again and the possibility – if not probability – that demand will stabilize, we don't see too much downside remaining. Stay tuned. *[October 2, 2009]*

Chart 4 – December wheat



Courtesy Reuters

SOYBEANS

Frost fears realized

The soybean market has seen a series of twists and turns in its underlying fundamentals over the past couple of weeks. Prices had been trending lower since early August, and the quarterly stock report – released on September 30 before the market open – seemed to confirm that trend. As of September 1, US soybean stocks stood at 138 million bushels, well above the average trade guesstimate of 112 million bushels. It was quite a surprise. The USDA estimate for 2008-09 ending stocks has been 110 million bushels since June. This figure now becomes 2008-09 ending stocks on the balance sheet.

The initial reaction included an opening bell selloff, but with a reversal to a higher close, which seemed to make little sense. Indeed, over the next few sessions prices proceeded to seven-month lows to reflect the no-longer-skimpy ending stock figure. Subsequently, a renewed bout of commodity bull-market-fever combined with weather worries help the market find support (Chart 5).

Some concern over early frost appears just about every year. The late-planted 2008-09 crop, however, has made this year's concerns somewhat more realistic. The most recent USDA weekly progress report shows that 67% of the crop is rated in good-to-excellent condition, up a notch from a week earlier, and compared with 57% last year at this time. The problem is that only 15% of the harvest is complete, down sharply from last year's 36% – and now, fears of cold weather are beginning to materialize. We've already seen some freezing temperatures damage immature crops in some parts of the Midwest. Other regions have seen excessive rain, which has hampered the harvest.

The October 9 USDA crop report estimated that US farmers will harvest 3.245 billion bushels of soybeans, 31 million bushels below analysts' guesstimates, but still a record crop. Yields in undamaged areas will in all likelihood have to be spectacular for us not to see further downward revisions, given the weather we've seen over the past few days.

On the global front, there were two significant revisions contained in the October 9 report. Argentinean production was forecast at 52.5 million tonnes, 1.5 million tonnes above the September estimate. This was partially offset by a 500,000-tonne downward revision for Chinese output, to 14.5 million tonnes.

Global ending stocks for 2009-10 are estimated at 54.8 million tonnes, or 23.7% of consumption, up from 19.1% at the end of 2008-09.

The market is heavily focused on the supply side at present, trying to determine to what extent the rosy outlook for the South American crops will mitigate the damage to the US crop.

On the consumption side, soybeans are one of the few commodity markets in which demand has remained fairly steady over the past year, primarily because of Chinese purchases. For some time, market participants have been skeptical about the sustainability of Chinese imports. Thus far, however, there has not been much let-up. Total US export commitments stand at 20.6 million tonnes, almost double last year at this time. And yet, the USDA estimate for the 2009-10 marketing year is 35.52 million tonnes, up only 640,000 tonnes from final 2008-09 sales of 34.84 million tonnes. Chinese purchases are 11.8 million tonnes, up from 5.4 million tonnes last year at this time.

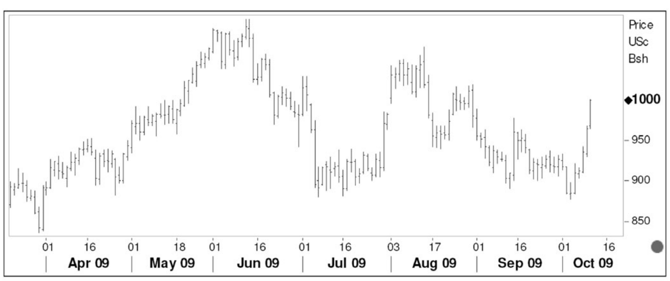
Then, on October 12, adding to the resurgent bullish sentiment of the market, the Chinese government announced that it would continue the program of stockpiling new crop corn and soybeans.

Soybean prices have rallied by $1 per bushel off their recent lows – that's over 10% – in the space of just a few sessions. If you're long, stay that way. Until the amount of damage to the US crop is resolved, prices should continue to rally. The market has been anticipating a bumper crop and that is now in jeopardy. The South American crops – large as they may be – are many months away from harvest. Besides, we're talking about a crop that is just being planted.

