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US wheat crops are shrinking, but does it matter?

The lion's share of this summer's rally in Chicago Board of Trade (CBOT) wheat has disappeared (Chart 1). Minneapolis Grain Exchange (MGE) wheat has lost its luster as well, but is still 20% above a one-year-long trading range (Chart 2).

MGE wheat represents US spring wheat, which has suffered from extreme drought in the primary growing region – the Northern Plains. To illustrate the damage, consider the most recent USDA crop ratings: The good-to-excellent portion of the crop stood at a scant 33% compared with 68% at this time last year.

To a degree, the participation of CBOT wheat and Kansas City Board of Trade hard red winter wheat, which represent soft winter wheat and hard red winter wheat, respectively, and which are just about completely harvested, was in "sympathy" with the move in MGE wheat. Although there is some overlap in uses of spring and winter wheat, they are not entirely the same commodities. But there was ample reason for traders to drive up prices of the winter wheats independently, at least temporarily.

US farmers have been shifting acreage away from wheat as foreign demand declined over the years, but this year's decline was stark. Winter wheat acres, which were planted in the fall of 2016 and are now being harvested for the 2017-18 marketing year, were 32.94 million acres, compared with 36.14 million acres for 2016-17, the smallest number of acres in over 100 years.

Of course, that left the crop more vulnerable to inclement weather, and indeed the weather was not perfect for winter wheat either. As of the USDA's most recent pre-harvest condition report published on July 5, the good-to-excellent portion of the winter wheat crop was 48% compared with 62% the same time last year.

The August crop report actually raised the estimate for winter wheat to 50 bushels per acre (bpa) from the July estimate of 49.7 bpa. The overall yield was dragged down to 45.6 bpa from 46.2 bpa because of the disastrous spring wheat crop. But the spring wheat crop compromises only 28% of the total crop.

The rally in wheat was an overreaction. The US role as an exporter is fading. Ten years ago US wheat exports accounted for 30% of world trade compared with less than 15% forecast for 2017-18. (Soybeans and corn account for 38% and 30%, respectively.)

Among major Northern Hemisphere exporting nations, only Canadian output will be materially lower than last year, because of bad weather. Production was revised down by 1.85 million tonnes from the July estimate, to 26.5 million tonnes, compared with last year's record crop of 31.70 million tonnes.

The others, however, had excellent crops. The EU is expected to harvest 149.56 million tonnes, up from 145.70 million tonnes in 2016-17. FSU countries all were revised higher in the August crop report. The most significant jump was for Russia, from 72 million tonnes in July, to a record 77.5 million tonnes.

The sloppy performance in the US was handily mitigated by the other producers. Global ending stocks for 2017-18 were revised upwards to 35.9% of consumption, compared with 34.9% last year. The last time world supplies were this plentiful was in the late 1990s when wheat was trading at $2.50 per bushel (Chart 3).

We recommend selling December wheat. Place initial stops at $5 per bushel, close only.

[Sholom Sanik, August 15, 2017]

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Chart 1 – December CBOT wheat

