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Does this cotton rally have any legs?

Cotton prices have been trading in a relatively narrow trading band over the past year. ecently they've rallied to the top of that range against a mixed bag of bullish and bearish developments (Chart 1).

As US production has dwindled over the years, so have inventories. This has left the market vulnerable to temporary supply squeezes. There have been shortages in mills in the Southeast where specific varieties are required, which is at least partially responsible for the strength in prices.

Estimates have begun to trickle in for the new crops to be planted this coming spring. Still in the bull camp, early forecasts for 2014-15 Chinese acreage call for a sharp drop in planted area of close to 11%. That would be the equivalent of about 3.5 million bales less than in 2013-14, which would in itself shave about 3% off global production. That is about where the bullish case ends.

On February 20, the USDA released its preliminary forecast for US 2014-15 crops. Planted cotton area is expected to increase by 1 million acres, or close to 10% more than in 2013-14. Output, however, is estimated to jump by 23%. Yields were poor and the abandonment rate high in 2013-14. With normal weather the output target should be achieved.

The main issue has been, and continues to be, China's burdensome inventories. Short-term regional tightness in the US and a new crop that might be a couple of million bales smaller are mere diversions. The February USDA crop report revised the size of the 2013-14 Chinese crop harvested this past fall down by 1 million bales, which resulted in a 1-million-bale downward revision in ending stocks. But it was a drop in the bucket. Chinese stocks still represent 160% of domestic consumption – a statistic unheard of in the annals of internationally traded agricultural commodities.

Moreover, the era of massive Chinese imports that fed that stockpile for the past three years could be over. On January 19, the government announced that it will end the stockpiling program for cotton and soybeans (see *Focus on Futures*, January 31). Instead, it will offer a direct subsidy to farmers if prices fall below a certain level. The goal is to provide an incentive for farmers to grow cotton to keep prices in line with international prices. It remains to be seen if the new policy, currently being tested in one province, will work.

Even before the announcement was made, Chinese purchases from the US for 2013-14 had already fallen off sharply from 2012-13. For the 2013-14 marketing year to date, Chinese commitments stand at 1.722 million bales compared with 3.976 million bales at this time last year. The USDA estimates Chinese imports from all sources for the season at 11 million bales, down from 20.33 million bales last year. So it was no great surprise that the market did not immediately react more negatively to the January 19 announcement. Smaller Chinese imports had been discounted for some time now.

Sooner or later, the Chinese will sell cotton from the monstrous buildup of stocks. We were stopped out of our short position at 86¢ per pound, basis March, as per our December 19 recommendation. Old-crop contract months are flirting with the 90¢-per-pound level, while new crop cotton is priced at 78¢ per pound (Chart 2), reflecting the reality that once short-term supply issues are out of the way, the market should settle back to the low end of the range. We advise reestablishing short positions in July cotton, currently trading at about 88.5¢ per pound. Steer clear of the front month where maximum pain will be felt if a *bona fide* – albeit short-term – squeeze develops. Place initial stops at 94¢ per pound, close only.

[By Sholom Sanik, February 25, 2014]

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Chart 1 – July cotton



Courtesy Bloomberg LP

Chart 2 – December cotton



Courtesy Bloomberg LP

SUGAR

Sweet again?

Sugar prices have rallied by close to 20% from their late-January lows. Yet a glance at the weekly chart shows a mere blip in a long bear market (Chart 3). The anticipated pre-March-expiry short-covering rally has been true to form (see *Focus on Futures*, February 5), with open interest shedding 50,000 contracts in the last two weeks of February. Will that be all? Or is this the beginning of a much broader bull run?

The rally was underpinned by some potentially very bullish news. Extremely dry weather conditions for the first six weeks of 2014 in Brazil could wipe out a significant chunk of the 2014-15 crop. The crushing season begins in April. Early forecasts called for a cane crop that would be 10 to 20 million tonnes above 2013-14. With the inclement weather, however, analysts estimate that about 40 million tonnes of cane may have been compromised. Both ethanol and sugar output will suffer. A rough estimate would put sugar production about 2 million tonnes below 2013-14 – enough to compromise the comfortable availability of exportable global supplies the market has become accustomed to over the past few years. If the weather does not improve, the shortfall could be closer to 4 million tonnes.

The 2013-14 marketing year will end in surplus, but the International Sugar Organization (ISO) – as well as analysts at all the major trade houses – have been trimming their estimates over the past couple of months. On February 26 the ISO revised its estimate for the surplus to 3.6 million tonnes, down from its previous estimate of 4.4 million tonnes. According to the ISO, it will be the first time since 2008-09 that sugar production will fall from previous-season levels. Some analysts see the surplus falling

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to closer to 2 million tonnes.

