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Wheat: light at the end of the bear tunnel?

In an era of expanding grain crops around the globe, US wheat production has been dwindling. The combined 2014-15 crops – winter wheat (planted in the fall of 2013 and harvested in June) and spring wheat (planted in the spring and almost through its harvest) – will be the smallest since 2011-12.

Regardless, prices are sinking (Chart 1). The US has been responsible for less than 10% of global output since the early 2000s. Based on recent USDA estimates, in 2014-15 that ratio will shrink to only 7.7%. Exports averaged about 25% of world trade in the early 2000s, then dropped to 20% in the latter part of the decade. This marketing year, foreign sales are expected to fall to only 16% of world trade.

Other exporting nations have grown larger crops and – on the surface – it would seem that those countries will be able to pick up the slack in US supplies. Global production was revised upwards in the September USDA monthly crop report by 4 million tonnes, to a record 720 million tonnes. That's up from 714 million tonnes and 658 million tonnes in 2013-14 and 2012-13, respectively.

Beneath the surface, however, it's not quite that simple. The only large exporting country that will have substantially more food-grade wheat available for export is Russia. Its crop is estimated at 59 million tonnes, up 7 million tonnes from last year, and exports are estimated at 22.5 million tonnes, up 4 million tonnes from last year.

After Russia, the single largest gain was in the EU. Its combined crops are estimated at 151 million tonnes, up close to 7 million tonnes from last year. The difference here is that the USDA is forecasting exportable surplus at 26 million tonnes, *down* from 32 million tonnes in 2013-14. This is because a very wet harvest season – for France in particular – compromised the quality of a disproportionate amount of wheat, which can now only be marketed for feed. French wheat accounted for about 65% of total EU exports last year. France's largest customers have already rejected large amounts of wheat that is normally bread quality. One estimate puts the total EU crop at 60% milling grade, compared with 71% in 2013-14.

One thing is for certain, with the record corn crop in the US, there will be no shortage of carbohydrate feed grain. But the loss of milling grade wheat from the EU could eventually create demand for the ample supplies of high-protein US wheat.

Even as prices tumble, US wheat commands a premium, and that may be warding off potential international customers. Indeed, the USDA is forecasting US 2014-15 foreign sales at 25 million tonnes, a 21% drop from last season. And rightly so. Export commitments are running behind even that dismal estimate, at 27% below 2013-14 sales. However, as the marketing year wears on, a market for US high-protein wheat could develop. The USDA might just be underestimating demand for US wheat.

It would be unwise to try to catch the falling knife, but there could be an alternative, relatively low-risk strategy.

The Kansas City hard red winter wheat contract demands a higher protein deliverable grade than Chicago Board of Trade wheat. Chart 2 shows that Kansas City wheat rose substantially *vis-à-vis* Chicago wheat during this period, perhaps as speculation that there would be a premium attached to wheat with higher protein content. The spread has pulled back, and we recommend buying December Kansas City wheat and selling December Chicago wheat on a spread, currently trading around 83¢ per bushel. Place initial stops at 65¢ per bushel.

[By Sholom Sanik, Sept. 23, 2014]

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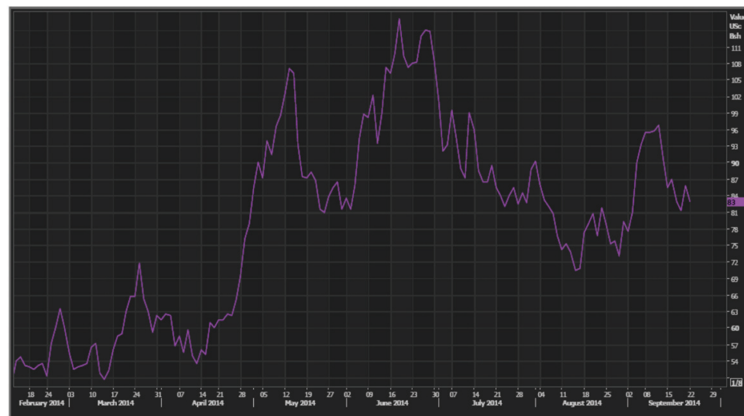
Chart 1 – December CBOT wheat

Courtesy Bloomberg LP

Chart 2 – Spread December Kansas City/CBOT wheat



Courtesy Bloomberg LP

SUGAR

Sugar prices that don't pay the bills will force a bull market

Sugar has been in a bear market since early 2011, when prices peaked at 36¢ per pound (Chart 3). Many contract expiries during this period were marked by sharp rallies. But prices would continue lower, and with the benefit of hindsight, we now know that the spikes were indeed nothing more than short-covering rallies.