Chart courtesy Reuters

Chart 2 – December MGE wheat

Chart courtesy Reuters

Chart 3 – Wheat: Global ending stocks as a percentage of consumption

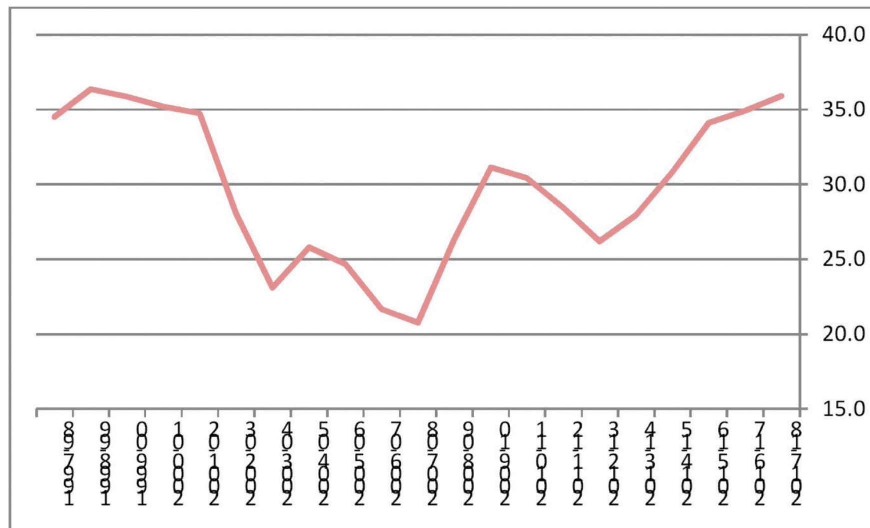

Chart: source USDA

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CORN

US crop failure is cancelled

The USDA's August crop report – the first field survey of the season – was expected to show the effects of poor crop ratings after a summer of hot and dry weather in many key growing regions. The average of analysts' guesstimates called for a sizeable downward revision to the bushel-per-acre (bpa) yield, to 166.2 bpa, from the 170.6 bpa July estimate. Traders were quite surprised when the USDA dropped the estimate by just 1.2 bpa, to 69.5 bpa. That would mean a US crop of 1.415 billion bushels (362 million tonnes), instead of the anticipated 1.385 billion bushels (352 million tonnes).

Corn prices fell by 15¢ per bushel on the news, which took out the low end of a trading range that held throughout the planting and growing seasons (Chart 4).

While the top two growing states – Iowa and Illinois – and the number-four state, Minnesota, are expected to see yields fall below last year's level, the number-three state – Nebraska – is expected to have higher yields. While we certainly will not make last year's 174.6 bpa record yield, there were enough states with normal growing conditions, which helped mitigate the damage.

The weekly crop progress report that followed the release of the monthly crop report made some sense of it. The good-to-excellent portion of the crop was increased by two percentage points from the previous week, to 62%. That's still well below last year's rating of 74% at this juncture of the season, but of note, with the most recent update, the crop rating is two percentage points above the five-year average. So unless the final growing weeks run into a fresh wave of bad weather, disaster has been averted.

Down the road, South American crops have been getting larger, and while still dwarfed by the size of the US crop, they are becoming a more prominent factor in world trade. This past season (2016-17) Brazil produced a record 98.5 million tonnes, up from 67 million tonnes the previous season. Argentinean farmers also increased corn area materially to take advantage of the elimination of the export tax. Output jumped by 38%, to 41 million tonnes. While it's early to speak of 2017-18 South American crops, which have not even been seeded, Argentinean planting intentions show that corn area will grow by 5% to 10%.

Having presented a largely bearish case, we nevertheless do not see corn prices falling apart completely. Global demand has expanded alongside the increase in output. In 2016-17, global production grew by 10% while consumption increased by 9.3%. For 2017-18, output is forecast to fall by 3%, while demand is expected to grow by 1%, drawing global inventories down. If forecasts are met, 2017-18 will be the first marketing year since 2010-11 in which there will be a global production/consumption deficit. That is a bit hard to believe in an environment where South American crops have increased by as much as they have.

Ending stocks as a percentage of consumption for 2017-18 are estimated at 18.9%, down from 21.6% in 2016-17. Chart 5 shows how global inventories have failed to grow and are back near levels we saw in the mid-2000s before the 2008 bull market sent prices soaring to $7.50 per bushel.

This is in stark contrast to robust global wheat and soybean inventories.

Early results for new-crop US exports are substantially below last year at this time – 5.7 million tonnes vs. 10.1 million tonnes. This explains why the USDA is forecasting a drop in US exports for 2017-18, to 47 million tonnes, down from 56.5 million tonnes in 2016-17. If the pace of US sales were to pick up once the new marketing year opens in September, we're confident that corn prices will find some support owing to the potentially vulnerable level of global ending stocks.

Despite the downward trend in global inventories, there is no near-term overt bullish case to be made. Funds hopped onto the long side in anticipation of a US crop failure, which has not materialized (Chart 6). We expect the market to drift lower as the funds liquidate their long position, and invariably there will be fresh shorts that will respond to a very heavy-looking chart.

For the moment, stand aside.

