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Cocoa: Has the bull been tamed?

With just a few weeks remaining in the 2009-10 cocoa marketing year, Ivorian arrivals have pulled ahead of last year's levels. For most of the main- and mid-crop seasons, arrivals lagged behind the previous season, at times by as much as 15%. The late surge brings arrivals to 1.15 million tonnes, 1.4% above last year at this time. Weekly arrivals averaged over 10,000 tonnes per week during August, more than double last year's levels for the same period. Even if arrivals continue at the same healthy clip, total output will pull in shy of 1.2 million tonnes. So while it will be a decent conclusion to what was otherwise a very dismal season a few months ago, it still leaves the general outlook for Ivorian output in perpetual decline from the 1.4-million-tonne crops it has produced several times over the past decade.

Neighboring Ghana once again declared that output will expand to 1 million tonnes for the 2010-11 season. In the meantime, it is doubtful that even this year's 700,000-tonne forecast will be met. The most recent data show arrivals of only 625,000 tonnes. That estimate is a couple of weeks old. But even after adding September output, as well as beans smuggled to the Ivory Coast, total production will barely reach the target.

We've been bullish on cocoa for some time, but sounded a note of caution in the August issue of *Focus on Futures*. We suggested bowing out of long positions on any further weakness. The primary concern was a precipitous decline in cocoa-butter ratios. Our theory was that as long as butter prices are weak, which leaves profit margins slim, processors would purchase beans only on an immediate-need basis. This in turn would keep bean warehouses well stocked and depress prices. In any case, at some point tightness would develop in the butter market, forcing processors to buy beans.

Over the past couple of weeks European butter ratios have sprung to life with a move back to levels not seen since this past spring. Chart 1 shows that the ratio last traded at 1.60 times the London spot price. Although that is still 50% below where it peaked in 2007, there is a possibility that it represents bottoming action. Even in Asia, where the ratio is crawling along the bottom of the range, it has been stable and has not made a new low since March (Chart 2). While this can hardly be interpreted as an independent bullish case, it does ease our micro bearish fears in what is otherwise a macro bullish environment.

On August 26, the International Cocoa Organization (ICCO) increased its estimate for the global deficit from its previous forecast of 69,000 tonnes to 72,000 tonnes – not a significant change. It does confirm, however, that despite the better-than-expected performance of the tail end of the Ivorian crop, the ICCO believes that demand is improving and will eat up the appearance of increased supply.

Third-quarter grind data to be released in October will give us an idea of whether the strong second quarter results have followed through. We won't be terribly disappointed, however, if the numbers show slower grinding growth. Based on the market's weakness over the past few months, we would venture that activity was indeed slow because of the unprofitable grinding environment. If, indeed, butter prices continue to show improvement, it will not show up in grind data until January.

Commodity funds are net-short this market, a fairly uncommon occurrence for cocoa, particularly when commodities all around are rallying back into 2008 ranges, and beyond. Chart 3 shows what happened on other occasions when the group flirted with the short side. The bullish case is deeply rooted in the long-term decline in global bean production *vis-à-vis* anticipated normal demand growth patterns. It doesn't hurt, however, to have a barrage of potential short covering on the sidelines that will inevitably come into play.