Cane crops were robust in 2013-14. Now that we are in the crushing stage, the dwindling surplus may be the first indication that low prices are discouraging sugar production.

Although government intervention halted the slide in sugar production in India, the recent saga underscores the problem. Mills did not start crushing until November – about one month late – because of frustrating negotiations over prices with cane farmers, who were not lowering their prices in line with the steep drop in world sugar prices, leaving crushers to operate unprofitably.

The mills acquiesced before there was any resolution to their problem. Then, after weeks of delays, the government finally came through with a subsidy for mills in the form of interest-free loans, which will allow mills to afford cane purchases.

Output for the period from October to mid-February is down 10.5% over last year. The gap has been narrowing, though, from as high as 17% several weeks ago, as mills are catching up from the late start to the crushing season.

There is no shortage of refined sugar in India – ending stocks are estimated at about 40% of domestic usage. The issue is the production of exportable raw sugar. The subsidies effectively enable India to produce enough raws to meet the export target of 3 to 4 million tonnes in 2013-14. So, for now, the stalemate between farmers and millers is no longer a bullish factor. The drama did, however, provide us with a glimpse of how output can falter when prices fall far enough below the cost of production. Traders will keep a keen eye on Indian output levels to see if the mills can overcome the early-season meltdown and meet the forecast for 2013-14 output of 25 million tonnes.

As the market begins to pay more attention to 2014-15 crops, Brazil will remain the primary focus. Early estimates look for a global production/consumption deficit of 1 million to 2 million tonnes. Maintain long positions in new-crop call options.

[By Sholom Sanik, March 5, 2014]

Chart 3 – Weekly ICE sugar



Courtesy Bloomberg LP

CORN

In transition from bear to bull

Political unrest in the Ukraine began to stir back in January. It wasn't until the tension escalated in early March, with ussian troop movements, that market participants began to connect the situation to the possibility of disruption of grain exports. In fact, the Ukraine is a significant exporter of wheat, and prices sank to a new low for the move in late January (Chart 4).

Meanwhile, corn prices had already been creeping off their lows in response to bullish January USDA reports (Chart 5). Lower-than-expected quarterly stocks, a disappointing downward revision in US 2013-14 crop yields, and bullish domestic demand numbers sparked funds to embark on a short-covering rally. Then in February, the USDA raised its estimate for 2013-14 US exports to round out the bullish picture.

To be sure, Ukrainian corn exports represent a significant component of world trade. Production for 2013-14 is estimated at 31 million tonnes, which would be only 3% of global output. However, only 40% is consumed domestically, while the other 60% is sold abroad and is equal to about 16% of total global exports. Were there to be problems with infrastructure and shipping, it would indeed tighten global supply channels. It is doubtful, though, if the political turmoil will have any effect on the industry. News reports have indicated that, thus far, it's been business as usual. Some crisis-

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related volatility can be expected, but we do not see any long-term supply problems emerging.

There are other far more bullish issues that have been masked by the situation in the Ukraine, which could have more far-reaching implications for global supply. The February USDA crop report kept its estimate for the Brazilian corn crop at 70 million tonnes, which was already down sharply from 2012-13 output of 81 million tonnes. Private forecasters have been slashing their estimates because of the drought in Brazil. On March 4, after several revisions over the past month, Informa Economics lowered its production estimate for Brazil yet again, to 65.45 million tonnes.

The March 6 US export report showed commitments were 1.5 million tonnes for the week, 700,000 tonnes above the high end of expectations. Total commitments for 2013-14 now stand at 37.5 million tonnes, 2.6 times last year at this time. That compares with the USDA estimate of annual sales of 2.2 times last year's tally. Shipments have been sluggish lately, but also showed strength for the most recent weekly period, at 1.138 million tonnes, well above the four-week average of 824,000 tonnes.

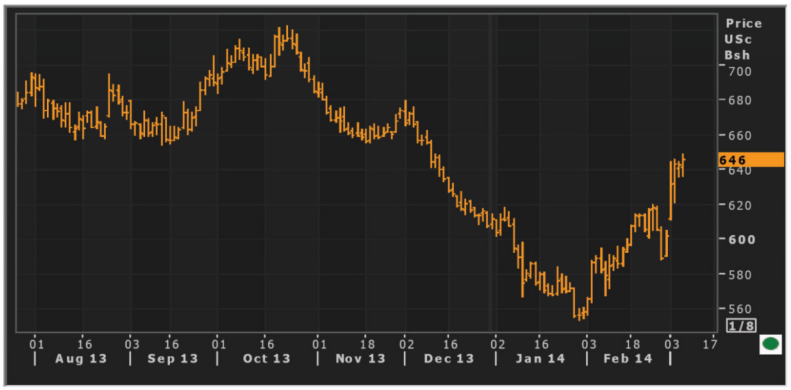
One nagging bearish factor that kept the market nervous was Chinese export cancellations down the road. Since November, China has already canceled 887,000 tonnes of Syngenta's MI 162 GMO corn shipments from the US. But on March 4, the government announced that it was moving quickly to approve that particular variety. A decision on allowing the GMO corn could come as soon as the end of this month.