[By Sholom Sanik, August 18, 2017]

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Chart 4 – December CBOT corn

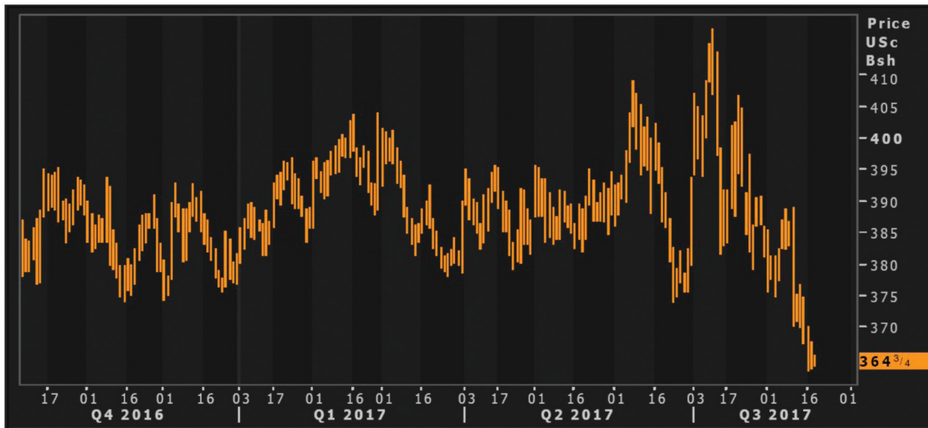

Chart courtesy Reuters

Chart 5 – Corn: Global ending stocks as a percentage of consumption

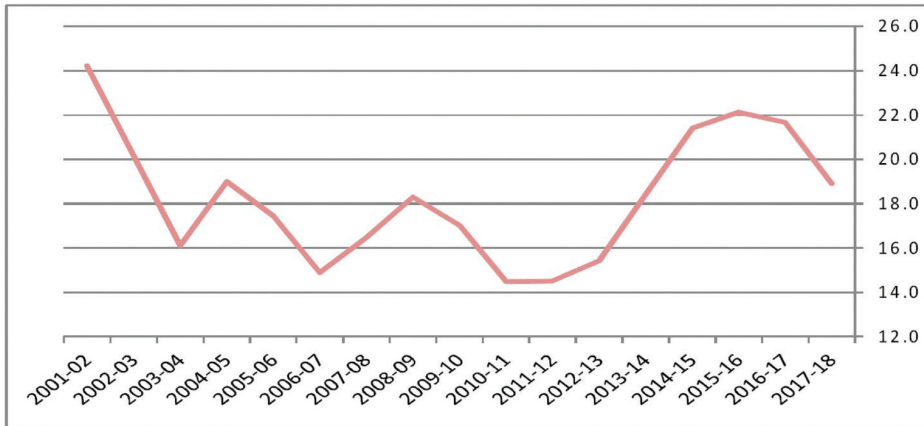

Chart: source USDA

Chart 6 – Corn: Commodity fund net-long position (bar)

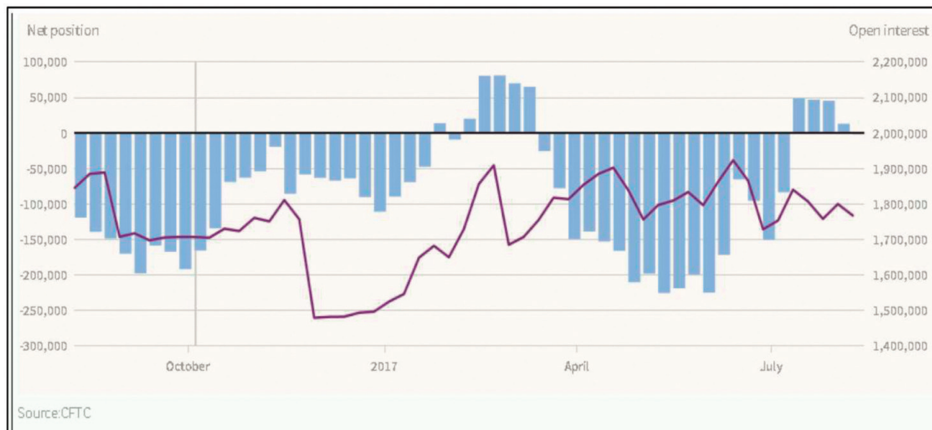

Chart: source CFTC

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SUGAR

Are frothy estimates for a global surplus sustainable?