The expiry of the current October contract seems to be history repeating itself, but with some extraordinary features. In early September, with only three weeks remaining in the life of the October contract, the contango between October and March (the following contract month) widened out to 268 points. That would be a modern-day record. You'd have to go back to 1989 to find the nearest contract at such a mammoth discount to the next month.

As we mentioned in our most recent sugar article (see *Focus on Futures*, September 5), there were concerns about burdensome old-crop inventories in Thailand, the world's second-largest exporter. Analysts believed that Thai traders would deliver large volumes – about two million tonnes – against the expiring contract. However, with only days remaining to the October expiry, news stories surfaced indicating that the fears were overstated and that much of the overhang had already been sold to refineries in China, Bangladesh, Iran, and Dubai – regular customers for Thai sugar. According to one report, only 200,000 tonnes of old-crop sugar remain. In response the spread narrowed dramatically and went off the board at only 97 points.

For us, this is a "boy-who-cried-wolf" trade. We've been bullish for so long, and the market keeps going down. The fundamentals, however, have not changed. Brazilian production has been stagnant for several years, and financial crisis in the Indian mill industry persist, while demand continues to grow. In fact, some of the key sugar analysts estimate that the 2014-15 global production/consumption balance will show a

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3-million-tonne deficit.

Last year, at about this time, mill owners in India declared that they would not begin the crushing season at its normal time – early November. They were demanding that the government find a solution to their inability to operate at a profit because of high cane prices. Well, the problem has not disappeared, and the threat of a delayed start to the crushing season has appeared again. Last year the industry muddled through with government subsidies. And while crushing began about a month late, and output was lagging, production by the end of the season reached a more-than-respectable 25.5 million tonnes.

Milling costs exceed revenues by roughly 15%, and mills are therefore heavily indebted to cane producers. Some mills are faced with foreclosure, and if the government doesn't step in with subsidies, as it did in 2013-14, at least some mills will have to shutter their doors. Even if the subsidies do appear in time, it would just be delaying the fallout from an obviously inefficient industry that could one day result in a material drop in sugar output.

Drought during the growing season in Brazil is expected to limit output for the 2014-15 marketing year to be equal, or slightly below 2013-14 output. Moreover, unlike in India, enough cane can be diverted to more-efficient ethanol production.

On September 25 the Brazilian government passed legislation that would raise the top end of the range of the mandated ethanol/gasoline blend to 27.5% ethanol, from 25%. It's early in the crush season, but we can already see crushers preparing for increased ethanol demand. According to recent data 56% of cane is being allocated to ethanol, compared with 51% at the same time last year.

We continue to believe that it is just a question of time before the global balance sheet tightens up enough to restrict the pool of available supplies in exporting countries. World prices will have to rise substantially to restructure a broken system.

Maintain long call option positions.

[By Sholom Sanik, Oct. 3, 2014]

Chart 3 – Weekly nearest contract ICE sugar

Courtesy Bloomberg LP

COCOA

Ebola fears and artificially high cocoa prices

Over the past few months cocoa prices have been influenced almost solely by the deadly Ebola virus (Chart 4). Two West African nations, Guinea and Liberia, have experienced the worst outbreak of the virus, and both countries share a border with the Ivory Coast, the world's largest cocoa bean producer.

The fears are twofold. First, Ivorian cocoa production is highly dependent on migrant workers from the two affected countries. There are legitimate concerns that authorities will be forced to seal the borders to prevent the virus from spreading to the Ivory Coast, which to date has not had any known cases of infection. So even if the Ivory Coast remains virus free, the availability of workers from Guinea and Liberia could dry up overnight. However, after a record crop and with plentiful global inventories, the chocolate industry could muddle through.

A more devastating scenario would develop if the virus itself crossed the borders to the Ivory Coast, which would force health officials to seal off production areas. That would halt shipments of beans to the ports and deliver an overnight supply shock.

Cases of Ebola have been identified in Guinea and Liberia in regions near their respective borders with the Ivory Coast. Traders' fears are palpable.

The actual supply/demand fundamentals are neutral, and were it not for the Ebola scare, it would be hard to

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make a case for cocoa prices maintaining these price levels. In addition, the strong dollar has depressed just about every internationally-traded commodity – coffee being a lone holdout.

The third-quarter grind showed mixed results. In Europe, the grind was down 1.1%. North America showed much stronger results, up 4.6%, much higher than analysts' guesstimates. But North American processors grind only about one third of the volume of their European counterparts, so the number is not as meaningful as the headlines suggest.

