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Coffee holding up in the post-frost season

The Brazilian coffee crop is in harvest, and the chances for any cold-weather damage at this point are negligible. The market has maintained the uptrend that began in September 2005 – for the moment anyway. This has been quite a feat, because along with almost every commodity on the board, coffee prices tumbled as the sub-prime crisis rippled through financial markets. In most cases, the mass liquidations had less to do with the effect a contracting economy would have on demand of a particular commodity than it did with liquidity and margin-call selling. The true test of any commodity that had its bull market interrupted by the wholesale selloff will be its behavior in the days and weeks to come. A snap back to pre-sub-prime crisis levels would indicate that the bull is back on track. We're currently consolidating the out-of-the-ordinary, one-day, 8¢-per-pound nosedive that the market suffered on August 16, the day the Dow Jones Industrial Average plunged to five-month lows.

Although we talk about total global production of coffee, which includes all varieties, in essence, the coffee market comprises two very distinct markets, arabica and robusta. It's important to make the distinction, because while a cursory glance at the two markets gives the impression that they move basically in tandem, a closer examination reveals that the performance of the two has diverged significantly over the past couple of years (Charts 1, 2, 3), and price direction is affected by two completely different sets of circumstances.

Robusta is grown mostly in Africa and Asia and can be delivered against the LIFFE coffee contract, whereas the higher-quality arabica grows mostly in South America and is deliverable at the NYBOT. Brazil is the number-one grower of arabica, while Vietnam is the largest producer of robusta.

Although the current 2006-07 season saw Vietnam harvest a record 18.6 million 60-kg bags, stocks were run down as a result of two years of sub-par output. Prices soared to eight-year highs. But the market began to form a top in early June as the tightness began to ease and the prospects for another record, or near-record, crop in 2007-08 began to take shape. As the start of the new-crop harvest nears, estimates vary widely – from 15 million to 18.5 million bags.

The situation for Brazilian coffee and the arabica market followed a similar script, but the timing was quite different. The market peaked at the end of 2006 as the 2006-07 crop became available. Although far from a record, output of 42.5 million bags was close to 20% above the previous, cyclically "off," season. Prices started to fade in early summer, but the annual freeze-watch halted the slide.

Most indications point towards a healthy 2007-08 crop in Vietnam – at least the size of this past season – which probably means that prices of robusta have peaked for now.

In Brazil, however, the cyclically "up" year was not strong enough to replenish inventories to a comfortable level. The most recent estimate for the 2007-08 crop was released on August 24 at 32.6 million bags. It was slightly above the government's April estimate of 32.1 million bags, but still a disappointment in terms of the previous "off" season in 2005-06, when output reached 36.1 million bags.

On the demand side, The International Coffee Organization estimates that global demand is growing at about 1.5% to 2% per annum, which puts 2007-08 consumption at about 120 million bags. But with global output expected to fall from 122 million bags in 2006-07 to 112 million bags in 2007-08, the swing from a small production/consumption surplus to a formidable deficit certainly places the market in a vulnerable position.

At present, we view current price weakness as a buying opportunity for NYBOT coffee, which is near the bottom range. A close below 105, basis the nearby contract, should be used as a stop. *[August 31, 2007]*

Inside

Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: *ssanik@friedberg.ca*).