Estimates for the 2017-18 global balance are beginning to appear, and on the surface, it would seem that the bear has a firm grip on the market. On August 18 the International Sugar Organization said that there would be a production/consumption surplus of 4.6 million tonnes, compared with a deficit of 3.9 million tonnes in 2016-17. One private analyst put the surplus at over 7 million tonnes.

There have been several developments. On the bearish side, output for the key Asian producing nations – India, Thailand, and China – will recover from a drought-stricken 2016-17.

In looking at each of these three countries individually, only Thai output – up more than 10% – will be a genuine bearish factor. Domestic consumption accounts for about 25% of output, with the balance marked for export. That will leave roughly 8.5 million tonnes for export, compared with only 7 million tonnes last year.

India

The largest output increase will be in India. Production is expected to jump by close to 25%, to 25 million tonnes in 2017-18, from 20.5 million tonnes in 2016-17

Domestic consumption has remained stagnant over the past several years, at 26 million tonnes. But with a 1-million tonne production/consumption deficit, stocks will be drawn down further. Ending stocks for 2017-18 are estimated at 4 million tonnes, even lower than the drought years at the beginning of the decade.

The Indian government claims that the market has ample supplies and kept saying that it will not allow duty-free imports despite the sharp drop in 2016-17 output. Subsequent to these statements and strangely enough, the government recently announced a relaxation of tariffs to allow for 500,000 tonnes of duty-free imports and is now considering expanding that by another 200,000 tonnes. While it is true that it will still be several months before mills begin crushing the 2017-18 crop, we believe facilitating imports could mean that the food-planning ministries are worried and it could be a red flag for downward revisions to the 2017-18 crop estimate. We therefore conclude that there is more than meets the eye to the recovery in Indian production.

China

The Chinese government has been cutting the quota on duty-free sugar imports in what it says is a move to protect its domestic industry. The duty-free quota has been lowered to 1 million tonnes, half of what it was in 2016. As a result, July imports fell to a three-year low. Total imports for 2017 are down about 15% from 2016.

The Chinese reportedly have ample ending stocks from which to draw. However, it will still run a 5-million-tonne production/consumption deficit, and the stocks will have to drawn upon to meet domestic demand. If the government continues to sell off its stocks, sooner or later imports will become necessary. Chart 8 shows that ending stocks peaked at 67% of consumption in 2014-15, but will fall to 47% by the end of 2017-18. If a restrictive import regime remains in place, that number should be materially lower in the months to come.

Brazil

Finally, the Brazilian government has also been jacking up its production estimate. The ethanol/sugar processing ratio has favored sugar since the crush began in April at roughly 40%/60%. Earlier this month, the government followed through with its threat to tax ethanol imports after domestic ethanol producers launched complaints. US imports of ethanol climbed three-fold in the first half of 2017. The 20% tax will all but halt US imports, and the effect on the ethanol/sugar ratio was affected immediately.

Industry analysts report that for the first half of August, the ethanol/sugar ratio in the Center/South, where 90% of mills are located, jumped to 50.5%/49.5%. Were that trend to continue – and we so no reason why it would not – the Brazilian sugar output estimate will certainly be subject to downward revision.

We are confident that the exuberant forecasts for a 2017-18 global surplus are dated. Once updated with the supply/demand fundamentals presented above, they will surely be trimmed.

One last note: Commodity funds have thrown in the towel on the bull market and are now short this market. The net-short position is the largest it's been since the CFTC began tracking commodity-fund activity separately in 2006 (Chart 9). Once there is more clarity on the bullish fundamentals, the short-covering rally that will ensue will help drive prices back towards 20¢ per pound.

Remain long March 16¢ calls as per our June 9 recommendation.

