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Cocoa: demand joins supply side in the bull camp

The past few weeks have seen cocoa prices spike out of their long-standing range of between $2,000 and $2,500 per tonne (Chart 1).

West African cocoa producers are heading into the final few weeks of their mid-crop seasons. The Ivory Coast, Ghana, Nigeria, and Cameroon will all harvest significantly smaller crops than they did last year. There are no great surprises, though. The final numbers are very close to estimates that have been on the street for several months.

As expected, there's been no improvement in Ivorian arrivals as the mid-crop progressed. In fact, the arrivals are 80,000 tonnes, or 5.7%, below last year at this time, compared with 3.8% at the beginning of July. Forecasts for the 2011-12 combined main and mid crops are at about 1.35 million tonnes, down from 1.5 million tonnes a year earlier. That estimate will be revised upwards, because we are already at that level, but not by much, and that's where the bearish news ends.

Ghanaian mid-crop arrivals are much weaker than last year's, currently at just over 51,000 tonnes. Last season, the mid-crop reached 107,000 tonnes. With very little time remaining, total mid-crop will not climb much more. That would bring total production for 2011-12 to somewhere between 825,000 and 850,000 tonnes, sharply below 2010-11 output of over 1 million tonnes.

While these poor production performances for the world's two largest producers have more or less been known for some time, prices were restrained by anemic demand (see *Focus on Futures*, July 13).

Grind activity over the past few quarters has been very weak. The most recent data for the North American and European grind, released in July, showed dismal results for the second quarter. The North American grind fell 9.8% from a year earlier, the largest drop in three years. The European results were even more dramatic – down 17.8% from the previous year, the biggest quarterly loss in 12 years! The bears were in control – or so they thought. Ironically, prices began to rise almost immediately after the quarterly grind data were published.

Butter ratios had fallen all the way down to 1 times the spot London bean price, after peaking at over 3 in 2007. With slim profit margins, the incentive to grind was weak. It seems, however, that actual end-user demand was not quite as weak as believed, because butter inventories were run down to the point of *bona fide* tightness. In mid-July the butter ratio began to rise. In Europe the ratio has now shot up to 1.6. At 1.4, the increase in the Asian ratio has been more moderate, but still indicative of a much tighter market.

Although powder prices have retreated from the peak set last year, the increase in the price of butter has been substantial. The combined butter/powder ratio (Chart 3) should provide enough stimulus for processors to ramp up grinding activity.

On August 28, The International Cocoa Organization (ICCO) reduced its estimate for the size of the global deficit, from 43,000 tonnes to only 19,000 tonnes, on account of the sharp drop in second-quarter grindings. Based on the explosive upward move in the price of butter, however, it's hard to imagine that grinding activity has not increased over the past few months. Third-quarter grind numbers will be released in mid-October, and we expect to see much stronger activity reflected in the new numbers.

Inside

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

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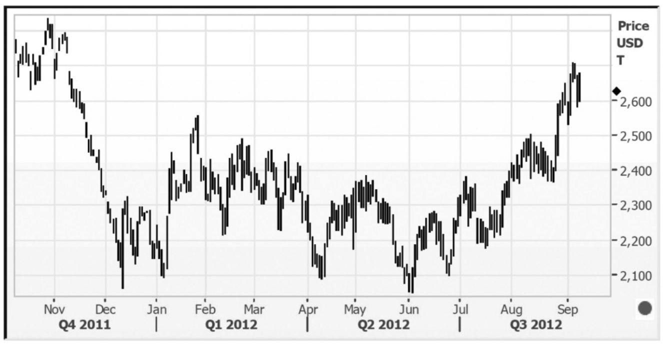
Not surprisingly, speculators have taken note of the rally. The spec community has been net short this market for the longest time and in the space of just several weeks has whipped around to the long side (Chart 4). So we can expect some volatility.

But make no mistake, with the drop in 2011-12 West African output and now that demand has improved, there's much more substance to this move than a fleeting short-covering rally. The rally is deeply rooted in long-term supply and demand fundamentals. This includes producing nations with potentially volatile output and – despite current economic woes – a long-term broadening of the consumer base, as developing countries adapt to Western snacking habits.

