

# FRIEDBERG'S

## FOCUS ON FUTURES

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## A massive global sugar surplus: The rest of the story

Spot sugar prices are trading just a whisker above the lows set in 2015. Bears are focused on a massive global surplus for the 2017-18 marketing year. Estimates range from 10 million to 15 million tonnes. According to the USDA's semi-annual balance sheet, ending stocks as a percentage of consumption will grow to 28%, up from 24.7% in 2016-17.

India is the largest contributor to the supply bubble. After a drought-stricken 2016-17 season that produced just over 20 million tonnes, output exploded to a record 32 million tonnes for the current crushing season, which is now drawing to a close. Ending stocks are expected to double to about 10 million tonnes.

Thai production also jumped, by about 3.5 million tonnes in 2017-18. While India produces far more sugar, Thailand is actually a larger factor because it exports far more sugar than does India – roughly 75% of total output. In fact, as we explained in a previous article (see *Focus on Futures*, June 27), at 2 million tonnes, Indian exports were about the same as they were in 2016-17. Which brings us to our first argument as to why we believe we might be in the vicinity of a bottom in this market.

Bears are caught up in the notion that the world is awash in excess sugar that will find its way to meet import demand. Regardless of which global-surplus forecast you subscribe to, the lion's share of the surplus consists of India's production/consumption surplus of between 6 million and 7 million tonnes. Thus far, there has been no evidence that this surplus has mobility. The government has eliminated the export tax, but there has been no rush to sell sugar abroad.

Southern Hemisphere producers are well into their 2018-19 crushing season, and Brazil – for this season anyway – will be displaced by India as the world's largest producer. The effect of higher energy prices has made ethanol processing a substantially more profitable business. Typically, the ethanol/sugar ratio slides back in favor of sugar production later in the season. With about half the cane crop crushed, ethanol production at 63.48% remains at historic highs for this point of the season. That compares

with only 51.55% at this time last year.

Production in the Center-South region through mid-July stands at 14.75 million tonnes, down 16.3% from last year. If the ethanol/sugar ratio holds at these levels, output will be down by about 5 million tonnes from 2016-17. The USDA balance sheet shows that export availability will fall by a similar amount.

Another issue is the option that Brazilians have in planting alternate crops. With the 25% tariff the Chinese have imposed on US soybean imports, farmers – wary of low sugar prices – are likely to feel more confident in planting alternative crops. Although it is not yet a widespread phenomenon and statistics are merely anecdotal at this time, widespread switching away from sugar could become a reality because it makes a lot of economic sense. Consider this tidbit from a recent media report: With sugar prices where they are now, soybean farming is five times more profitable than sugar farming!

EU sugar production jumped substantially over the past two seasons because of the elimination of export quotas. More so than the spike in Indian production, the increase in EU output contributed to falling prices.

For years, the EU exported about 1.5 million tonnes, the amount permissible under the quota regime. In 2017-18,

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exports more than doubled to 3.7 million tonnes. It has been a hot and dry summer in Europe, and the 2018-19 beet crop is expected to fall by about 2 million tonnes from the previous season. That means that production and domestic consumption will be roughly in balance, compromising export availability to a great extent.

It all comes down to whether India will ramp up exports. If they do, we can see a continuation of the bear market, and there's no telling how low prices can fall. If they do not, then

the fantastic estimates of the global sugar surplus do not carry much weight. We will have to accept that in the space of one year, Brazil may have lost its status as a supplier of last resort – at least for the next 12 months.

We continue to suggest maintaining a modest long position in this cheap commodity by steering clear of futures and maintaining a long position in call options. March 12¢ calls are currently trading at about 50 ticks.