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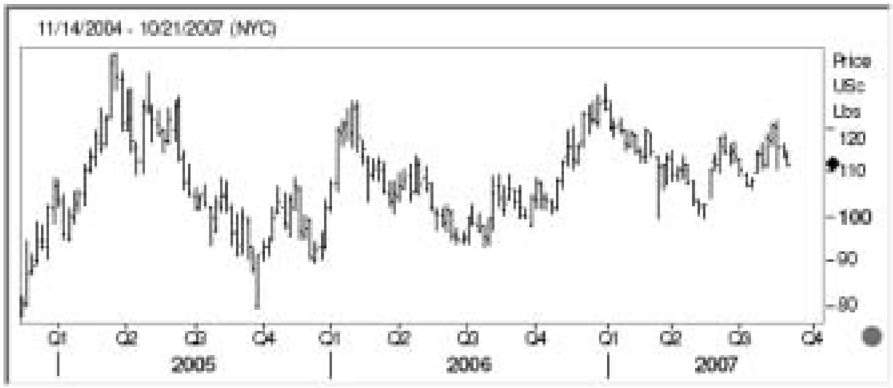
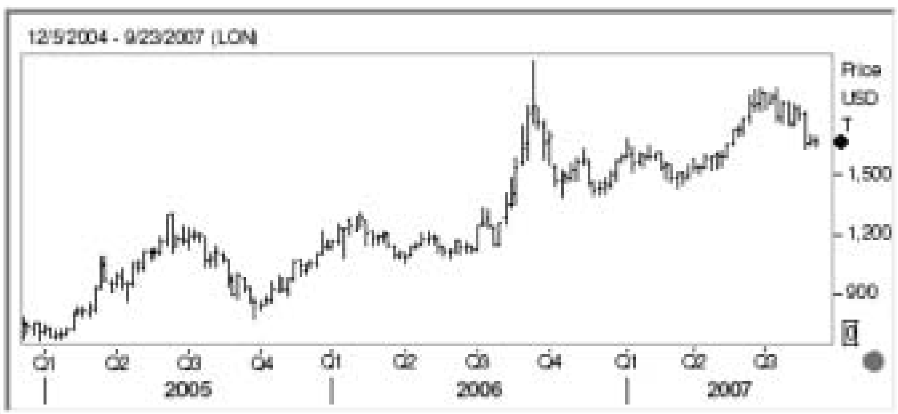
Chart 1 – Nearest contract NYBOT (arabica)



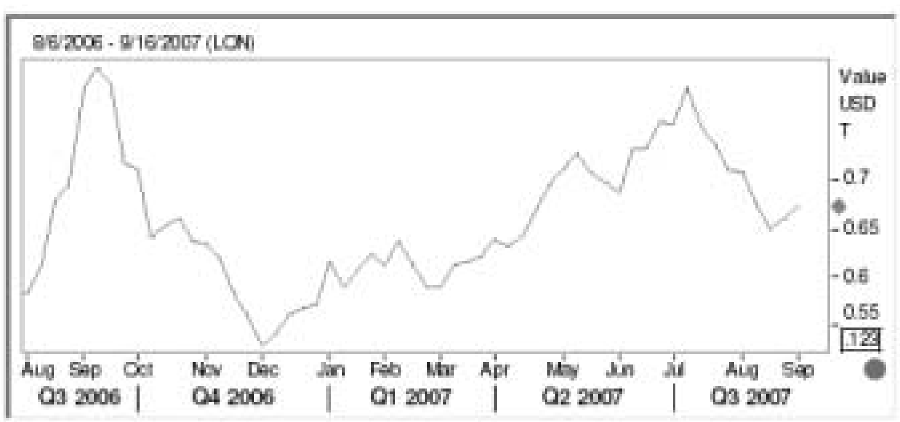
Courtesy Reuters

Chart 2 – Nearest contract LIFFE (robusta)



Courtesy Reuters

Chart 3 – Ratio nearest contract LIFFE/NYBOT



Courtesy Reuters

COCOA

Just a correction, and it's over

The cocoa market enjoyed a solid bull run in 2007, with prices jumping by about 35%. The 2006-07 crops of all the West African producing countries – whose combined output represents over 70% of the world's cocoa production – were poor and threatened to cause a significant drawdown in global stocks. But the rally ground to a halt in early July, and prices tumbled $400 per tonne, or close to 20% (Chart 4).

It would be easiest to blame the broad meltdown in commodity prices on the sub-prime crisis – indeed, prices topped right about the time the stock market posted its record high in mid-July. But traders were looking forward and were focusing on the new 2007-08 West African main crops, which are slated to return to normal levels after trudging through a dismal season. Rains that came too late for the 2006-07 mid-crop were quite beneficial for the new crop. So along with the generally poor environment for being long commodities – owing to factors completely external to the supply/demand fundamentals – those markets with crops that were looking good for the new crop year took an additional beating.

Although this market is looking very weak and is having trouble moving away from the low of the range, we believe that it remains tight. Traders who are focusing on the prospects for the new crop are ignoring a potentially widening deficit.

Ivorian arrivals for 2006-07 as of September 3 stand at 1.195 million tonnes, down 140,000 from last year at this time. But even this number is misleading, because the precipitation of the last two months arrived too late to help the mid-crop, but did result in an early start to the 2007-08 main-crop season. We estimate that mid-crop arrivals dried up in early August, because weekly arrival data are far too high to be coming solely from the mid-crop. This means the actual 2006-07 total crop will be about 20,000 tonnes less than will eventually be reported.