Reclaim your long positions. *[September 13, 2010]*

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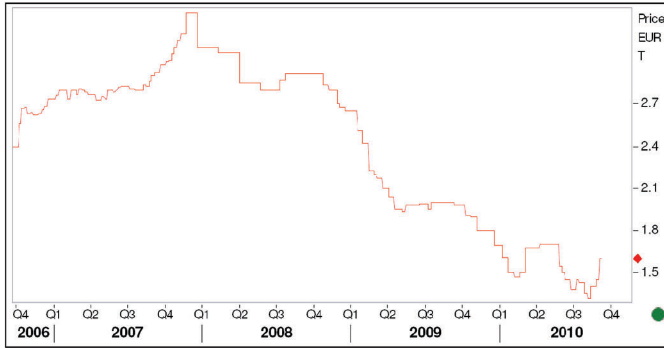
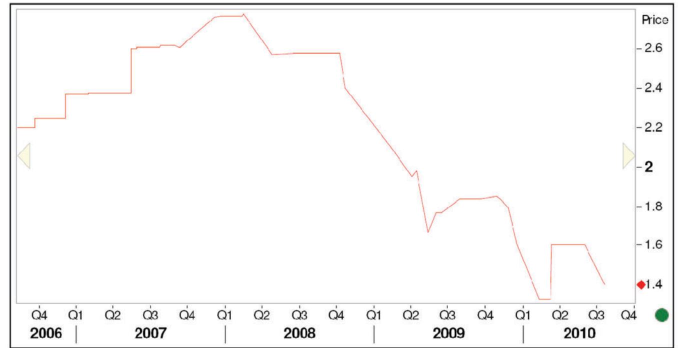
Chart 1 – European cocoa-butter ratios



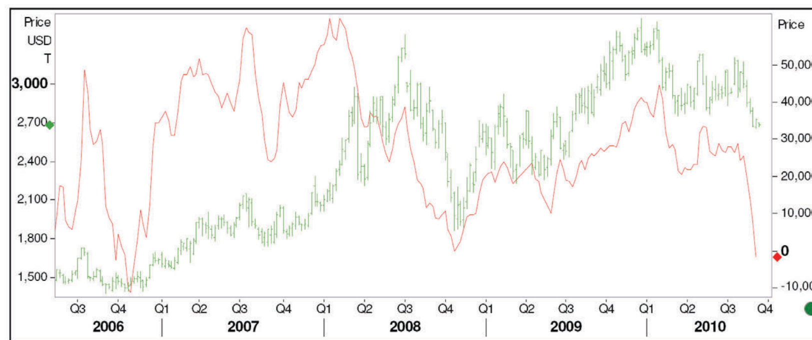
Courtesy Reuters

Chart 2 – Asian cocoa butter ratios



Courtesy Reuters

Chart 3 – Nearest contract cocoa (bar), Commodity fund net-short position (line)



Courtesy Reuters

COPPER

Excellent breadth for global demand drives prices higher

Double dip, jobless recovery, deflation, consumer apathy...whatever the bleak economic flavor of the day, somebody forgot to inform the commodity markets. While softs are taking a breather from scoring some truly extraordinary gains, precious metals and industrials have surged. The petroleum complex – even after weeks of absorbing mostly bearish data – has raced to challenge its summer highs. Gold is rewriting the record books.

Earlier this year, with only a limp recovery evident in the US economy and problems spiraling out of control in Europe, it became clear that the copper market could not rely indefinitely on Chinese imports to keep prices strong. After trading at fresh recovery highs back in the spring, the market finally responded to several months of weak Chinese imports with a $1-per-pound selloff. The market has now recovered and has surpassed the spring highs (Chart 4).

At the beginning of 2010 the global refined copper market seemed to be in a comfortable surplus position. According to the International Copper Study Group (ICSG), the market slipped into a small deficit by the end of the first quarter. And its most recent update, released on September 21, which covers the first half of 2010, shows the deficit has grown to 281,000 tonnes. That's more than double the 125,000-tonne-deficit in the same period a year earlier.

The large deficit is a result of improved global demand against a backdrop of sluggish production growth. Global consumption in the January to June study period grew by 7.3% over the same period in 2009. In 2009 global usage was flat.

Total refined output is growing by 5.7% year to date, a much stronger pace than last, but with demand growing at 7.3% we're going to see inventories drawn down quickly. In fact, warehouse stocks have fallen steadily since the beginning of the year and are now 30% off their peak (Chart 5).

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ICSG does not expect the market to remain in deficit by year-end, but has made massive revisions to its annual forecasts for both 2010 and 2011.