*[By Sholom Sanik, August 17, 2018]*

Chart 1 – Weekly nearest contract ICE sugar

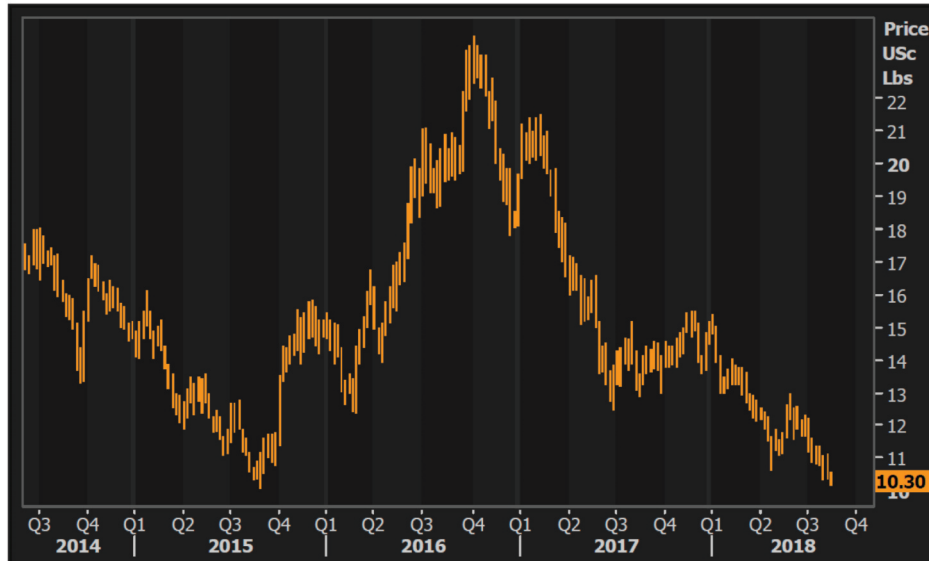


Chart courtesy Reuters

## COTTON

# How will China close its supply/demand deficit?

Cotton prices are trading at nine-month lows (Chart 2). The primary market driver is the trade spat between the US and China and how China will meet cotton requirements to supply its mills.

It has not been a stellar year for cotton weather in Texas, where 45% of the nation's cotton is grown. Although the national abandonment rate for the 2018-19 crop that is currently being harvested was extremely high by historical standards, the crops that survived are estimated to achieve near record yields. The harvested-to-planted ratio is estimated at just 75%, compared with 94.4% and 88% in 2016-17 and 2017-18, respectively. Yield, on the other hand, is estimated at 901 pounds per acre, down just slightly from last year's record 905-pound-per-acre yield.

The Chinese government implemented a 25% tax on US imports in August as part of its response to the brewing trade war with the US. A close look at US export data will explain why the headline export commitment number is

outdated and misleading.

US export commitments for the 2018-19 marketing year stand at 9.02 million bales, up from 7.39 million bales last year at this time. So where's the problem? First of all, the 2018-19 year-to-date tally includes a record carry-in from unshipped 2017-18 cotton of 1.5 million bales. Which in itself is not terrible if we do not experience mass cancellations, and all – or at least most – of it ends up being shipped. But new sales have dried up to a trickle. Consider: Over the past six weeks, weekly sales have averaged 77,000 bales, compared with 152,000 for the same six-week period last year. At this pace, it will only take several more weeks for 2018-19 sales to fall behind last year's.

The USDA estimates that the production/consumption deficit in China will grow from 13.5 million bales in 2017-18 to 15 million bales in the current marketing year. It may not sound like much, but the gap needs to be filled. Chinese ending stocks stand at below 30 million bales, down from

over 60 million bales at their peak five years ago. As we have mentioned many times, what remains is in all likelihood not necessarily useable for the manufacture of goods destined for export to the West. To maintain its industries, Chinese mills will need to get hold of US cotton – one way or the other. There are no other countries that can provide the volume required.

The global balance sheet continues to normalize. In its October crop report, the USDA implemented some historical revisions for India that resulted in a downward ending-stock revision of 3 million tonnes. While the report carried few other changes from September, the Indian revision caused global ending stocks to fall to 58.2% of usage, down from 60.5% in September and light years from the peak of several years ago when global inventories were over 100% of consumption.