Raise stops to $2,300 per tonne, basis the nearest contract month. Close only.

[September 11, 2012]

Chart 1 – December cocoa



Courtesy Reuters

Chart 2 – Cocoa powder

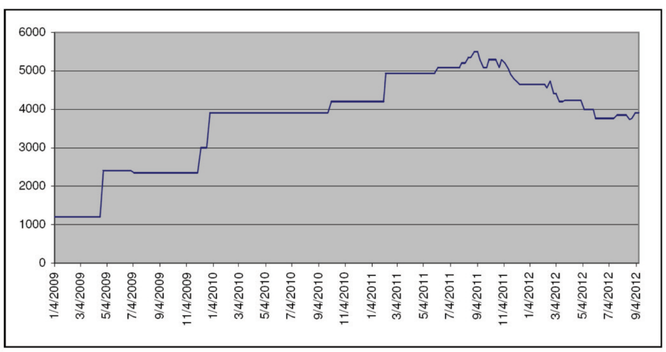


Chart 3 – Cocoa butter/powder ratio

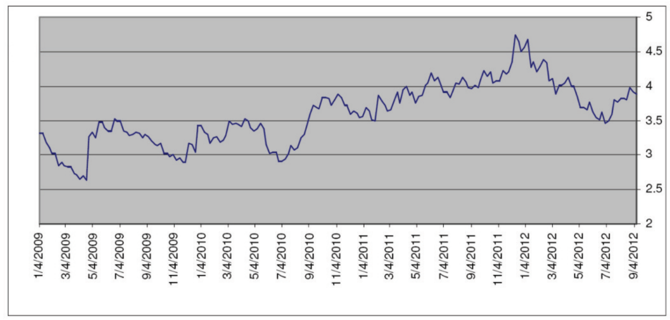
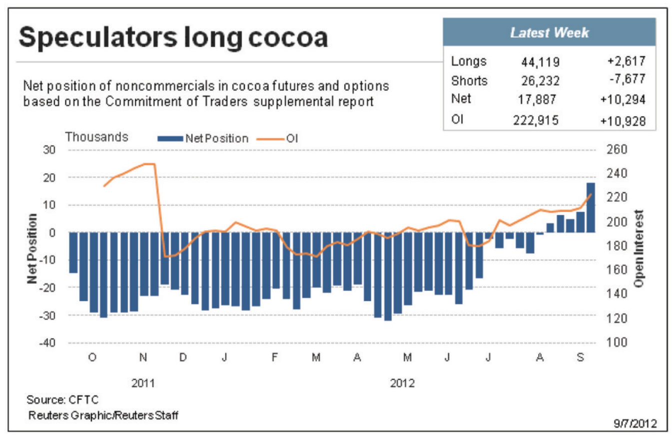


Chart 4 – Net speculator position



Courtesy Reuters

SOYBEANS

US crop gets a boost – is it enough?

It finally rained in August. Too late for corn, but not so for soybeans. The most punishing heat came in June and July, just when the early-planted US corn crop was in pollination. Soybeans are planted much later, though, and were still in a position to benefit from the rain.

Soybean prices peaked in early September, even while most analysts were still forecasting a worst-case scenario for the crop. The September 12 USDA monthly crop report lowered the bushel-per-acre yield (bpa) to 35.3, down from the 36.1-bpa August estimate and not far off the average of analysts' guesstimates of 35.8 bpa. Even the most recent weekly crop progress report put the good-to-excellent portion of the crop at 33%, only three percentage points above the worst readings that prevailed through most of the season and dramatically worse than last year's reading of 53% at this juncture of the season.

Although soybeans that were planted early did not fare much better than corn, late-planted crops, which include beans that are double planted, seem to have grown under fairly normal conditions. A survey of analysts taken in recent days indicated that the average national yield would rise to 35.8 bpa. Traders, however – judging from the $1.50-per-bushel price slide – seem to believe that the improvement in yield was considerably larger.