Official 2007-08 output figures will then be smaller than the indicated forecasts unless crop conditions are spectacular enough to push yields up. This is unlikely, because black pod disease has been prevalent in many areas, particularly in the southwest part of the Ivory Coast. While black pod is not new, and we hear about it every year, it seems that the problem is somewhat more serious this season.

In any case, the outgoing season has been a disappointment for output in all major regions – including Indonesia – which will leave a gaping production/consumption deficit. Recent estimates have decreased the size of the deficit to 125,000 tonnes, from 150,000 tonnes. We're skeptical about that, however, because we don't know of any supply-side factors that have improved, and the demand side has not shown any signs of weakness.

Third-quarter grind data for Europe and the US won't be out until mid-October, but recent butter ratio levels have been supportive. In Asia the ratio has been quoted in the neighborhood of 2.6 times the London spot prices, about 10% higher than earlier in the year. But in Europe the ratio has maintained the 2.9 level, which is historically close to the high end of the range. This means that grinding margins are attractive and will sooner or later push processors to step up bean purchases.

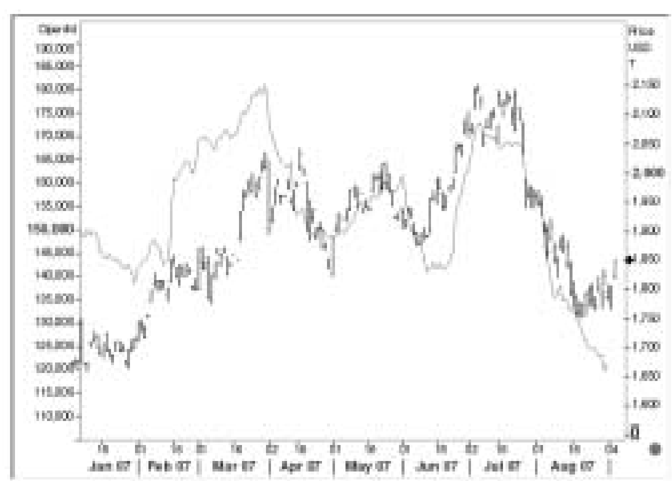
Open interest has dropped with prices (Chart 4), which we believe has served to clean out uncommitted bulls.

In conclusion, the pressure on the supply side that resulted from this past year's poor crops has drawn down stocks, and the optimism for replenishing inventories with the new crop is an uncertainty.

We advise maintaining long positions.

[September 6, 2007]

Chart 4 – December cocoa (bar), Open interest (line)



Courtesy Reuters

SOYBEANS

Are the beans overcooked?

For US farmers, allocating soybean-to-corn-acreage ratios earlier this year was a no-brainer. Soybean prices had fallen close to historic lows verus corn (Chart 5). The result was a massive shift of soybean acres to corn. The first USDA planting intentions report in March forecast that soybean acres would drop to 67.14 million acres. Along with every analyst on the street, including those with access to actual field surveys, we were embarrassingly off the mark with our assumption that higher prices would ensure that soybean farmers would "find" acres and that the more important June estimate would reflect this. The average guesstimate for the June planting intentions report was for an increase to 68 million acres, but the actual figure was 64.1 million acres. And that bit of information has by-and-large directed soybean prices since.

The sub-prime crisis interrupted the bullish euphoria with a brief but devastating correction (Chart 6), but the market has since snapped back. The August supply/demand situation report pegged the crop at 71.45 million tonnes, down from 86.77 million tonnes for the outgoing season. US ending stocks are expected to plunge to 6 million tonnes, or 7% of consumption, from 15.66 million tonnes, or 19% of usage.

Crop conditions have deteriorated throughout the summer. The good-to-excellent portion of the crop fell from 68% in early July to the current reading of 56%. Weather conditions in the US South and Midwest are adequate at the moment, but not perfect.

Global demand has grown steadily over the years, and for the most part, output has kept up with consumption. This coming season will be different, though, with consumption exceeding production by 12 million tonnes. Global ending stocks are forecast to fall to 51.63 million tonnes, or 22% of consumption, compared with 29% of usage last season.