Second-quarter Asian grind results have not been released yet, except for Malaysia, where the grind was dismal – down 13.7% over last year. The Malaysian industry is small, so it's not as bad as it sounds. However if it is an indication for the other countries – mainly Indonesia – the "booming demand" story is right out the window. Asian grinding growth should be charging ahead. Indonesian grinding capacity alone is larger than Europe's.

As shown in Chart 5, the combined butter/powder ratio seems to be curling off the bottom, but the picture is a bit deceptive. Butter prices, which actually drive the market, have softened. The uptick in the ratio is the result of a small improvement in powder prices.

The Ivory Coast is coming off a record 2013-14 crop of better than 1.7 million tonnes, compared with 1.45 million tonnes is 2012-13. That's a 17% increase and even after factoring in other countries' output and the most optimistic grinding growth rate, we are looking at a global production/consumption surplus.

It's quite true that the market would spike if the "overnight-shock factor" of an Ivorian shut-down surfaced, and it could be devastating for shorts.

Nevertheless, we continue to believe that these prices are ridiculously high. Hopefully, global efforts to get the Ebola virus under control will succeed. As soon as traders feel that this is happening, cocoa prices will plunge.

Purchasing put options is not a viable alternative to being short futures because they are – understandably – expensive, as well as thin and illiquid. We recommend establishing short positions with tight stops, with the stops based on nothing more than the amount you are willing to risk. In a departure from our typical recommendations, the stops should be "good anytime," rather than "close only." Be prepared to try this more than once and to adopt this approach as part of your strategy when considering how much money you are willing to risk.

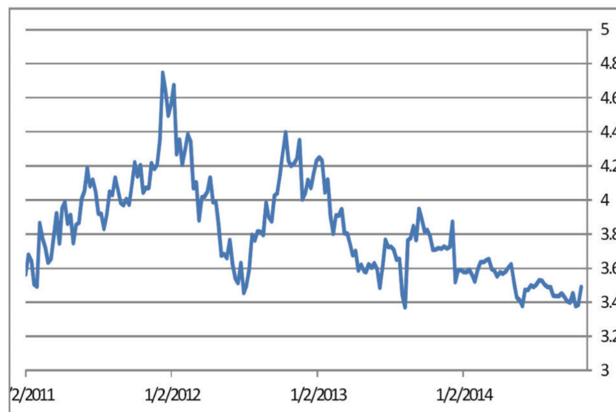
Sell December cocoa at the market.

[By Sholom Sanik, Oct. 22, 2014]

Chart 4 – December cocoa

Courtesy Bloomberg LP

Chart 5 – Butter/powder ratio



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COPPER

Steady Chinese demand and soft Chilean output growth could mean higher prices

Copper prices have been trending downwards since early summer and are now testing the $3-per-pound level (Chart 6).

On the surface, it would seem that as far as the demand side is concerned, prices remain vulnerable to further weakness. China is the world's largest importer and consumer of copper, but the current state of its economy does not support confidence that the importing patterns of the past several years can continue. The most recently released data showed that the economy grew 7.3% in the third quarter. That was the slowest quarterly growth rate in five years.

Maintaining the strength of Chinese imports faces another challenge – not necessarily connected to the strength of the economy. Banks have tightened financing conditions for the copper trade because of alleged illegal activity that was uncovered this past June.

Despite these potentially negative demand fundamentals, imports continue to hum along at a respectable pace. September imports of refined copper jumped by 23% from August, to 288,000 tonnes. While they were down 14.2% year-over-year, it's been four months since the threat of curtailed financing has been hanging over the market, and imports continue to be holding at reasonable levels.

Warehouse stocks have upticked, but as seen clearly in Chart 7, combined stocks at LME, Comex, and Shanghai warehouses remain at depressed levels. Information regarding the rumored stockpile in bonded warehouses in China, and which could be as large as 700,000 tonnes, remains elusive.

The International Copper Group (ICSG) reports the global refined production/consumption balance stood at a small surplus at the end of July. As always, however, its monthly reports are three months behind, and as such, the information could be dated. In particular, we draw attention to Chilean production.

Back in April, the Chilean government forecast that output would grow at 5% over 2013. At the time, that seemed to be a reasonable estimate. But in the past two months for which data are available – July and August – production fell by 3.1% and 2%, respectively. That would put the current annualized growth rate through the end of August at only 1.6%, a far cry from the early estimates. But official forecasts have already been downgraded to levels that would leave output roughly equal with last year's. It is not an unwillingness to produce at these prices; rather, ongoing labor problems, declining ore grades, and assorted production problems at key mines are the culprits.