For 2010 it chopped the estimate for the year-end surplus to 200,000 tonnes, down from its April estimate of 580,000 tonnes. Looking ahead to 2011, it anticipates a deficit of 400,000 tonnes, a complete about-face from the April estimate of a 240,000 tonnes surplus.

Chinese imports of refined copper grew in August by 18.9% over July, after a 6% increase in July. More significant, though, is that demand in Europe has been very strong, with anecdotal evidence of *bona fide* tightness. Japanese and European usage grew by 37% and 11.7%, respectively, in the first half, a much faster pace than the global average of 7.3%.

On the supply side, with prices at these levels one would expect mine output to be taking off, but it really has not. Using Chile – the world's largest copper miner – as a proxy, production growth has been rather flat. July output was decent, with a year-over-year increase of 6.3%. There was no follow through, however, with August up a scant 1.3%. Since the start of 2010, output in Chile is up only 3.61%.

We woke up from a bearish slumber during the summer and never issued a buy recommendation. Do not be afraid to own modest-sized long positions.

[October 6, 2010]

Chart 4 – December copper

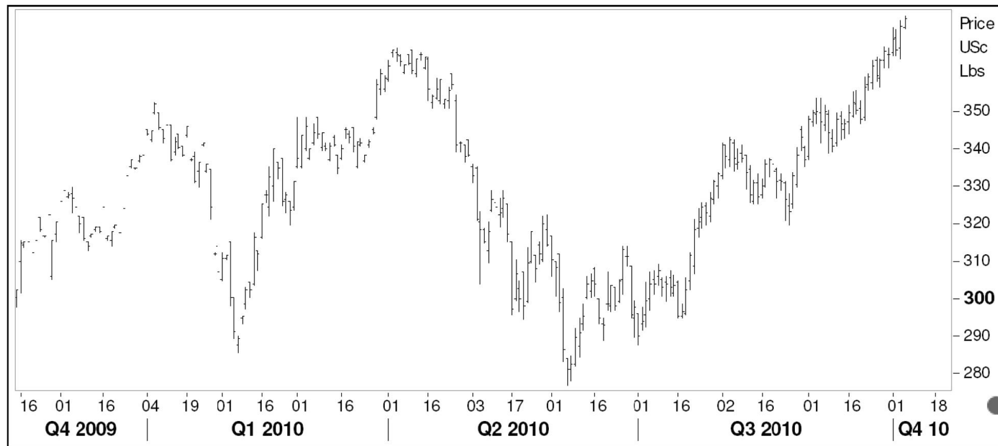
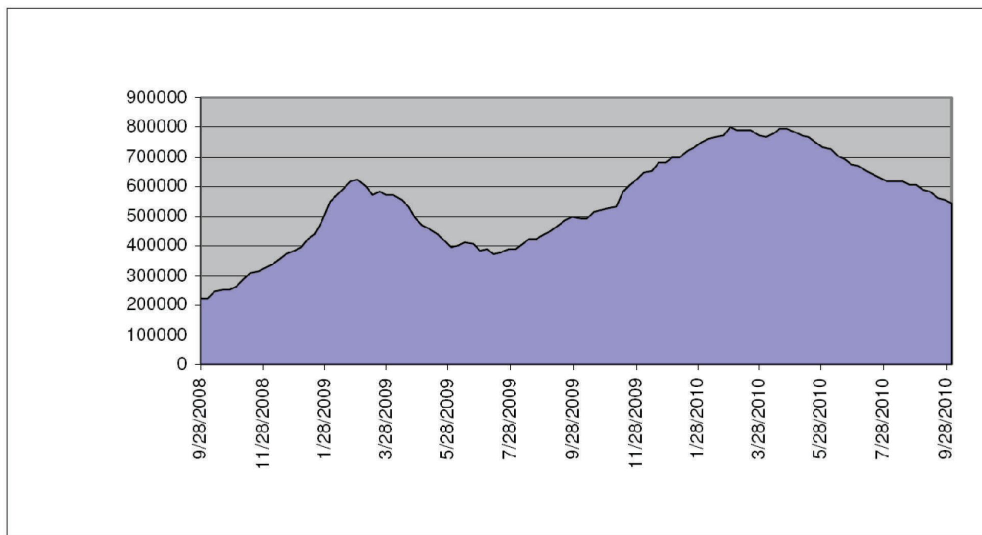