One possible bullish strategy with a more moderate level of risk than buying the market outright after such a strong rally is a bull spread between the 2009-10 crop and the 2010-11 crop. The spread between January 2010 and November 2010 is currently trading at 22¢ per bushel (Chart 6). This past June the old-crop/new-crop spread widened out to reach as high as $2.45 per bushel (Chart 7), so there is ample profit potential if the market were to tighten again.

[October 13, 2009]

Chart 5 – November soybeans



Courtesy Reuters

Chart 6 – Spread – January/November

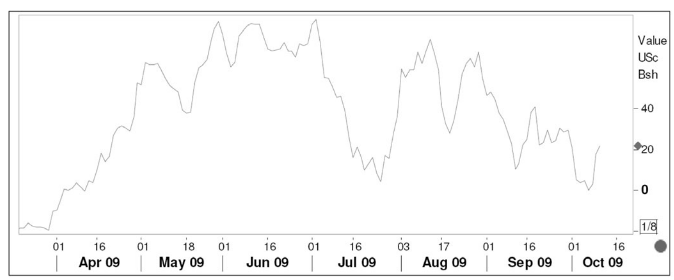


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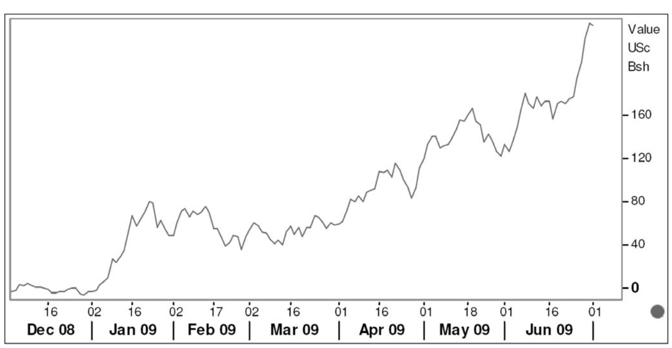
Chart 7 – Spread – Old crop 2008-09/New crop 2009-10



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COCOA

A shaky recovery in demand and better-than-expected Ivorian arrivals give the bull a rest...a short rest

After moving to within target range of the $3,385-per-tonne high set in July 2008, cocoa prices suffered a sharp setback (Chart 8). The volatility can be traced to confusion regarding the as-it-is-sparse data available for this market.

Early signs of an improvement on the demand side seemed to emerge with the release of the third-quarter German grind on October 7, which showed an increase of 11% over last year. The report was met with some apprehension as to how meaningful the data really were, because German capacity has been expanding, and the unanticipated uptick may have been the result of shifting grinding locations rather than new demand. One plant's capacity grew from 30,000 to 100,000 tonnes. Still, the bull run held its ground.

Then, on October 9, the European Cocoa Association reported that the European grind – a far broader measure of demand – was up a much-higher-than-expected 16.5%, only to issue an alert several hours later indicating that the data were flawed because of a statistical error issued by one of the reporting processors. After setting fresh contract highs at $3,329 per tonne on the initial news, the market tanked, and left in place the makings of a classic reversal. A revised report is to be issued on October 14, before the London markets open. The North American grind is set for release later this month.

The market suffered another setback the following session when the government agency Bourse du Café et Cocoa revised the final figures for the 2008-09 Ivorian marketing year. On October 5 it reported final arrivals at 1.178 million tonnes, down 189,000 tonnes, or 13.8%, from the previous season. On October 12 it raised the estimate to 1.22 million tonnes, down only 146,000 tonnes, or 10.7%, from 2007-08, citing late declarations by some exporters.

For many months now, the market had been trading on the assumption that the crop would be roughly 15% smaller, so this was indeed a surprise, and the market responded accordingly, falling an additional $175 per tonne.

After bottoming this past spring, European and Asian butter ratios have remained steady, but have not improved, leaving little incentive for processors to ramp up their bean purchases.

The bullish fundamentals that we felt fairly confident with in recent months seem to have faded to some degree, at least temporarily. The global deficit will be smaller than earlier believed, at least by 45,000 tonnes, the amount of the increase in Ivorian port arrivals. Demand has stopped falling, but is not growing very quickly.