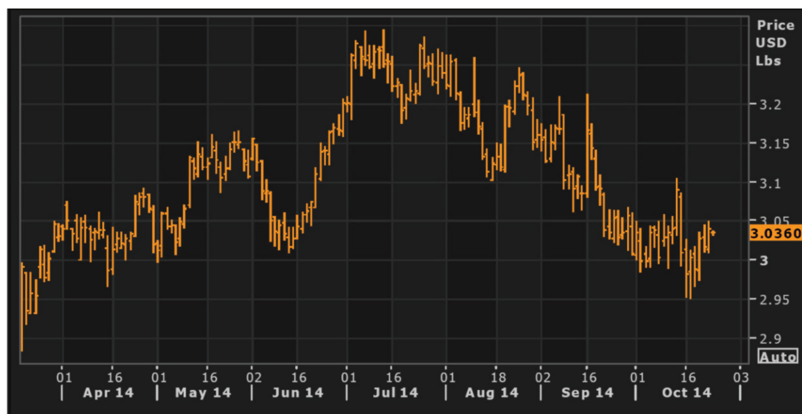
With China being the world's largest consumer, at 40% of global usage, and Chile being the world's largest producer, at 30% of global output, what happens in the rest of the world can possibly be described as minutiae. The US economy is growing, while Europe is still struggling, which balances out the demand side outside of China. Production outside of Chile, among other major producers, is generally growing, but is being dragged down by Indonesia and Zambia, where production in ICSG's study period is down 10% and 13% respectively.

Chile releases production figures for the previous month near the end of each month. The September data have the potential of being a market mover and could spark a meaningful short-covering rally. Commodity funds have shifted from a substantial net-long position of 49,000 contracts this past summer to a net short of 11,000 contracts (Chart 8). Bullish news from the Chilean production side would serve to complement what we see as the mostly neutral-to-bullish developments on the Chinese demand side.

We recommend establishing a long position in December copper at current levels of roughly $3 per pound. Place initial sell stops at $2.95, close only.

[By Sholom Sanik, Oct. 24, 2014]

Chart 6 – December copper



Courtesy Bloomberg LP

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Chart 7 – Combined global warehouse stocks

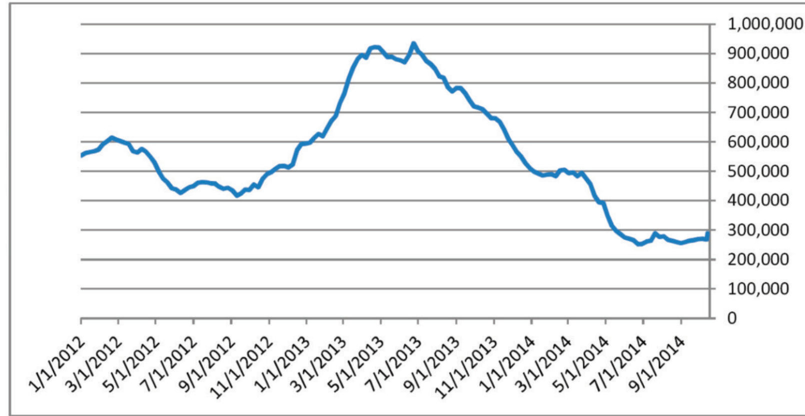
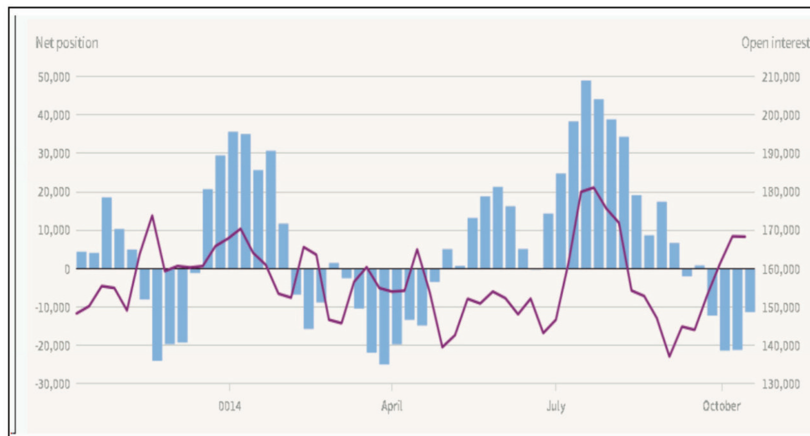


Chart 8 – Comex copper open interest and net fund position



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