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Cotton: China holds the key

After touching three-and-a-half year lows in late August, cotton prices jumped 6¢ per pound, or by roughly 10% (Chart 1). The bulk of the rally occurred on September 12 and 13 in response to news of progress in talks between the US and China regarding the ongoing trade spat (Chart 2). The White House reportedly had offered a deal to China. The US would hold off on some upcoming tariffs and lower some existing ones in exchange for concessions from China that would include a commitment on agricultural purchases. (The soybean market, which is even more reliant on Chinese imports, mapped out an almost identical chart pattern in the same time frame.)

Actually, the hope generated by this breakthrough "saved" the market from a largely bearish monthly USDA crop report, which was released on the same day as the potential breakthrough in the trade quagmire.

The US numbers were neutral. Planted area was revised downwards from the August estimate by 140,000 acres, and yield was lowered by 16 pounds per acre, or 1.8%. But that was offset by a drop in the export estimate to 16.5 million bales, down from 17.2 million bales.

The forecast for the 2019-20 global harvest was lowered by 700,000 bales from the August estimate, to 124.9 million bales, but that is still record-high production and substantially more than 2018-19 output of 119.05 million bales. In any case, this downward revision was more than offset by a 1.33-million-bale downward revision for domestic consumption. Global ending stocks are set to rise to 68.8% of usage, up from the August estimate of 67%.

While global inventories are still mammoth when compared with virtually any other tradeable agricultural market, we should bear in mind that mid-decade levels reached over 100% of consumption. So there has been progress in terms of whittling down that stockpile, mainly as a result of China selling off government-held stocks. Chinese ending stocks peaked in 2014-15 at 68 million bales and now stand at 33 million bales. We believe that there is very little cotton left that can be used to meet the standards for clothing export to Western consumers.

The market's bullish reaction to hope for a breakthrough in trade talks in the face of bearish balance sheet statistics is telling. It leads us to conclude that the primary issue that will determine cotton prices down the road is Chinese imports. Although it has not attracted many headlines, Chinese cotton buying from the US has already improved.

In the 2018-19 marketing year, which ended on July 31, the Chinese took delivery of 1.323 million bales of US cotton. That was down from 2.175 million bales in 2017-18. We are less than two months into the 2019-20 marketing year, and China has already booked 1.761 million bales from US exporters. This includes 224,300 unshipped bales carried over from 2018-19 but is still impressive when there is a 25% tariff being paid by the importer. Easing or elimination of the tariff should unleash a flurry of buy orders by Chinese importers.

Stopping short of offering a political opinion, the bearish case has become vulnerable if we're headed towards a thaw in the relationship between the US and China. As illustrated, Chinese demand for cotton exists – with or without a trade war. China grows only 70% of its annual cotton needs, and it may have exhausted its inventories.

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Commodity funds are heavily short. As has been the case, any hints of accommodation will trigger a short-covering rally.

Buy March cotton. Place initial sell stops at 57¢, close only.

[By Sholom Sanik, September 19, 2019]