The promise of massive South American crops to be harvested next spring is expected to provide relief should the US "run out of beans." As always, though, weather has made predicting South American crops impossible, and we're beginning to see shades of trouble. Argentina had an extremely wet August, which is a positive in terms of securing adequate subsoil moisture and inspired analysts to increase their crop estimates. The precipitation, however, was excessive to the point of flooding in key regions, affecting hundreds of thousands of acres that cannot be planted until the fields dry out. Late planting typically reduces yields.

The USDA estimate for combined 2012-13 Brazilian and Argentinean output is 136 million tonnes, up from last season's 107.5 million tonnes. Some analysts have suggested that farmers will go wild because of high prices that would leave them with extraordinary profits and have come up with a "leap frog" forecast of 150 million tonnes. Aside from the potential weather issue, it is doubtful that the infrastructure for planting, cultivating, and transporting that kind of volume exists in either Brazil or Argentina. Brazil has been working on modernizing its highway network, but that will certainly not be in place for moving the 2012-13 crop to market. The USDA estimate is much more realistic. Last year's crops were plagued with weather problems, but a year earlier the combined crop reached 124.5 million tonnes.

The other potential bullish factor is demand. Unlike many other commodities, sticker shock has not been a factor – yet. US export commitments stand at 21.4 million tonnes, well above last year at this time when sales were only 15 million tonnes. The USDA actually lowered its estimate for 2012-13 exports by 1.5 million tonnes, or 5%, from its August estimate, to 28.71 million tonnes. This compares with last year's final sales of 37.01 million tonnes. The USDA estimate is more of a reflection of how much the US *can* sell, rather than demand.

Global ending stocks for 2012-13 are currently forecast at 53.1 million tonnes, or 20.6% of usage. That's right on the border – anything lower than that has sparked multi-year bull markets in the past.

To be sure, the US crop will still be significantly below the average of the past few years, even with the improved weather. When prices approached $18 per bushel, however, the market was pricing a total disaster. Any further reduction in yield would have sent US ending stocks below 100 million bushels.

With a more optimistic outlook for the crop, the market is now repricing the drought's impact on soybean supply. The size of South American crops is important, and the extent of weather-related problems is not yet known. In all likelihood, with the expansion of acreage, production should still be sufficient to compensate for the US crop – even with some weather problems.

Still, unexpected strong demand and the South American situation remain strong variables. Remain long. Maintain stops recommended on August 31at $15.40, close only.

[September 23, 2012]

Chart 5 – November soybeans

Courtesy Reuters

CORN

More demand rationing?

The October USDA crop report for corn did not contain any extraordinary revisions from September data, although the market's reaction – a 36¢-per-bushel rally – seemed to indicate otherwise.

There was some discussion about late rains salvaging some of the drought-ravaged corn crop as they did for soybeans, but the damage was done, and it was not realistic to expect much improvement. Analysts polled in the days leading up to the report estimated that harvested acreage would fall further, but yield would be bumped up. They didn't get it quite right. The estimate for harvested acreage was raised by 300 million acres, to 87.7 million acres. The yield came in at 122 bushel-per-acre (bpa), down from the September estimate of 122.884 bpa. The crop estimate now stands at 10.706 billion bushels, 21 million bushels below last month's estimate – in the grand scheme, a relatively small amount.

The estimate for 2012-13 US ending stocks fell to a 20-year low of 619 million bushels, or 5.6% of usage, down from the 733-million bushel September estimate. The largest contributing factor was a near 200-million bushel downward revision of 2011-12 ending stocks, but that was known weeks ago – on September 28 – when the USDA surprised the market with a much lower-than-expected quarterly stocks figure.

In the meantime, export demand for US corn is almost nonexistent, at a time of year when harvest pressure depresses prices and foreigners are normally booking orders for the soon-to-be-harvested corn crop. US export commitments over the past four weeks averaged an embarrassing 100,000 tonnes – which included two weeks of near zero sales. In the same four-week period last year, average weekly commitments were just under 1 million tonnes. Actually, this year was not really an exception in regard to harvest pressure; it's just that the "depressed" prices were still at record highs, as well as higher than those of other foreign origins.