Chart 5 – Global copper warehouse stocks



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CORN

A sharp drop in US yields sends prices soaring

In recent years, US corn market participants have become accustomed to a familiar pattern: Early-season bullishness generated by poor spring planting weather and the inevitable growing-season crop scare. Then, increasingly heartier seed varieties would defy all odds, yields would rise, and prices would fall as we neared harvest, but not this year.

The 2009-10 crop harvested last fall yielded a record 164.7 bushels per acre (bpa). Up until mid-summer, the USDA was still forecasting that yields for the 2010-11 harvest would surpass that record. The August crop report estimated yields at 165 bpa, but it's been downhill ever since. The September estimate dropped to 162.5 bpa which was followed by this month's shocker. Analysts' guesstimates for the October 8 crop report ranged between 162.1 bpa acre on the high side and 158.2 bpa on the low side. The average guess was 160 bpa, but the actual figure came in at 155.8 bpa.

There were two bearish items in the report. The planted-area estimate was increased by 300,000 acres (46.7 million bushels), and the estimate for the old-crop carry in was increased by 322 million bushels.

The old-crop carry-in revision was not news, because it was just the incorporation of the bearish quarterly stocks report released several days earlier, on September 30. The response to that report was a three-day, 35¢-per bushel sell-off to multi-week lows.

Weaker demand in 2009-10, however, was offset by a 150-million-bushel *increase* in the feed-demand estimate for 2010-11.

Even after adding the newly-found acres and accounting for lower-than-expected domestic demand in 2009-10, the net-effect would be a drop in the estimate for 2010-11ending stocks to 902 million bushels, down 214 million bushels from the September estimate, and quite a distance from the average guesstimate of 1.172 billion bushels. As a percentage of usage, carryover stocks drop to 6.7%, down from 8.3% last month, and compared with an average carryover of 13.4% for the previous three seasons. It will be the lowest inventory level in the US since the 1995-96 season, which triggered a major bull market that drove prices from $2 to $5.5 per bushel between 1994 and 1996.

Argentina is the world's second largest and only other significant exporter of corn, and its 2010-11 corn crop is expected to jump by 20% when harvested late this year.

This is well known, however, and the global inventory picture remains vulnerable. At best, the global balance sheet for 2010-11 was heading towards a balanced production/consumption outlook. With the revisions in the October 8 report, we will now be drawing down stocks by 15 million tonnes. The stocks-to-consumption ratio falls to 15.8%, down from the September estimate of 16.3%. This compares with an average of 18.6% for the two previous seasons and a move back towards to the 2006-07 level of 14.7%, which was the underpinning of the 2008 bull market.

Open interest has ballooned with this rally. Commitment of Trader data as depicted in Chart 7 show that the net-long position of funds is larger now than it was in 2008, which clearly should make holders of long positions a bit nervous about the inevitable corrections. Still, the explosive rally that followed the Oct. 8 crop report is an accurate reflection of the change in fundamentals, and we therefore recommend maintaining long positions.