Looking ahead to the US 2014-15 crop that will be planted this spring, the early USDA forecast calls for corn acreage of 92 million acres, down from 95.4 million acres in 2013-14. While new-crop corn prices have gained some ground over new-crop soybeans (Chart 6), corn prices are still depressed *vis-à-vis* soybean prices in historical terms (Chart 7). Corn prices would still need to rally substantially to steer acres away from soybeans to corn.

To balance what is clearly a very bullish case, some analysts believe that US domestic feed consumption estimates are overstated because of the possibility of a sharp drop in hog production in the coming months. Hog prices have soared to record highs (Chart 8). The PEVD virus has been spreading, and is threatening to reduce the US hog population by close to 15%.

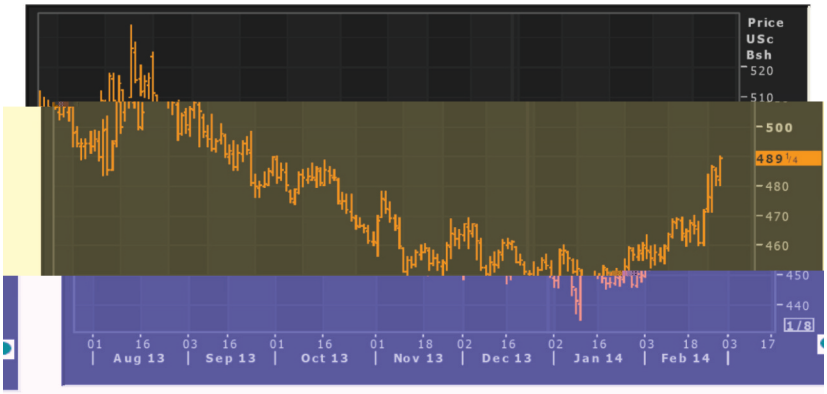
emain long December corn as per our January 14 recommendation. aise stops from $4.25 per bushel, to $4.50 per bushel, close only. *[By Sholom Sanik, March 7, 2014]*

Chart 4 – May wheat



Courtesy Bloomberg LP

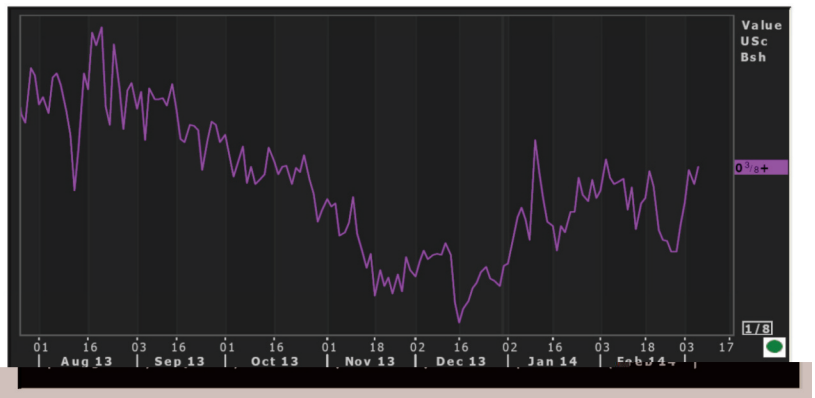
Chart 5 – December corn



Courtesy Bloomberg LP

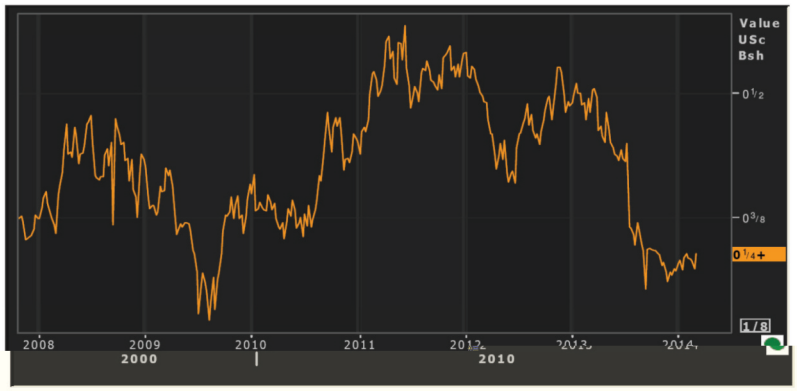
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Chart 6 – December corn/November soybean ratio