The USDA lowered the estimate for 2012-13 exports by 2.5 million tonnes, to 29.2 million tonnes, which would be down an astounding 25% from last season and the lowest US export figure since the 1974-75 season. Total commitments for 2012-13 stand at 10.4 million tonnes, which is 43% below last year at this time.

The forecasts for all principal demand categories are dramatically below last year's levels. Feed demand is estimated to fall by 9%, while ethanol is expected to be 10% lower. Unlike exports, where the pessimism is based on hard facts, US feed demand has not shown any weakness yet, which is precisely what the USDA's eye-opening quarterly stocks report was about.

The harvest is almost complete, so it is unlikely that US crop forecasts are going to vary materially from the October estimate at this point. South American corn output, however, will now begin to play a larger role, than it ever has. In 2011-12 Argentinean farmers planned to harvest a record crop, but because of drought, production reached only 21 million tonnes, 16% below the previous season. Planting intentions are about the same for the 2012-13 crop. Weather permitting, that should yield a crop of 28 million tonnes and exports of 18.5 million tonnes.

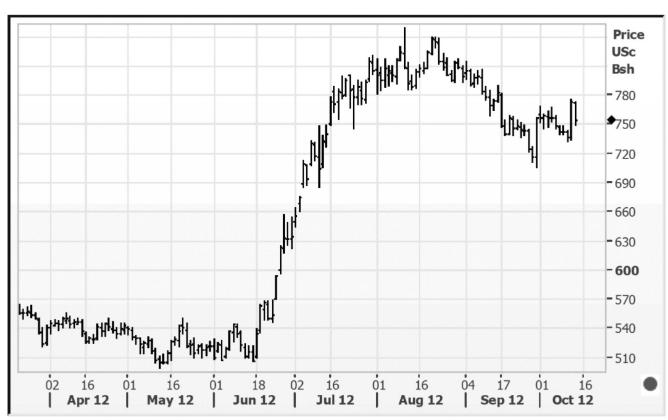
At 70 million tonnes, Brazil's crop will be smaller than last year, but with exports of 16 million tonnes it is still the third-largest exporter behind the US and Argentina. Still with the history of crop-altering erratic weather swings in South America, the estimates of export availability are all conjecture at this time.

So that leaves us with two major wild cards. Any glitches in South America, and even a small uptick in global demand, will tighten the market further. As it stands now, global ending stocks are estimated at 13.74% of consumption, their lowest level since 1973-74.

Maintain long positions and raise stops to $6.95 per bushel, basis December, close only.

[October 14, 2012]

Chart 6 – December corn



Courtesy Reuters

COPPER

No muscle in this rally

The recent rally in copper prices could appear to reflect bullish developments in supply/demand fundamentals (Chart 7). The International Copper Study Group's (ICSG) most recent data show that the global refined copper deficit at the end of the first half of 2012 had grown to 473,000 tonnes. A closer look, however, might cast some doubt on such optimism.

First, after lagging in its traditional relationship with the stock market for most of 2012 (Chart 8), copper prices had some catch-up to do. With the Dow Jones Industrial Average at five-year highs, it was inevitable not to associate the powerful equity market with a stronger economy down the road, and ultimately, improved demand for copper and other industrial commodities.

ICSG data are dated by three months, though, and at least some more current supply-side data would indicate that the market is not nearly as tight as the headline statistics portray. In its forecast for the balance of 2012, ICSG itself estimates that the deficit will moderate somewhat by year-end, down to 400,000 tonnes, and that in 2013 the market will flip completely to the other side with a *surplus* of 458,000 tonnes!

For the first time in ever so long, Chilean output has strung together a fairly decent stretch of robust monthly output figures.

Production for 2011 was 3.2% below the previous year. Earlier this year it seemed that the two restrictive forces that hampered increased output – labor strife and dwindling high-grade ore – would continue to keep a lid on growth. Output shrank 1.2% in the first quarter, but then grew 3.6% in the second quarter. June and July averaged an increase of 8.8%. Average monthly output for the year so far is 3.08%. That is far shy of original forecasts that put output growth at 6% to 10% for 2012. But if the pace remains steady, those levels – with four months of reporting remaining – are still achievable.