[By Sholom Sanik, August 31, 2017]

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Chart 7 – March sugar

Chart courtesy Reuters

Chart 8 – Sugar: Chinese ending stocks as a percentage of consumption

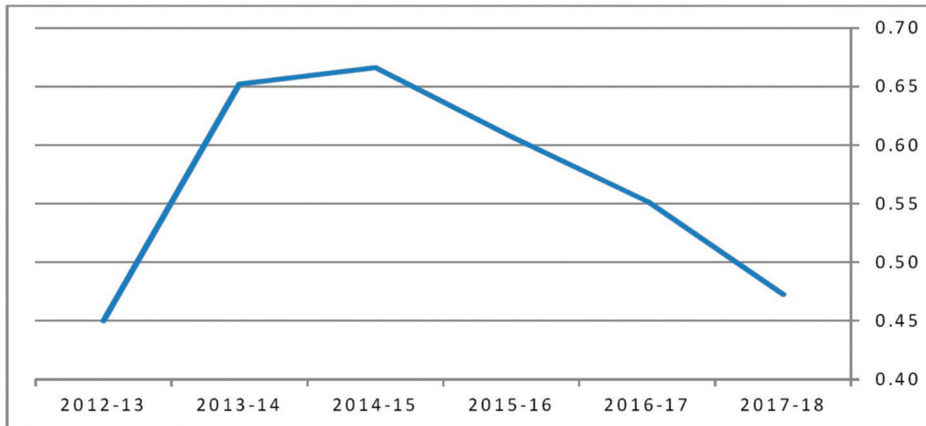
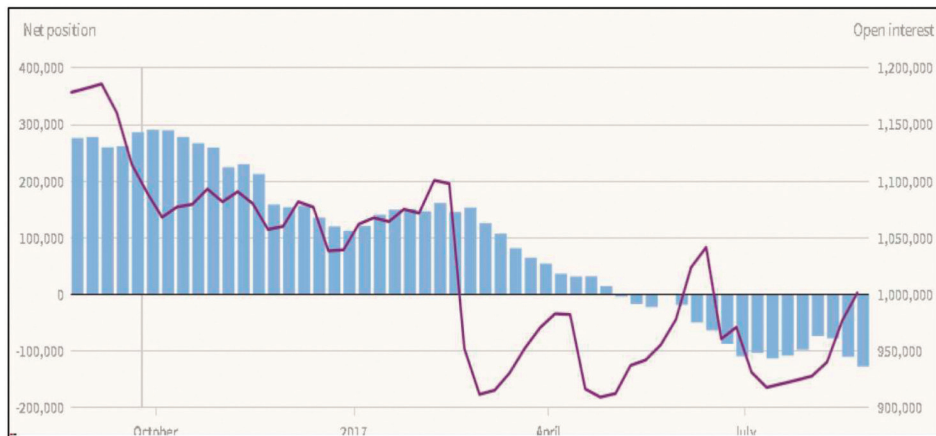


Chart: source USDA

Chart 9 – Sugar: Commodity fund net-short ICE position (bar)



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COTTON

Harvey wreaks havoc with Texas cotton

Analysts were widely skeptical of the USDA's July estimate for 2017-18 US cotton yields to be harvested this fall. Weather had improved over the course of the growing season. Heading into the August crop report, 57% of the crop was rated good-to-excellent, compared with 48% at the same time last year. The July crop report put the average national yield at 816 pounds per acre, down from a final yield of 867 pounds per acre in 2016-17. And indeed the August crop report – the first report of the season based on actual field surveys – revised the yield estimate upwards to 892 pounds per acre. That ties the record set in 2012-13. (Of note, in the most recent weekly progress report, the good-to-excellent portion of the crop climbed to 66% – but that was before the fallout from the twin hurricanes were factored in. See below.)

As a result, the estimate for output jumped by 1.55 million bales, to 20.55 million bales. It was the most significant item contained in the August report and drove global ending stocks up by a full percentage point to 76.73% of consumption.

December cotton greeted the news by tumbling the daily trading limit of 3¢ per pound. The selling continued over the following week (Chart 10).

However, as Hurricane Harvey barreled toward the key growing regions in Texas, the market found support just above the July lows. Texas grows about half of the nation's cotton. Harvey destroyed some cotton crops completely. Estimates vary widely. At present, although there has been no indication from the USDA, private estimates put the losses at somewhere below 500,000 bales for crops that were *completely* destroyed. In terms of crops that were damaged, but survived, we should expect to see yield estimates lowered.

There was damage in surrounding states, but no other state in the region grows enough cotton to have an appreciable outcome on the final results.