[October 12, 2010]

Chart 6 – December corn

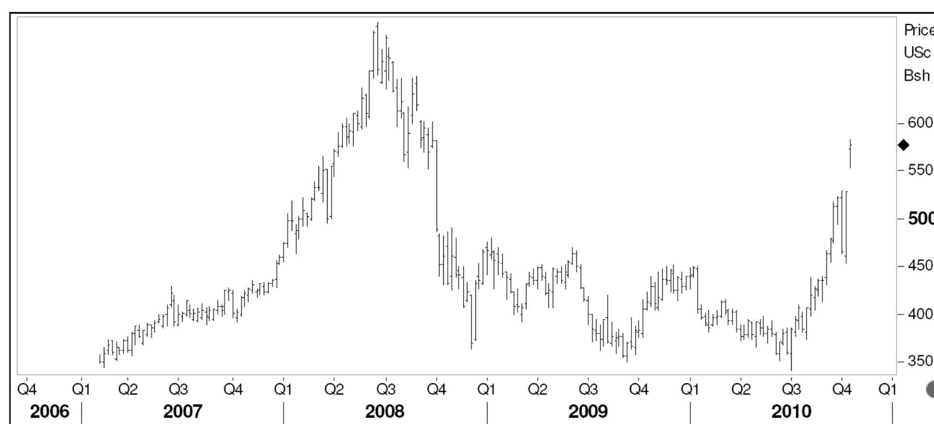

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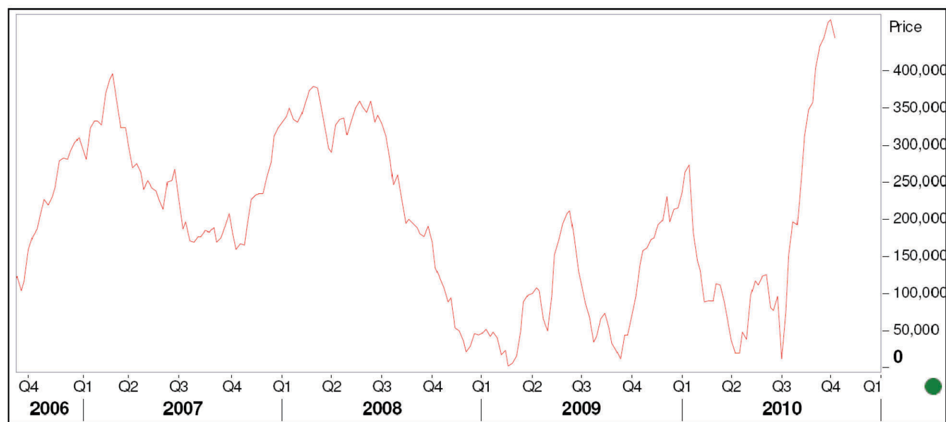
Chart 7 – Fund net-long position



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WHEAT

Are prices overextended?

Wheat prices have rallied by $1 per bushel over the past two weeks. The lion's share of the move happened on the day the October USDA crop report was released. December wheat was up the 60¢-per-bushel trading limit (Chart 8). Was the quick spike commensurate with fresh developments in the fundamentals?

Wheat prices began to move in early summer when all significant European grain-growing regions began to experience drought. Western Europe came out of it fairly intact. The October 8 USDA crop report actually raised the EU 2010-11 production estimate by 500,000 tonnes, to 135.63 million tonnes, which is down only 1.7% from 2009-10 output.

The effect on FSU crops, however, was devastating. The USDA maintained last month's 2010-11 production estimate at 84.56 million tonnes, down a whopping 29.28 million tonnes, or 25.7%, from 2009-10. The impact on world trade is stark. FSU exports in 2009-10 were 36.73 million tonnes, or just over 25% of all global exports. The USDA estimates that the FSU will export only 16.7 million tonnes in 2010-11.

All definitely very bullish, but almost exactly what we knew a month ago. For that matter, the one sizeable bullish revision in the October crop report was not news either. The estimate for US output was revised downward by 1.1 million tonnes, to 60.51 million tonnes, but that was already contained in the small grains summary that accompanied the September 30 quarterly stocks report. The strange thing is that the market sold off on that very item following the release of the report and proceeded to make a new low. It was not until the October 8 crop report altered the landscape for the corn and soybean markets that wheat sprang to life.