With the fair assumption that seemingly burdensome Chinese inventories are a misleading statistic, the market should begin to focus on *bona fide* supply/demand fundamentals.

Soybean prices have recovered *vis-à-vis* cotton over the

past two months, but the price ratio remains depressed in historical terms (Chart 3). US farmers who have the option of planting cotton instead of soybeans are almost certainly going to favor cotton. Both commodities share the same tariff issue with China, and farmers will be afraid to over-plant. So they are likely to swing to the more profitable commodity.

Nevertheless, the International Cotton Advisory Council released a report earlier this month indicating that it expects all major cotton producing nations to plant smaller crops for 2019-20 and that yields will be smaller. It forecasts that cotton production will fall by 4%.

Global consumption for 2018-19 is estimated at a record 127 million bales, but even so, it all comes down to Chinese demand. If we see the Chinese coming back in the market for US cotton, prices will stabilize and begin to climb. At this time, however, with sluggish US export sales, we can see the market continue to drift lower.

We were stopped out of our long position in December cotton at 82.5¢ per pound, as per our August 3 recommendation. Remain sidelined, but stay tuned.

[By Sholom Sanik, October 15, 2018]

Chart 2 – December ICE cotton

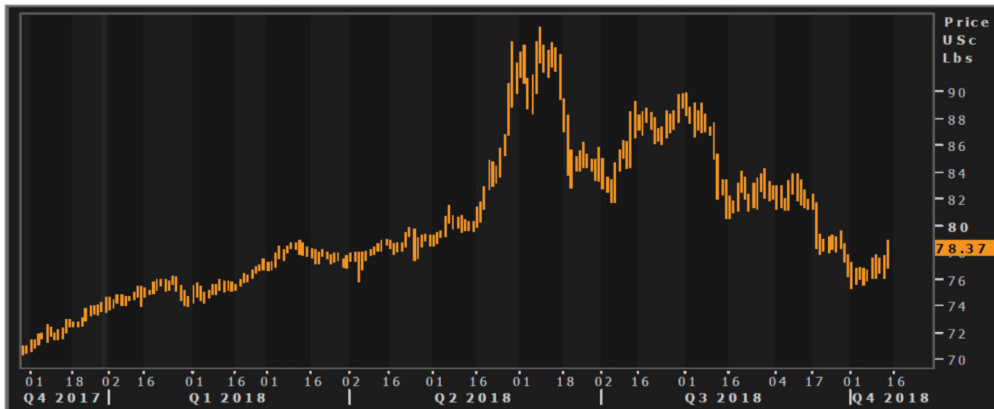


Chart courtesy Reuters

Chart 3 – November 2019 soybeans/December 2019 cotton



Chart courtesy Reuters

**SUGAR**

**The ethanol/sugar ratio heads to the East**

At the end of September, spot sugar prices traded briefly below 10¢ per pound – a three-year low. The market then turned on a dime and sprinted to nine-month highs, backed by a series of bullish developments.

A rally in the Brazilian real purportedly prompted exporters to curtail sales of their largest agricultural products – sugar, coffee, and soybeans – as receipts in the local currency would be smaller. This is the weakest of the various bullish fundamentals because it is a net neutral factor for supply, as it only shifts those sales forward in time.

A far more trenchant observation is that the consequence of ethanol production’s better profitability over sugar is no longer a matter of theory or prediction – it is a full-blown reality. Estimates for 2018-19 sugar output have fallen precipitously. Recent downward revisions put production at below 27 million tonnes for the Center South, down 9 million tonnes from the previous season. That’s a nine-year low.

Between domestic usage and exports, Brazil normally consumes all the sugar it produces each year and therefore has little inventory to speak of. This will leave a sharp drop in the amount of sugar available for world trade.

Moving over to India – the savior. Or is it? The large global surplus consists largely of Indian ending stocks. But just how available are those stocks? As we’ve noted in the past (see *Focus on Futures*, August 17), the government has implemented strategies to encourage exporters to sell sugar abroad without much success.

