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Fighting the sugar bear

Judging by the sharp drop in open interest during June, the rally in sugar prices off six-year lows was nothing more than short covering. Open interest fell by more than 100,000 contracts during this period, and Commitment of Trader data confirm that commodity funds covered 60,000 contracts of their net-short position (Charts 1 and 2). But the market is back to its old tricks, with October sugar setting yet another contract low just a few trading sessions after failing to break through the minor resistance level at 12.5¢-per-pound.

Sugar prices are battling a series of broader commodity-market restraints. With the Greek crisis out of the headlines and speculation surrounding a Fed rate hike that would make the US the only industrialized country with rising rates, the US dollar has resumed its uptrend (Chart 3).

Furthermore, Brazilian ethanol-demand elasticity is perceived to fluctuate with the price of crude oil. As such, the recent $10-per-barrel drop in crude prices has put additional pressure on the price of sugar as traders speculate that the ethanol/sugar ratio will swing back in favor of sugar.

There is not much evidence, however, to support this relationship. While overall fuel consumption in the first half of the year fell because of a weak economy, the government reports that year-over-year ethanol consumption during the period rose 38.3%. Some estimates put the ethanol/sugar output ratio for the 2015-16 marketing year at 59%, up from 57% in 2014-15.

Cane crop estimates have been rising, but as a result of strong ethanol usage, sugar production is expected to remain stagnant at 32 million tonnes for the center south region, where about 90% of Brazilian sugar grows. And that is an optimistic forecast. While it is still early in the crushing season, sugar output is down about 15% over the same period last year.

Estimates for 2015-16 Indian sugar output have been strong, but there is still fear of El Niño-related effects. The monsoon rains are still below average, leaving many key growing regions suffering from drought.

As we've discussed in earlier articles (see *Focus on Futures*, June 4), China is becoming a more significant factor than it has ever been. Until recently China was largely self sufficient. Its balance sheet has now swung from production/consumption surpluses all the way to deficits – large enough to require substantial imports to meet demand. Five years ago there was a surplus of about 3 million tonnes. For the 2015-16 marketing year, preliminary estimates are calling for a deficit of 6 million tonnes. China is now expected to be the world's largest importer, with estimates for imports as high 5.5 million tonnes.

According to the International Sugar Organization (ISO), global demand is growing at 2% per annum (Chart 4). At the moment, after years of production/consumption surpluses, there are ample stocks to meet near-term demand. Down the road, however, the ISO estimates that there will be deficits in 2015-16 and 2016-17 of 2.5 million tonnes and 6.2 million tonnes, respectively, eventually eating into stocks and tightening the market.

Maintain the (albeit) frustrating strategy of holding long-term call options.

[By Sholom Sanik, July 24, 2015]

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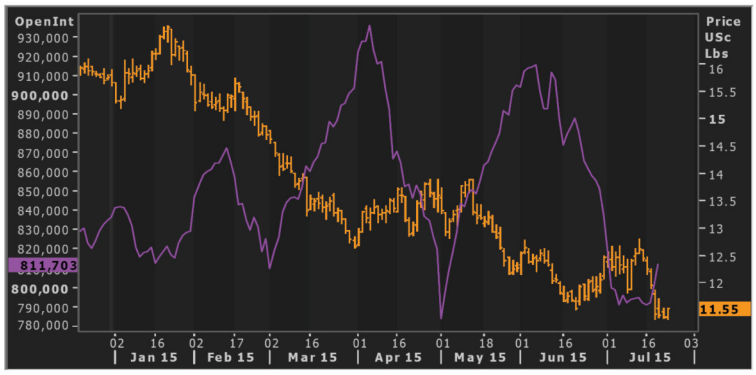
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Chart 1 – October sugar (bar) and open interest (line)