Chart 1 – Weekly nearest contract cotton

Chart courtesy Reuters

Chart 2 – March cotton

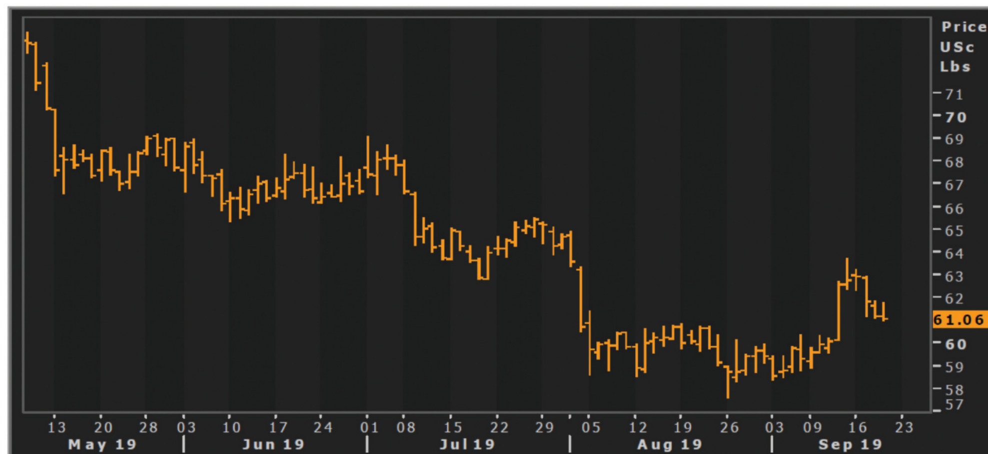

Chart courtesy Reuters

SOYBEANS

With or without tariffs, Chinese livestock will not go hungry

Much has transpired in the soybean market since the trade war between the US and China commenced in July 2018. We've been through two US growing seasons, one South American harvest, weather scares, and a long list of the usual revisions – bullish and bearish. And of course, both sabre-rattling and conciliatory gestures. Surprisingly, though, one thing that has not changed very much is the price of US soybeans. After the initial plunge in summer 2018, prices were confined to roughly a $1-per-bushel range (Chart 3). If you had established a long or short position in November 2019 soybeans in, say August 2018, you'd be breaking even. You would have lived through some volatility, but you're

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neither richer nor poorer. But where do we go from here?

On the surface it appeared that the buildup of soybeans in US silos generated by the drop in US exports to China in the 2018-19 marketing year would remain the operational fundamental for the foreseeable future. Indeed, that was the case. US farmers, however, responded to the situation by slashing planted area. In addition, the spring planting season presented weather challenges.

As of the most recent USDA acreage update, planted area for the 2019-20 crop fell to 76.7 million acres, 14% lower than the record area planted in 2018-19. Poor weather will be responsible for a disappointing yield of 47.9 bushels per acre, down from 51.6 bushels per acre in 2018-19. The resulting crop is currently estimated at 3.633 billion bushels (98.87 million tonnes), down 20% from 2018-19. That will be the smallest US crop since 2013-14.

The curtailment of Chinese buying of US soybeans in the 2018-19 marketing year left the US with the largest carryover in modern history. Ending stocks are estimated at 1.005 billion bushels (27.36 million tonnes), or 25% of consumption. That compares with an average carryout of 5.8% in the previous 10-year period. But turn to the outlook for 2019-20 and inventories do not look quite as insurmountable as they did even a couple of months ago. After the USDA revisions in the September crop report, ending stocks are forecast at 640 million bushels (17.43 million tonnes), or 15% of usage.

Now, that is still high by historical standards. But we have to consider that at this moment the USDA is working with the assumption that there will be little or no headway made on the trade front. Total US exports are forecast at 1.775 billion bushels, all but the same as in the trade-war stunted 2018-19 marketing year.

China simply does not grow enough soybeans to meet its needs. Yes, there is South America, but as we detailed in a previous article (see *Focus on Futures*, August 27), the gap between Chinese production and consumption is so wide that ultimately, the US is the only country that can fill that gap. Eventually, China will come back to the US market.

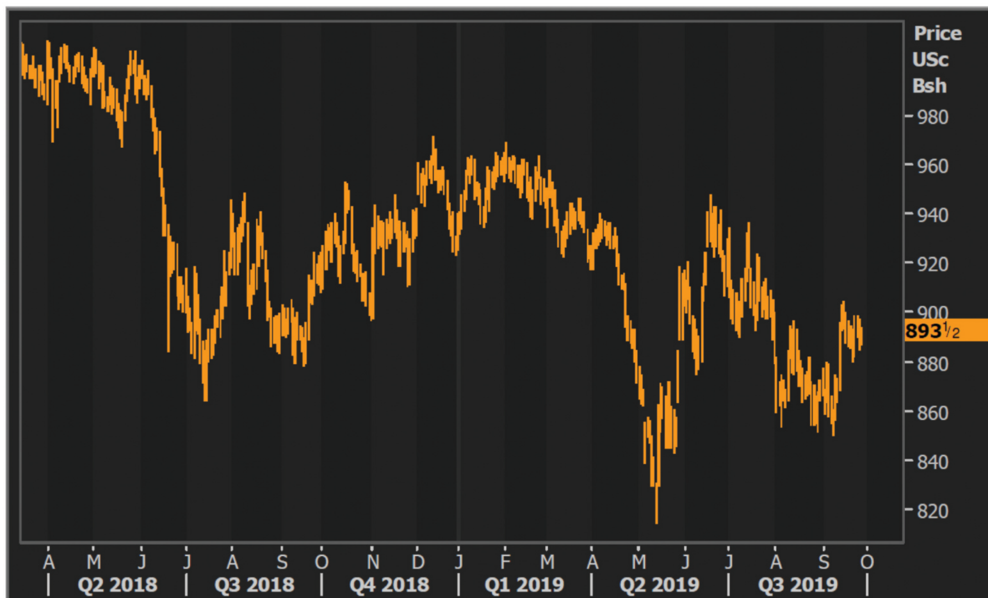
This theory has gained at least some prominence recently. On September 24 it was reported that the Chinese government granted tariff waivers – not reductions – on between 5 and 6 million tonnes of US soybeans. Private exporters have reported that there have been actual sales of close to 2 million tonnes. While the move was touted as a goodwill gesture by the Chinese, it underscores the reality that China needs US soybeans.