In early September the government announced another measure that could help reduce excess sugar supplies down the road. It increased the state-controlled price of ethanol by 25% in an attempt to divert cane processing away from sugar. India already has a minimum petroleum/ethanol-mix require-

ment, and discussions about raising the ethanol price were ongoing. The 25% increase was much higher than expected, though, so while it will take time for it to work its way into the system, the move could hasten a jump in the Indian ethanol/sugar output ratio.

The liberalization of sugar export quotas in the EU was one of the many bearish factors that allowed sugar prices to fall as they did. Annual EU exports under the quota system were only 1.5 million tonnes. Farmers took advantage of the new regime, produced more sugar, and saw exports more than double to 3.7 million tonnes in 2017-18. Poor weather in 2018-19, however, reduced the size of the cane crop. Estimates keep falling, with some analysts saying that output will reach only 17.3 million tonnes, down from 19.6 million tonnes in 2017-18. And with that, exports are expected to reach only 1.6 million tonnes.

As a result of these changes, the global production/consumption surplus estimate for 2018-19 has been slashed by about 3 million tonnes by all the major analysts, to roughly 4 million tonnes. That’s down from over 10 million tonnes in 2017-18.

Looking forward, there are forecasts for smaller crops in Brazil, India, and Europe for the upcoming 2019-20 marketing year. A global production/consumption deficit of about 2 million tonnes is expected. Prices are still too low to compete with ethanol, and the size of cultivated area is expected to reflect this. The market will have to move much higher to counter this trend.

Maintain long positions in March 12¢ calls which were trading at 50 ticks when recommended on August 17 and are now trading at 2.10.

*[By Sholom Sanik, October 19, 2018]*

Chart 4 – Weekly nearest contract ICE sugar



Chart courtesy Reuters

**COCOA**

**Demand is budding – but will it matter?**

After setting a nine-month low in early October, cocoa prices have been climbing back (Chart 5). Has the bear market ended?

Final 2017-18 port arrival data for the Ivory Coast show that output was 1.958 million tonnes, which is 45,000 tonnes, or 2.2%, below the record achieved in 2016-17, but still the second largest in history. More compelling for a bearish case was Ghanaian production. Early in the season Ghana was expected to have an off year, with output at about 750,000 tonnes. Excellent weather conditions propelled the crop to over 900,000 tonnes, above the high end of expectations.

The West African 2018-19 marketing year has begun. Arrivals in the early going stand at 165,000 tonnes, well above 113,000 tonnes last year at this time. At this point the wide gap means next to nothing. We would need to see the spread over last year persist through December to draw any conclusions.

On the demand side, as we pointed out in our previous discussion on cocoa (see *Focus on Futures*, July 26), the extraordinary second-quarter grinding results were not likely to be sustainable. Product prices recovered in the last half of 2017 and hovered at multi-year highs into early 2018 (Chart 6). This facilitated an excellent grind for the first two quarters this year (Table 1).

**Table 1: Grinding results in key regions (%)**

	EU	Asia	N. America
2017 Q4	4.4	4.2	-1.28
2018 Q1	5.5	7.2	-1.14
2018 Q2	7.3	15	-3.11
2018 Q3	2.7	3.7	2.53

After cocoa butter prices fell back into the middle of a two-year range, however, processing activity slowed. Third quarter data show that Europe gained only 2.7%, compared with 7.3% in the second quarter. The 3.7% increase for Asia paled in comparison with an unusual jump of 15% in the second quarter. We believe that the contraction of processing activity explains why bean prices plunged to below \$2,000 per tonne early this month. More recently, an uptick in product prices may very well make sense of the recent rally in bean prices.

The growth rate for global grinding has been much stronger over the past four quarters than it has been in years. Europe and Asia grew by 4.9% and 7.5%, respectively. Average global growth in the previous 10-year period was 1.9%.