Obviously, there is a strong correlation between wheat and corn, in that a smaller corn supply means greater demand for feed-quality wheat. The reaction by wheat traders, we believe, was nonetheless overdone. In fact, in the few sessions that followed the October 8 report, corn and beans continued to make new highs, while wheat merely consolidated its gains.

There is no doubt that the FSU disaster has shaken up the market. The significance of US exports has been dwindling. In 2009-10 US sales fell to 23.98 million tonnes, from 27.64 million the previous season. Before there was even a hint of weather problems in Europe, the forecast for 2010-11 US exports was 24.49 million tonnes. That estimate has now ballooned to 34.04 million tonnes. That's a 38% increase from the early season forecast. Export commitment data show that foreign purchasers have contracted to buy 17.1 million tonnes since the marketing year began on June 1, 59% above the same time last year.

It would be misleading, though, to extrapolate that the USDA's 34.04-million-tonne estimate is understated. After a torrent of sales in August, when it became clear that the FSU crop would drop dramatically, sales have begun to fall back into a normal pattern. Average weekly commit-

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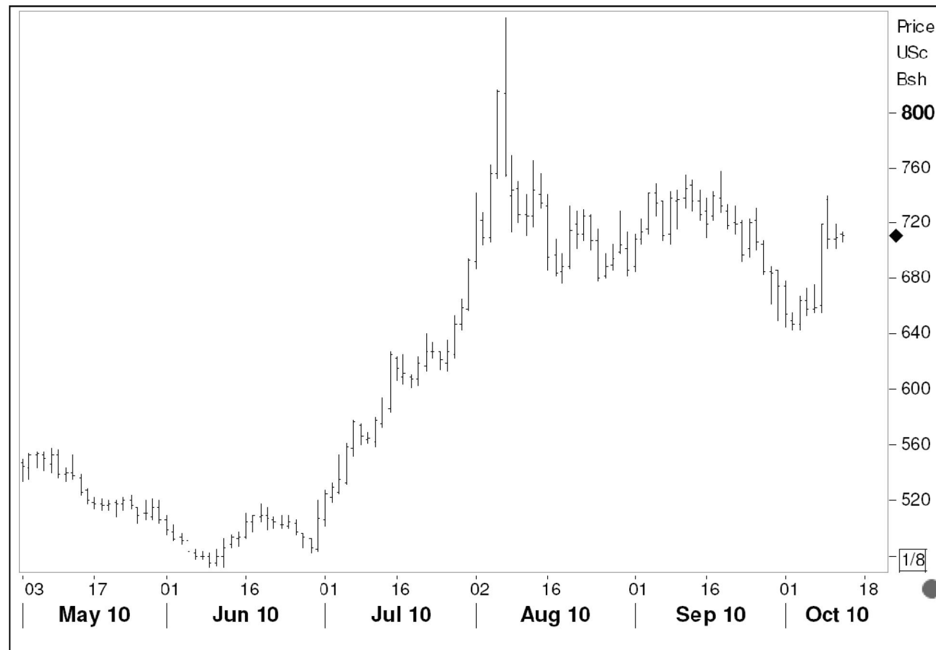
ments for the 2010-11 marketing year in August were 1.159 million tonnes, but have since slipped to a weekly average of 718,000 tonnes.

With a 2.1-million-tonne increase for the estimate of global consumption, ending stocks were revised to 26.33% of consumption, down from the September estimate of 26.88%. That compares with last season's 30.19% of usage. That's still above the 2008-09 carryout of 25.7% and well above the inventory plunge of the 2006-07 and 2007-08 season that saw ending stocks fall to 20% of consumption.

Considering the weak dollar and the broad commodity bull market, we are, frankly, a little anxious about being too aggressive on the short side. The limit-up move following the October crop report provides ample illustration of how markets can behave even without support from the supply/demand fundamentals. Nevertheless, we believe that the market should be contained inside the established range. Sell December wheat at the market, risking $7.60 per bushel, close only.

[October 13, 2010]

Chart 8 – December wheat



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