Chinese imports for September were strong – 11% above August and 3.6% higher, year over year. As Chart 9 illustrates fairly clearly, however, total imports are still in a downtrend and nowhere close to the levels that were indicative of the urgent Chinese buying that drove prices. With softer economic growth rates in China it is difficult to expect a return to an environment in which the Chinese will not be price conscious.

Combined LME, COMEX, and Shanghai exchange warehouse stocks have been falling since 2010, but have been inching up over the past few months (Chart 10). These inventories do not include the off-exchange stockpiles that have been accumulated in China and are locked up in financing deals, rumored to be as large as 600,000 tonnes.

Perhaps the greatest evidence that the rally in copper was powered by a speculative flurry rather a shift in fundamentals is found in an examination of the open interest. The 20,000-contract increase in open interest to the 155,000-contract level in itself was not that extraordinary – it was higher earlier in the year (Chart 11).

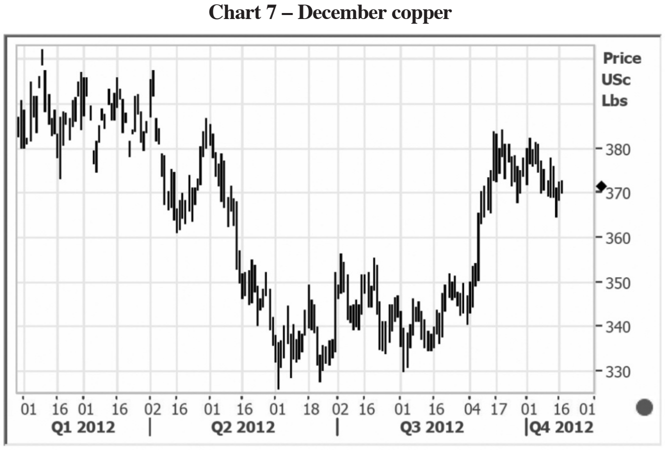
The net-position of commodity funds, however, swung around dramatically, from a large net-short of about 13,000 contracts, to a huge net-long position of about 24,000 contracts in the space of just a few weeks (Chart 12). That is a bit unusual.

Moreover, the lion's share of the rally happened in just a few days, but prices have stagnated since and have drifted lower even while open interest continued to build, proof that a good deal of the buying was inspired by nothing more than a bullish-looking chart.

We were stopped out of our short position at $3.56 per pound, basis December, as per our August 2 recommendation. The rally has now run its course. Sell December copper, placing initial stops at $3.85 per pound, close only.

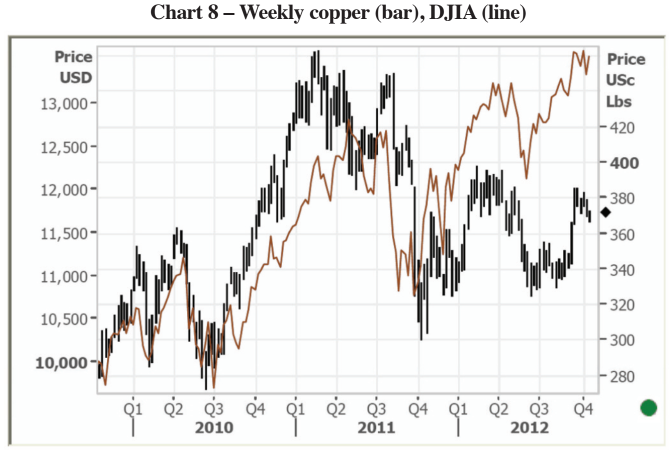
[October 17, 2012]