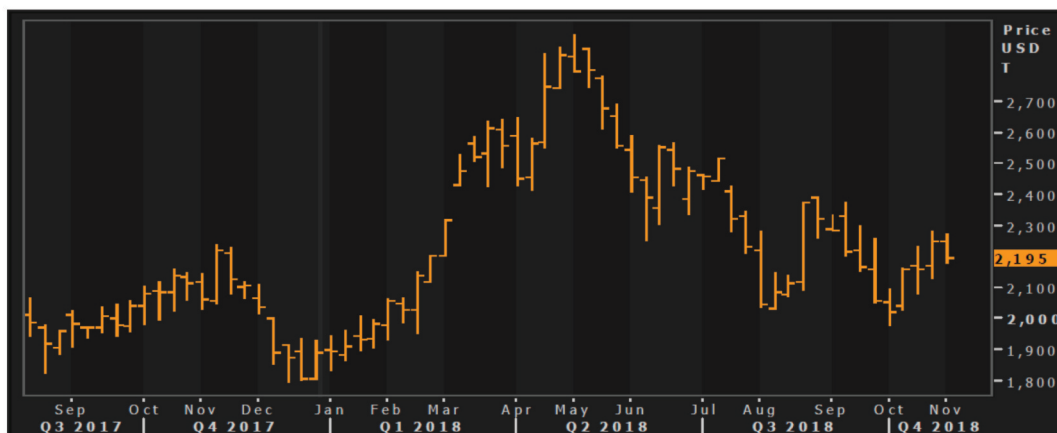
As amply illustrated above, bean prices can indeed be vulnerable to any meaningful movement in grinding activity in the short term. Strong demand, though, was obviously no match for an even stronger supply side. The 2018 bear market that saw bean prices fall from over \$2,900 per tonne to below \$2,000 was the direct result of a 20% increase in Ivorian output in 2017-18. And that price drop occurred even with impressive grinding results.

Any consistency in the trend of explosive growth in West African crops should overwhelm consumption growth rates. As such, monitoring Ivorian port arrivals closely will be the key in determining the future direction of this market.

Remain short December cocoa, as per our May 20 recommendation. Lower protective buy stops from \$2,650 per tonne, to \$2,450, close only.

*[By Sholom Sanik, October 29, 2018]*

**Chart 5 – Weekly nearest contract ICE cocoa**



*Chart courtesy Reuters*

Chart 6 – Combined cocoa butter/powder ratio

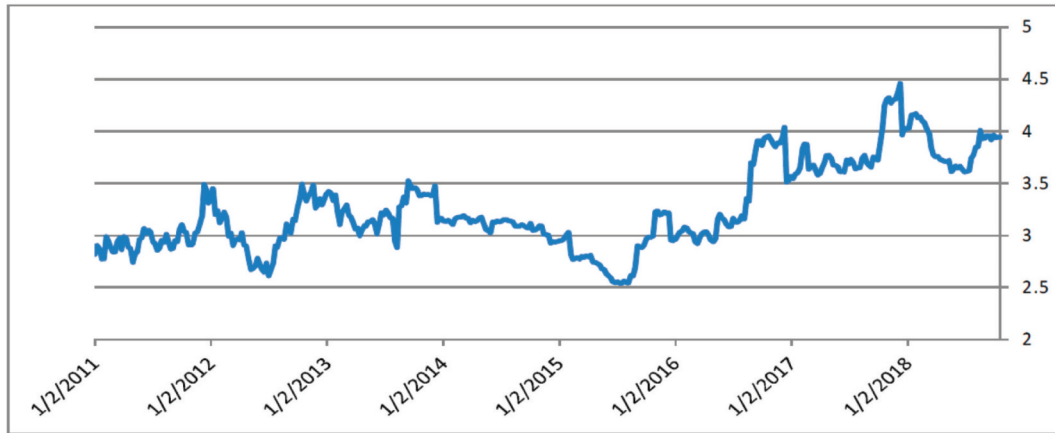


Chart source: Reuters

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