Courtesy Reuters

Chart 2 – Commodity funds net short position

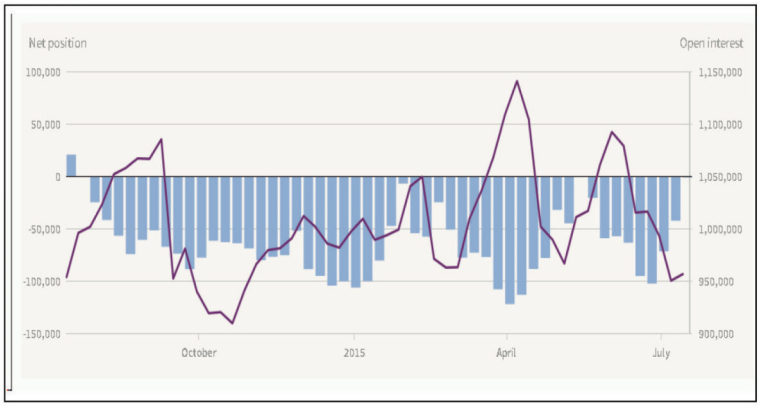
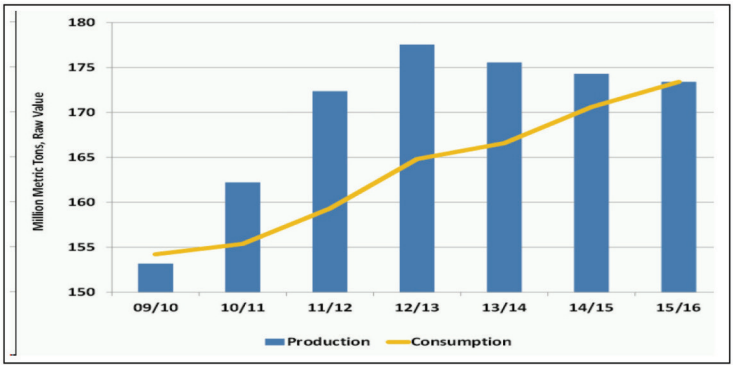


Chart 3 – Spot dollar index



Courtesy Reuters

Chart 4 – Global sugar production (bar) and consumption (line)



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COCOA

The bear is back

After hitting one-year highs, cocoa prices have taken a bit of a breather. Even so, the market continues to be the strongest commodity on the board – bar none – defying a strong dollar and uncertainty surrounding Chinese demand, both of which have broadly thrashed metals, energies, and agricultures.

Over the past year we underestimated the impact of the weak crop in Ghana, the world's second-largest producer. In 2013-14 output was 850,000 tonnes. With two months remaining in the 2014-15 marketing year, arrivals are running about 20% below the previous season. If mid-crop arrivals do not improve, it would be a challenge to see output reach even 700,000 tonnes, which is considerably below current forecasts of 750,000 tonnes.

In the Ivory Coast, comparative arrival levels have fluctuated all season long. At present, they have once again caught up with last year's pace. The most recent figures indicate output of 1.673 million tonnes, just ahead of 1.668 million tonnes seen at this time last year. Such strong production did not seem possible for a good part of the season. Normally, such a performance from the world's largest-by-far producer would have depressed prices. Neighboring Ghana's production woes, however, offset the potential bearish influence of unexpected consecutive bumper crops in the Ivory Coast.

The European quarterly grind is always the first to be reported. The dismal global demand picture received a faint glimmer of hope when second-quarter grindings figures eked out a small gain of 0.6% against expectations of a drop of 2.5%. The market proceeded to new highs for the move on the European news, but it wouldn't last.

The balance of the grinding data released throughout July was all lower than expected, which set the stage for what has now turned into a meaningful 10% correction (Chart 5).

The North American grind followed with the weakest figures in two-and-a-half years, falling by a greater-than-expected 8.6%.

Based on expanded processing capacity, Asia, which includes Malaysia, Indonesia, and Singapore, should be experiencing better processing results, but is disappointing as well. The area, the latest region to report, was down 12% for the quarter.

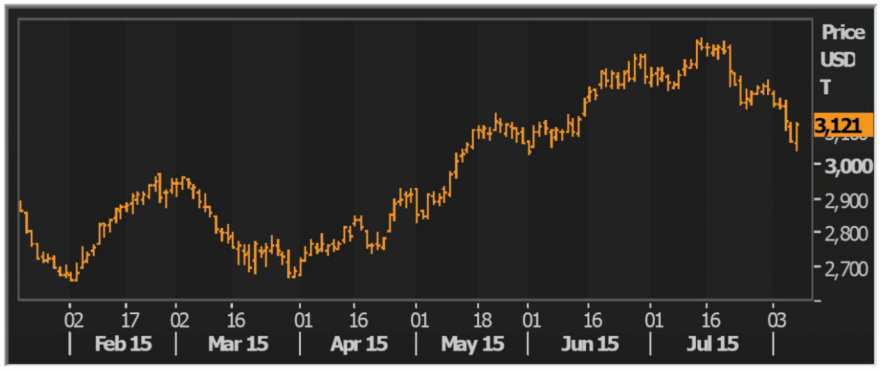
West African origin countries represent the only area where grindings are probably still growing, and as a group these countries have become the single largest processors. Although comprehensive and periodical data are not published, the ICCO estimates that the region's grindings are growing by 2% per annum. Global demand is actually estimated to *contract* by 2% to 5% in the current marketing year.