By all rights, we should be quite bullish, and indeed, it would be difficult to argue that the bull run was not completely warranted.

But we're not bullish, because we're skeptical about a number of issues.

First of all, the basis of the intense relationship between corn and soybeans revolves around the rapid growth of the ethanol market and the ever-increasing share of corn output that biofuel will grab. Corn prices are now languishing because farmers responded quickly and grew a huge corn crop at the expense of the soybean crop. But looking down the road, farmers are not out to save the world and provide efficient energy sources; they're out to run profitable businesses. Chart 5 shows that the advantage of planting corn over soybeans is all but gone because the ratio has returned to normal levels. The higher soybean prices rise, the higher the probability that we will return to a trendline crop size in 2008-09.

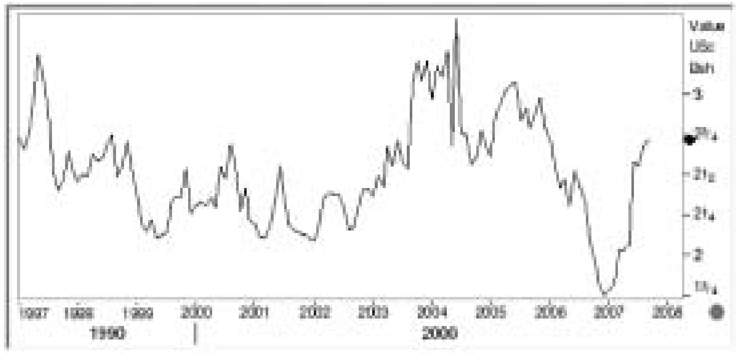
But we don't have to wait that long. Brazilian farmers are planting their 2007-08 crops now. Unlike the US farmer who came into this crop year with the soybean/corn ratio down at the bottom of the chart, the Brazilian farmer is coming in at relatively normal levels. Analysts have been downplaying the possibility of another record Brazilian soybean crop, because of the attractiveness of planting corn, but that's now ancient history.

The USDA is forecasting a 61-million-tonne Brazilian soybean crop, up from 59 million tonnes in 2006-07. We've seen the early Brazilian estimates change dramatically over the past five years – usually to the downside. The Brazilian estimates will therefore become increasingly important during the fall months as we get a better idea of how many acres were planted.

Another issue is the USDA's 41.5-bushel-per-acre yield estimate for the US crop. Although crop conditions – as illustrated – are not ideal, we've seen time and time again in recent years how the pessimism surrounding US crops does not bear out, mostly because of advanced agricultural technology. We've seen some upticks in crop estimates – albeit cautious ones, after the humbling experience analysts suffered with the July planting intentions report – which indicate that others share this view.

Although a global ending stock ratio of 22% of consumption is below the level of the past few seasons, it is not alarmingly low in historical terms. We view $9-per-bushel soybeans as extraordinarily high. We are not willing to go short, because the US crop is not made, and we don't really have a good idea about the size of the Brazilian crop. If the supply side does not suffer any setbacks over the next several weeks, prices will certainly begin to fall. Remain sidelined for the moment, but do stay tuned. *[September 10, 2007]*

Chart 5 – Soybean/corn ratio



Courtesy Reuters

Chart 6 – November soybeans

Courtesy Reuters

WHEAT

Peering down from dizzying heights

In the foreseeable future, all of us in the commodity futures business are going to feel silly applying the many verbs we typically use loosely to describe rising commodity prices such as "soared," "skyrocketed," "exploded," spiked," etc. Wheat prices, well..., uh, all of the above, by $4 per bushel since April, almost doubling in price.

Evidence of the frenzy that has driven prices to historic highs is overwhelming. Europeans are paying the equivalent of over US$10 per bushel. US export commitments for new crop wheat stand at 17.2 million tonnes, compared with only 8.9 million tonnes at this time last year, an extraordinarily high number for this early in the year. Although the forecast for 2007-08 is for a jump in foreign sales to 32.41 million tonnes, we're still way ahead of the typical pace, with over half of anticipated sales already contracted. In 2006-07 and 2005-06 at this point in the season, commitments were 36% and 41% of final sales, respectively. This means that even if sales slow down, we should meet the USDA estimate, which would be the largest US export tally since the 1995-96 season.