If there is a deal and Chinese importers reestablish exports back to normal levels, US ending stocks would actually fall to below the historical norm because of the materially smaller crop. Even without a deal, the Chinese are back in the market to some degree, as illustrated.

We advise buying March soybeans, currently trading at $9.20 per bushel. Place initial sell stops at $8.75, close only.

[By Sholom Sanik, September 26, 2019]

Chart 3 – CBOT November soybeans



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COCOA

False hopes for higher prices

After a $400-per-tonne rally that began in late summer, cocoa prices have been in a holding pattern near recent highs (Chart 4). The strength was triggered largely by efforts of the Ivorian and Ghanaian governments to address the issue of low farmer income. Nigeria and Cameroon have since signed on as well. The joint effort would guarantee farmers a minimum price of $2,600 per tonne payment for their beans. This would be accomplished by capping production levels in the hope that prices would rise substantially. These West African countries combined grow about 75% of the world's cocoa beans. If the scheme is successful, it would amount to the formation of a cartel of sorts. Details of how the governments would control farmer activity are not clear.

After achieving a record harvest of 2.18 million tonnes in the outgoing 2018-19 marketing year, 10.9% higher than the previous season, the new crop is off to a good start. Port arrivals for 2019-20 stand at 208,000 tonnes, 30,000 tonnes higher than last year at this time. Prices remained firm because the season began with excessive rainfall in the Ivory Coast, which impedes the drying process for harvested beans. The weather has since stabilized, and prices have slipped back to the lower end of the recent range. Regardless, it is far too early in the season to draw any conclusions regarding the final outcome.

On the demand side, grinding activity continues to shift from the traditional regions to origin countries. For the recently completed 2018-19 season, the Ivorian grind was 8.3% higher than in the previous year. The third-quarter Asian grind was up 14.73% year-over-year. In Europe, still the largest grinding region, grinding activity was 0.1% lower for the quarter. Finally, the North American grind was 7.4% lower.

Chart 5 shows the combined ratio of butter and powder prices vs. bean prices. Product prices have trended higher since mid-year but remain near the low end of their multi-year range. The International Cocoa Association (ICCO) estimates that global grinding activity grew by 4.1% in 2018-19, to 4.651 million tonnes. Production, however, was 4.849 million tonnes, an increase of 4.3%. The resulting 198,000-tonne surplus will be the largest since the 2016-17 marketing year.

It is unlikely to achieve the extraordinary growth in output for the Ivory Coast in 2019-20 that we saw this past season, but it is fair to assume another 2-million-tonne-plus harvest. If demand continues to grow at this year's pace, a small production/consumption deficit would result. However, inventory has been accumulating and can easily ward off a deficit. Since the start of the decade, consumption growth has averaged roughly 2.8%, while production growth has averaged about 3.8%. The ICCO estimates 2018-19 global ending stocks at 1.74 million tonnes, or 36.4% of usage.

In conclusion, the ambitious plan by West African governments to push cocoa prices higher is just that, ambitious. In the meantime, the market is well supplied, and the supply/demand dynamics indicate this will continue to be the case.

On August 22 we suggested selling short on a $100-per-tonne rally, which would have put the entry at $2,300, basis December. We recommend placing buy stops at $2,600, basis March, close only.