While powder prices have been rising steadily, the overall picture for product prices remains depressed. Butter is the primary product, and butter ratios have ticked down to two-and-a-half-year lows (Charts 6, 7, and 8), leaving little hope that processors will be rushing to stock up on beans to grind.

The Ghanaian crop failure was weather-related, and there is no reason to assume that output will not return to trendline levels for the 2015-16 marketing year. The ICCO expects the global balance sheet for the current marketing year to end with a 37,500-tonne production/consumption deficit, but only because of Ghana. There were no general problems with West African producers, and demand, as indicated above, is faltering. Early forecasts for the 2015-16 marketing year, which begins in October, are looking for an 85,000-tonne surplus.

We've been bears all along, but we were thankfully stopped out of our short position before prices spiked to near $3,400 per tonne. We now recommend reentering the short side. Sell December cocoa. Place initial stops at $3,400, close only. *[By Sholom Sanik, August 7, 2015]*

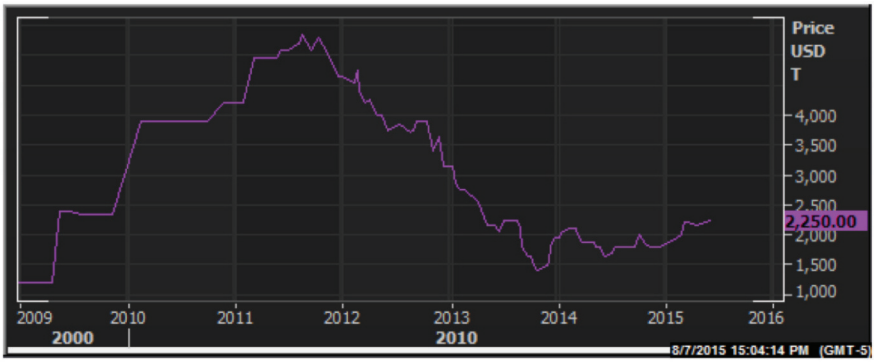
Chart 5 – December cocoa



Courtesy Reuters

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Chart 6 – Cocoa powder (US$ per tonne)



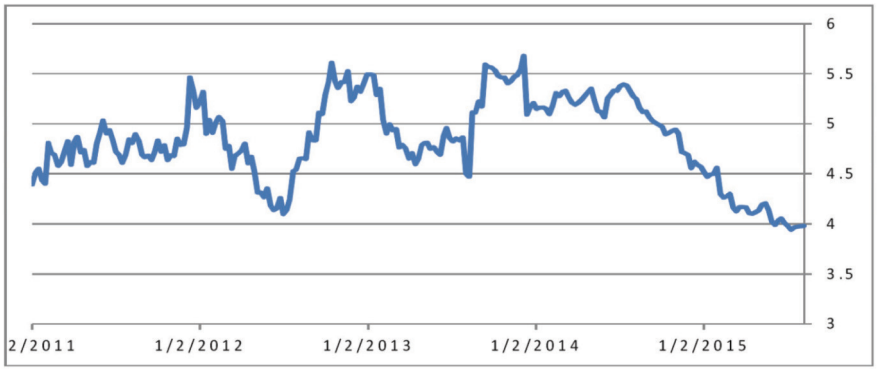
Courtesy Reuters

Chart 7 – Cocoa butter ratio



Courtesy Reuters

Chart 8 – Combined butter/powder ratio



COPPER

In the grips of the bear

Copper prices have fallen to six-year lows (Chart 9) in response to mostly bearish developments in supply/demand fundamentals, and in anticipation that the biggest fundamental of them all – Chinese demand – will become increasingly bearish.