We are now bracing for Hurricane Irma on the East Coast of the US. Georgia grows about 12% of US cotton, and the Carolinas combined grow about 5%. The principal threat from Irma will be directed at Florida's orange crop, but cotton could be vulnerable in those states.

In any case, with the outright losses in Texas, the still-to-be determined lower yield for surviving crops, and the unknown effects of Irma, we're looking for at least a 5% haircut to the USDA's total US output estimate. We will revert back to July's 19-million-bale forecast, if not below. The dramatic close-to-10¢-per-pound rally in December cotton may be a bit overstated in the short term, but certainly not unwarranted.

Turning to the demand side, we have focused on the sharp drop in Chinese cotton imports in recent articles. While China continues to feed the domestic market by selling off state reserves, we also find some evidence that the nosedive in Chinese foreign purchases may be bottoming.

The 2016-17 global marketing year ended on July 31. Final Chinese purchases of US cotton were 2.016 million bales, up from 642,000 million bales in 2015-16. Just a few years ago China would buy as much as 5 million bales from the US. But consider that we are only one month into the 2017-18 marketing year and Commitment data show that the Chinese have already bought 1.4 million bales from the US. Last year at this time, purchases were only 320,000 bales.

Chinese domestic demand is estimated at 38.5 million bales. Production is estimated at 24.5 million bales. That still leaves a wide gap between production and consumption. Ending stocks have already been whittled down from a high of close to 70 million bales, to the current estimate of 39.35 million bales.

Although there are no accurate figures, it is assumed that the burdensome stockpile included a significant amount of low-quality cotton that will not be suitable for mills that manufacture clothing for export to the US and Europe. As such, we should see the sales from reserves slow down. We believe that the – albeit small – increase in Chinese imports from the US could be the beginning of a trend.

In its August crop report, the USDA revised its estimate for US exports to all destinations upwards by 700,000 bales, to 14.2 million bales, compared with 2016-17 exports of 14.92 million bales. Early as it may be, Commitment data would indicate that this forecast is conservative. The weekly foreign sales report show that 2017-18 Commitments stand at 6.6 million bales, up from 4.2 million bales at this time last year.

In the July 30 issue of *Focus in Futures* titled "Is China coming back to the table?" we advised remaining sidelined. The dynamics have changed, though. China has come back to the table, and the US crop losses, as illustrated, are material

While the market may seem overbought, Chart 11 shows that the net-long position of commodity funds is still modest compared with where it was several months ago. Buy December cotton, currently trading at 74¢ per pound. Place initial protective stops at 66¢, close only.

[By Sholom Sanik, September 7, 2017]

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Chart 10 – December cotton

Chart courtesy Reuters

Chart 11 – Cotton: Commodity fund net-long position (bar)

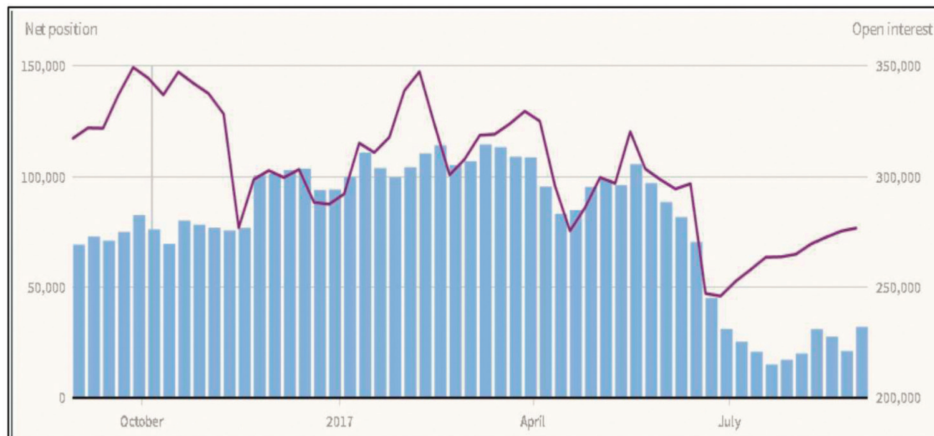

Chart courtesy CFTC

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