[By Sholom Sanik, October 25, 2019]

Chart 4 – March ICE cocoa

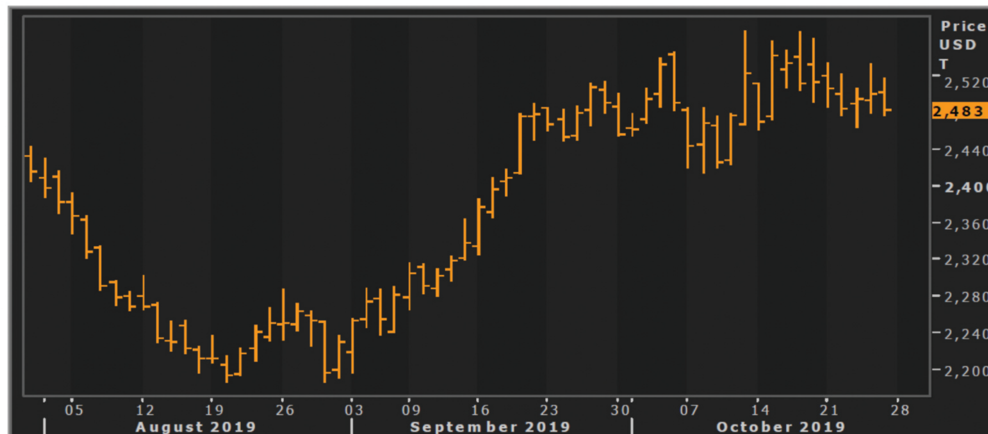

Chart courtesy Reuters

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Chart 5 – Cocoa butter/powder combined ratio

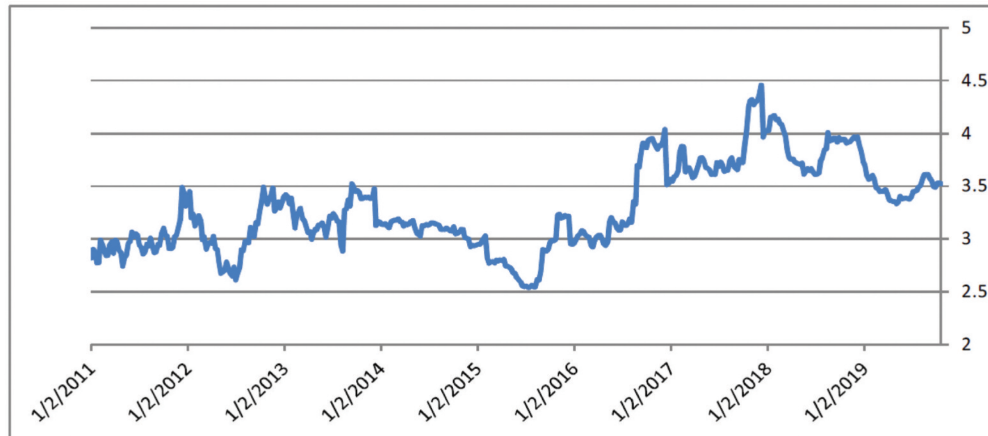

Chart: Source Reuters

SUGAR

A global deficit on the horizon

As the Brazilian 2019-20 crushing season winds down, analysts are looking ahead to the 2020-21 cane crop, which is now growing and will be harvested in the spring. Like last year, forecasts are calling for a greater allocation of cane to sugar than the previous season. That forecast was totally off. In fact, at 34.7%, the sugar/ethanol ratio was the lowest in history.

We cannot see much rationale for the trend that favors ethanol production to change significantly. First and foremost, sugar prices are still low. For sugar processing to be more profitable than ethanol, world prices would need to reach closer to 14¢ per pound. Regardless of the profitability ratio between sugar and ethanol, there is actual ethanol demand to consider. Brazil has become a net importer of ethanol, purchasing corn-based ethanol from the US. In this environment it is difficult to envision output growth for sugar gaining much traction in the foreseeable future.

In India the 2019-20 crushing season is just getting underway. Output is expected to fall by about 7% from 2018-19, to 26 million tonnes. Overall, the monsoon was beneficial in most of the country except for Maharashtra State, the second-largest growing state, which normally accounts for roughly 30% of total Indian output. Disastrous results for Maharashtra included extraordinary monsoon rains that appeared late in the season and reduced sugar content in some areas of the state while drought affected the plants in others. Output was reduced by close to 50% from the previous season, to just below 6 million tonnes.

There is a broad range of estimates for Indian domestic consumption, but even using a conservative estimate of 26.5 to 27 million tonnes, ending stocks will stop growing. At the low end of the estimated output range, we are looking at an Indian production/consumption deficit.