Chilean copper production has been somewhat erratic this year. After a very strong start, the traditional problems of labor strife, weather, and lower ore grades resurfaced. February, March, and April were all lower year-over-year, but then May and June showed decent gains. For the first half of the year, output was up 2.6%, which is higher than earlier estimates that called for a 1.7% increase. There's no guarantee that it is a sustainable trend, but the improved pace has added to the bearish tone of the market.

Through the end of July, Chinese copper imports have not batted an eyelid (Chart 10). Preliminary data for July show that imports were up 3% over last July.

The devaluation of the Chinese yuan halted a budding

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rally in copper prices and saw prices sink to new lows. While speculation about the effects of a faltering Chinese economy had been pressuring commodity prices for months, the decisive action by the central bank was seen as a clear admission by the government that the country was in trouble. Prices are now trading at the same level as they were in late-July, however, an indication, perhaps, that weaker demand for industrial materials has been discounted – at least to some degree.

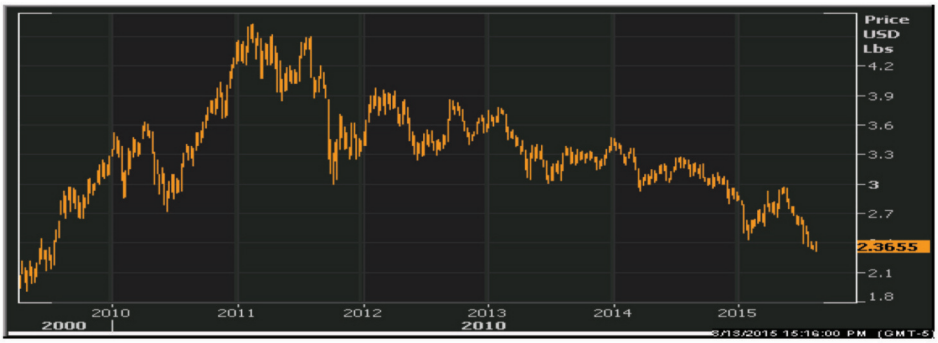
A significant amount of Chinese copper imports is not intended for industrial purposes, but is used as collateral for dollar-denominated loans and ends up in off-exchange bonded warehouses. As such, the devaluation will increase the costs of these loans. We could therefore see the first appreciable chink in the flow of imports as the volume of loans declines. Furthermore, copper now held in the bonded warehouses would have to be sold by dealers who are forced to default on loans they are unable to carry because of the devaluation.

As illustrated above, neither of the two flagship apparent indicators for this market – Chinese imports and Chilean production – are screamingly bearish. But the market has turned. The International Copper Study Group's (ICSG) data – dated as it may be – are showing the global balance of refined copper was in a 62,000-tonne surplus from January through April. This compares with a 436,000-tonne deficit for the same period last year. Chilean production in May and June was strong. And while Chinese imports have been firm, the gains have not been significant. So it's a good bet that ICSG's surplus will continue to grow.

The Chinese devaluation was a big event, but at the moment, judging by the market's tepid response, it would seem that for copper anyway, it was a sell-the-rumor-buy-the-news scenario. As such, we advise establishing short positions in copper on 15¢-per-pound rallies. Place initial stops at $2.70, basis December, close only.

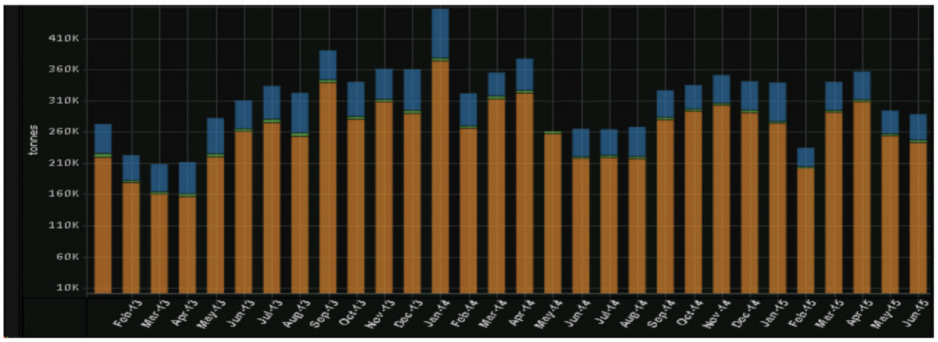
[By Sholom Sanik, August 14, 2015]

Chart 9 – COMEX copper, weekly nearest contract



Courtesy Reuters

Chart 10 – Chinese copper imports



COTTON

Can a US crop failure bring back the bull?