Even before we knew the extent of the damage suffered by Northern Hemisphere winter wheat crops, we were headed into a third consecutive year of global production/consumption deficits. December wheat was already trading at over $5.5 per bushel to reflect this. Then, as is obvious from Chart 7, the street was spooked by the June 11 supply/demand situation report, which was the first post-bad-weather glimpse we had of FSU crops. The estimate was slashed by 7.3 million tonnes from the initial May estimate.

There is no shortage of bullish news. Daily press reports detail seemingly desperate purchases. The Australian, Canadian, and European crops are slated for downward revisions.

Actually, the estimate for global ending stocks – the lowest inventory level in recorded history – has not really changed very much, because demand was revised down as well. The May estimate – the first look at the new crop year – forecast stocks at 113 million tonnes, or 18.4% of consumption, whereas the current August estimate stands at 114.78 million tonnes, or 18.1% of consumption.

Revisions such as those to the crops of the producing countries mentioned above will surely see the estimate for global output drop by several million tonnes in the USDA's

September 12 report. Using the International Grain Council's August 23 estimate as a guide, we could see production fall by 7 million tonnes, which – if there is no change to the demand side of the balance sheet – would pull global ending stocks down to 108 million tonnes, or 17.4% of consumption.

The market can easily continue to run. Still, we believe that there are some sobering points to be made that have not been the focus of the media, which is concentrating strictly on the excitement of this fantastic bull market.

First, open interest has nosedived throughout the meat of the move (Chart 7), which means that somebody is covering shorts. When that punishment ends, we might run out of buyers. True, export sale levels indicate that physical demand accounts for at least some of the demand, but at these prices we don't know if that is sustainable either.

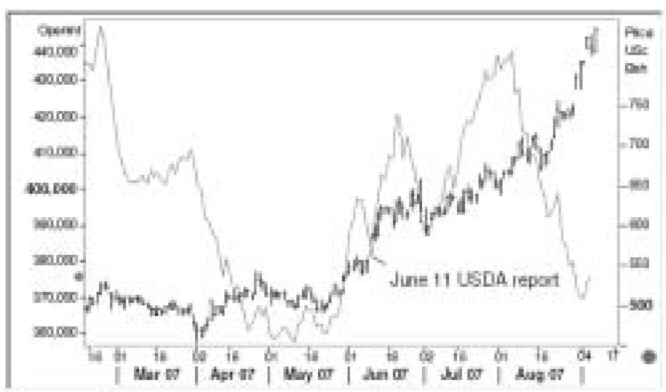
More importantly, for years, global wheat output declined, mainly because prices were low, and there were other more profitable crops to plant. This is no longer the case. If we look at the next crop year's contracts to which the winter wheat crops that are now being planted can be delivered, we find that farmers can hedge at prices they've never seen, beating any crop for profitability. Even at $2.5 per bushel below current spot prices, July wheat is trading at just below $6 per bushel, dramatically above-average prices of the past decade (Chart 8).

We have not seen much discussion about winter wheat acreage, both in the US and abroad. There is little reason to assume that wheat will not follow the pattern of other commodity bull markets of recent years in which high prices became the most bearish of fundamentals, such as sugar and, dare we say, corn.

We advise doing absolutely nothing at the moment – trading either side of this market can be hazardous. However, we also recommend being on the lookout for key reversals, which would inspire us to sell short deferred contract months.

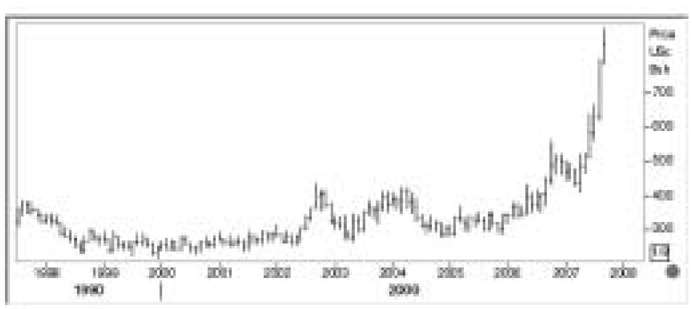
[September 10, 2007]

Chart 7 – December wheat (bar), open interest (line)



Courtesy Reuters

Chart 8 – Monthly nearest contract



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