The conclusion drawn by some market observers is that cocoa prices – as well as those of other commodities – have been part of a collective commodity frenzy, bereft of a bullish background story. We don't think it's quite that stark for the cocoa market. Open interest has increased with the latest spike over $3,000 per tonne, but as Chart 9 indicates, the level pales in comparison with the magnitude of the speculative bubble of 2008. At 28,000 contracts, the net-long position of non-commercials is smaller, but if measured as a percentage of total open interest, it's not that far off 2008 levels. Still, with smaller volumes, the depth of long liquidation flurries should be milder.

And that's really what it's all about. We don't believe for a moment that the bull market is over. As we saw from the late surge in Ivorian arrivals, it's impossible to get an exact reading on a crop until long after the harvest is complete. Although prices paid to farmers have increased with the rise in market prices, it doesn't seem to be enough to stem the tide of falling Ivorian output. Most analysts are forecasting production to fall again in 2009-10. Disease and aging plantations with their optimum production years behind them are still a problem, even if farmers were to spend more of their increased income on maintenance to improve quality.

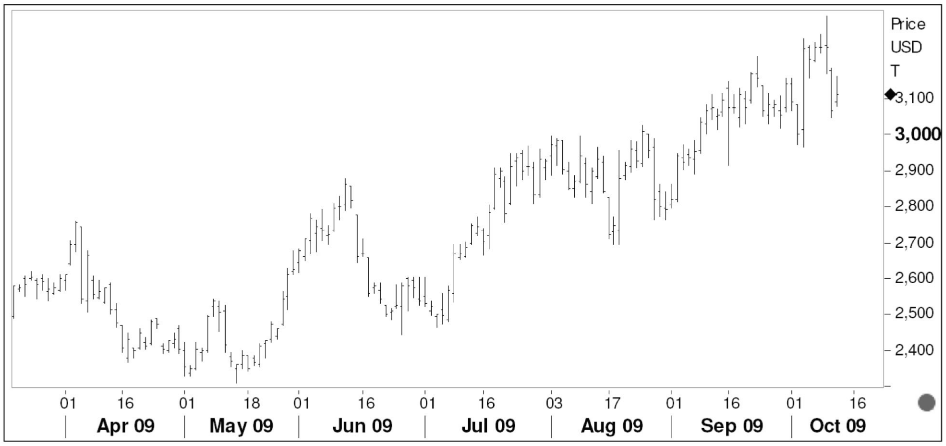
The other West African producers are seeing their crops improve gradually over the years, but at best, the total increase would be roughly equal to the amount of production lost by the Ivory Coast. When – and if – demand returns to trendline 3% or so yearly growth, the deficits will continue to grow and deplete the once-burdensome carryover stocks.

If the corrected European grind and the US data are friendly, look for a quick end to this correction.

The strategy of maintaining positions that can be held through 15% corrections is still the suggested approach.

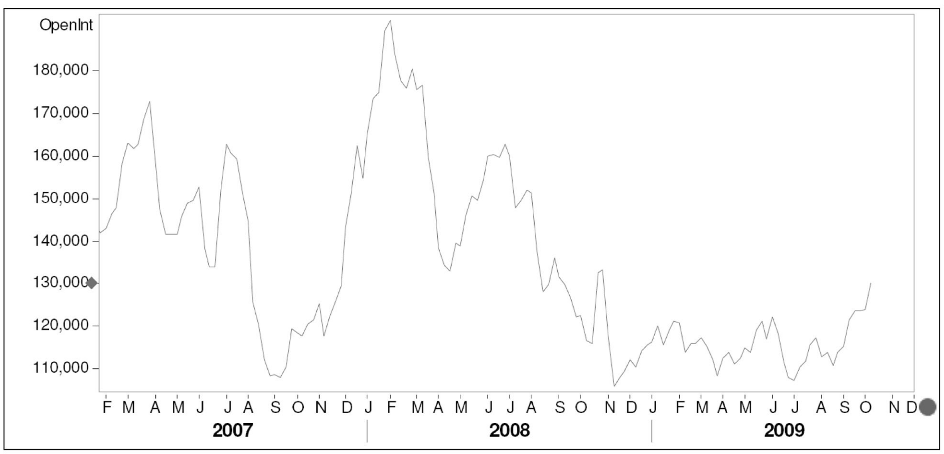
[October 13, 2009]

Chart 8 – December cocoa



Courtesy Reuters

Chart 9 – Cocoa open interest



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