The Indian government's incentive to reduce inventories by offering export subsidies on 5 million tonnes met with some success in 2018-19. Exports for the marketing year were about 4 million tonnes. The subsidies have been renewed for 2019-20 for 6 million tonnes of sugar. Thus far, exporters have contracted to sell about 800,000 tonnes abroad. Considering the fact that world prices continue to languish – analysts did not expect exporters to grab the opportunity before prices reached 14¢ per pound – we would have to conclude that the program may be working.

However, if all 6 million tonnes were sold this marketing year, ending stocks would fall to about 8 million tonnes. In order for the sudden supply surge from Indian exports generated by Indian exports to have a longer-term bearish effect on the global market, 2019-20 output would have to surprise on the upside. Otherwise, as illustrated above, we would be in a new phase in which Indian stocks are being drawn down to dangerously low levels.

Forecasts for a 2019-20 global production/consumption deficit keep inching up. One recent estimate from a credible analyst puts the deficit at close to 8 million tonnes. And that includes what we believe to be optimistic Brazilian output

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estimates for 2019-20.

Commodity funds have covered some shorts, but as Chart 6 shows, the net-short position is close to an all-time record. With a looming global deficit and prices still near multi-year lows (Chart 7), we do not believe those shorts will be vindicated. Expect to see massive short covering.

On August 30 we recommended purchasing July 13¢ calls at 0.60 per pound, and they have maintained their value. Remain long those calls.

[By Sholom Sanik, November 5, 2019]

Chart 6 – CFTC ICE sugar commodity fund net position

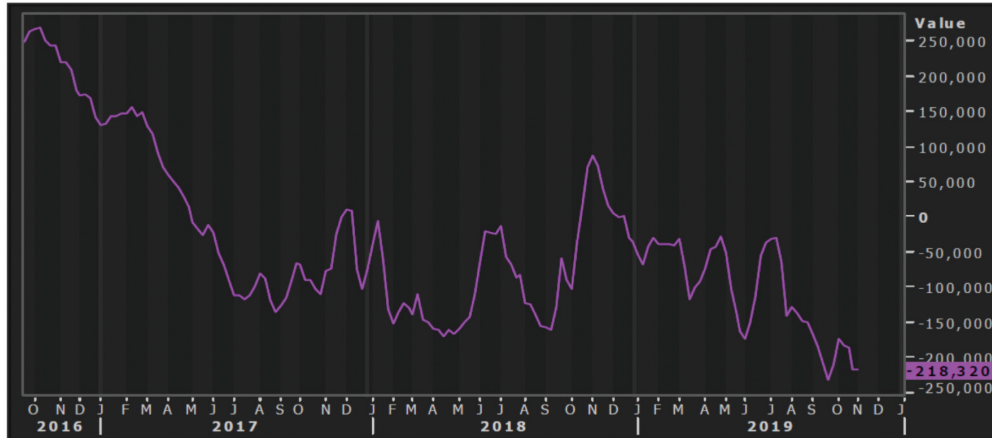

Chart courtesy Reuters

Chart 7 – ICE sugar weekly nearest contract

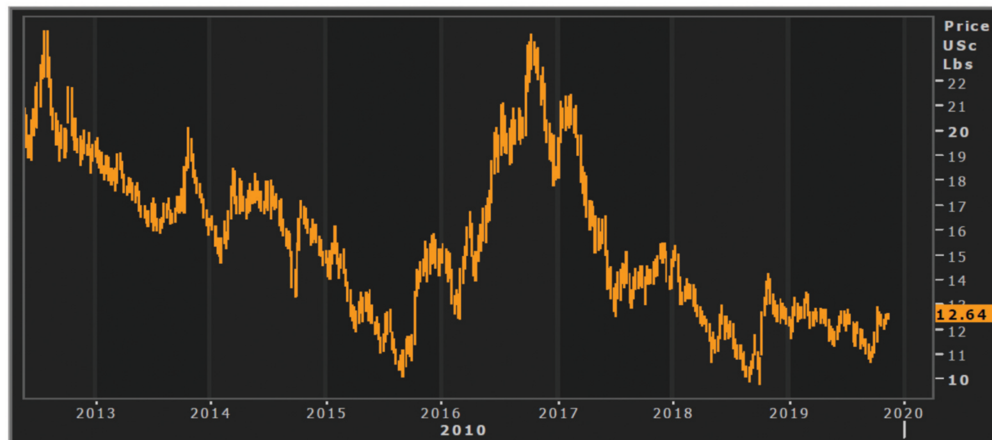

Chart courtesy Reuters

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