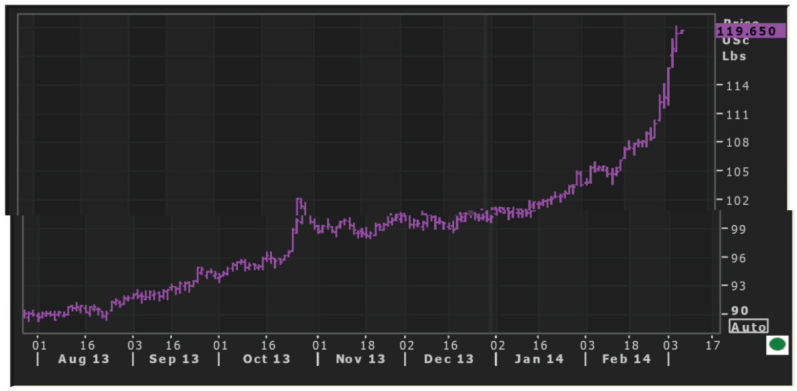
Courtesy Bloomberg LP

Chart 7 – Weekly corn/soybean ratio



Courtesy Bloomberg LP

Chart 8 – June hogs



Courtesy Bloomberg LP

SOYBEANS

Can drought in Brazil tighten the market?

Soybean prices have rallied by as much as $2 per bushel since early February, before consolidating. Nothing to do with the Ukraine. Unlike wheat and corn, in which the Ukraine is a major player, Ukrainian soybean production accounts for only 1% of global output. ather, drought in South America has been the primary factor driving prices higher.

With about half the harvest complete, estimates for the 2013-14 Brazilian crop were getting close to 92 million tonnes, up from 82 million tonnes in 2012-13. Drought in some key regions wreaked havoc in the latter stages of crop development, and those estimates began to tick down. Some private analysts revised their estimates to as low as 86 million tonnes.

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The March 10 crop report proved to be a disappointment for bulls, though. The USDA took the conservative approach, lowering its estimate to 88.5 million tonnes, down from the 90-million-tonne February estimate. That was above the average trade guesstimate of 88.1 million tonnes. Bulls were disappointed. May beans dropped $1 per bushel over the next few sessions (Chart 9).

Aside from the South American drought, strong US exports underpinned the rally. As of the most recent weekly US export report, commitments reached 44 million tonnes, up from 34 million tonnes at the same time last year. That is above the USDA estimate for annual sales of 41.6 million tonnes. Shipments are strong, at 37 million tonnes.

However, while prices spiked to seven-month highs going into the March crop report because of the anticipated downward revision to the Brazilian crop estimate and strong demand, trouble was already brewing for the bull case. On March 5, US exporters announced that the Chinese canceled 272,000 tonnes of 2013-14 sales. Furthermore, rumors circulated that the Chinese were about to cancel some Brazilian purchases as well.

It is early in the season to see US cancellations, but as illustrated, the USDA sales target can be met handily, even if the Chinese do cancel some of their purchases. It is not that unusual to see the Chinese switch origins as the South American crops become available. But it is very early for the Chinese to be canceling Brazilian purchases. All of which raises fears that we are seeing the effects of the new Chinese policy that replaces stockpiling soybeans (and cotton) with direct subsidies to farmers (see *Focus on Futures*, January 31).

Traditionally a heavy weighting was placed on US ending-stock levels. At 4.5% of consumption, US inventories indeed remain near historic lows. But as we've pointed out numerous times in the past, the world has changed. Even if South American crops are not quite as large as we believed they would be just a couple of months ago, the US has been bumped from its status as supplier of last resort. Going back just a couple of seasons to 2011-12, combined output of Brazil, Argentina, and Paraguay was 110 million tonnes versus US output of 84 million tonnes. This year, even if we shave off 2.5 million tonnes from the USDA estimate and go with the more pessimistic estimate of private forecasters, the change is staggering. Combined output of the three large South American producers would be 150 million tonnes compared with 89 million tonnes for the US.

The fear that gripped the market with the inclement weather in Brazil may very well have been exaggerated. Even if the estimates of the private forecaster turn out to be accurate, global ending stocks will still be close to historic highs.

Global demand is forecast to rise to a record high of 270 million tonnes. That includes implied demand from Chinese imports. The USDA balance sheets still estimates Chinese imports at a record high 69 million tonnes. Once the policy is in force, though, it is difficult to see that estimate stick. The USDA attaché in China has already reduced the import estimate by 1 million tonnes. Whatever supply is lost to the Brazilian drought could be compensated for by falling demand.

We were mercifully stopped out of our short position in March beans at $1,300 per bushel. eestablish short positions in May. Place initial stops at $1,475, close only.

[By Sholom Sanik, March 12, 2014]

Chart 9 – May soybeans



Courtesy Bloomberg LP

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