In the days leading up to the August 12 USDA crop report, it appeared that the one-year-old tight trading range for cotton prices was on the verge of being resolved to the downside (Chart 11). There were definitely some weather problems for the US crop, but on the whole, the crop was getting by. The good-to-excellent portion of the crop was 56%, compared with only 52% at the same time last year.

Coupled with the overhang of burdensome Chinese

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inventories that saw the 2014-15 marketing year close out with global ending stocks that were over 100% of consumption, analysts had generally expected a bearish outlook heading into the report. But the USDA presented a radically altered view of the crop.

First, the estimate for planted area was slashed by 100,000 acres from the July estimate. Then the harvest-to-planting ratio estimate was lowered, from 94.4% to 88.7%. The effective yield would be 7.95 pounds per acre, down from 8.5 pounds. That would all result in a massive downward revision of 1.42 million bales, to 13.08 million bales, or 9.7% below the July estimate. Totally unexpected.

Another bullish component of the report was a 500,000 downward revision to 2014-15 ending stocks. December cotton rallied about 4¢ per pound over the next few sessions, clawing its way back to near the top of the recent range.

The impact of the sharp drop for the forecast of the 2015-16 crop was mitigated with a significant drop in the estimate for new-crop exports, from 10.8 million bales to 10 million bales.

Both Chinese and Indian production were revised downwards as well, by 500,000 bales and 1 million bales, respectively.

In the grand scheme, the net effect on the 2015-16 global balance sheet was minimal in terms of any progress in eating into the gargantuan Chinese stockpiles. The ending-stock estimate fell to 105.19 million bales, or 91.75% of usage, down from 94.5% at the end of the 2014-15 season.

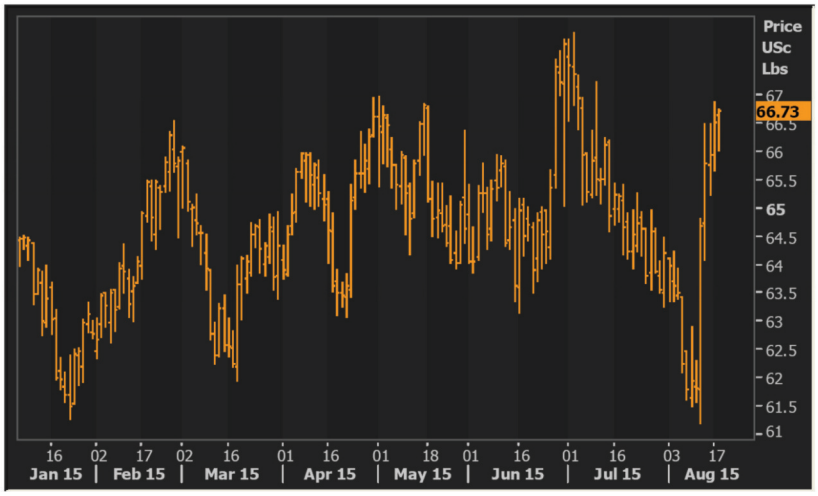
The disappointing results of the US crop and smaller Asian crops have definitely given bears something to think about and may have placed somewhat of a floor on prices – at least in the near term. However, it is premature to assume that this market has much upside. As we've detailed in recent cotton articles, Chinese imports have dwindled dramatically, and until there is an appreciable drawdown in inventories, Chinese imports will no longer be a force on world cotton trade.

To get an idea of how Chinese imports have shriveled, consider the early-season US export statistics: The marketing year for cotton began on August 1. As of the most recent weekly commitment report, advance new-crop sales stood at 2.5 million bales, compared with 4.5 million bales last year at this juncture of the season. Of that total, China accounted for only 62,000 bales, down from 750,000 bales last year.

So for the moment, we believe that this market will remain range bound and we do not see any trading opportunities. Stand aside.

[By Sholom Sanik, August 18, 2015]

Chart 11 – December ICE cotton



Courtesy Reuters

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