Chart 7 – December copper



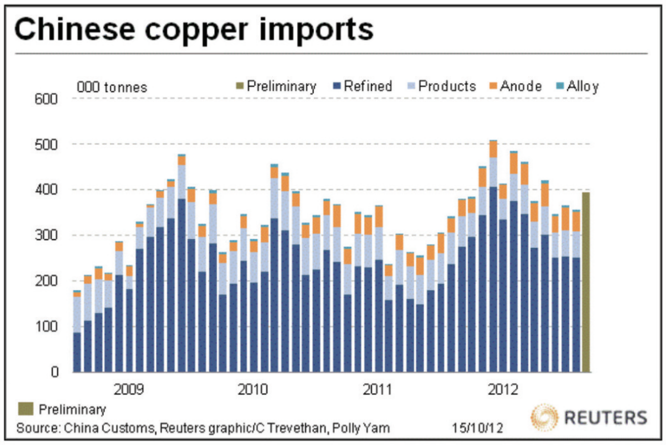
Courtesy Reuters

Chart 8 – Weekly copper (bar), DJIA (line)



Courtesy Reuters

Chart 9 – Chinese copper imports



Courtesy Reuters

Chart 11 – COMEX copper open interest

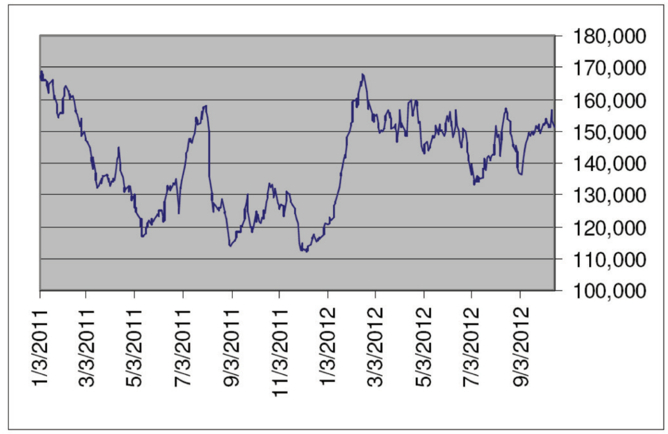


Chart 10 – Global exchange warehouse stocks

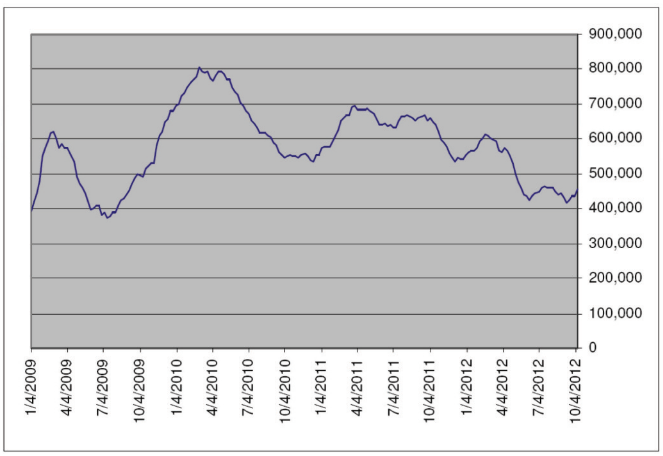
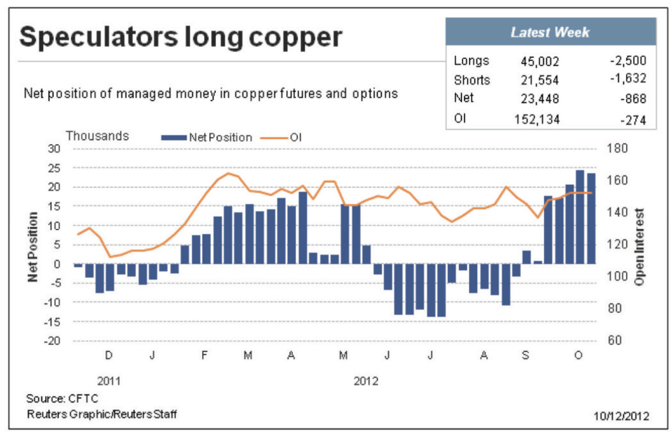


Chart 12 – Speculative net copper position



Courtesy Reuters

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