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Is the copper bubble about to burst?

Base metals have been the strongest-performing commodities this year. Copper traded at a three-year high, and even after the recent sharp setback, prices are up about 20% since January 1 (Chart 1).

In our previous article on copper (see *Focus on Futures*, June 9) we were concerned about China, the world's primary source of demand. Chinese imports dipped sharply in April, but have since climbed back (Chart 2). However, the recovery was not overwhelming. Monthly totals are still well below some of the fantastic results seen in 2016.

The Chinese economy – at least in terms of recently released manufacturing data – has been stronger than expected, with data releases consistently beating estimates. Moderate growth in copper imports should be a given in such an environment. Is the bull run sustainable?

The other base metals – aluminum, lead, nickel, tin, and zinc – have followed a similar pattern, which could be consistent with the argument that industrial demand has been driving the market – not to mention a weakened US dollar.

We believe the underlying strength originated as a supply-side issue. The first quarter of 2017 saw Chilean mine output plunge after a 44-day strike at Escondida mine, the longest strike in Chilean history. All production activity was halted. The resulting statistics were staggering. Chilean output was the lowest for the first half of the calendar year since 2005. Average monthly production for the first half was down 6.75%. Through the end of July, that figure has improved with production down only 5.02%, but that leaves an uphill battle ahead in terms of meeting production expectations.

Early forecasts for 2017 Chilean production were looking at growth of 4.3%. That is obviously out the window. More recently, estimates were lowered to an increase of 2%. We do not believe even that is achievable. Since production at Escondida resumed in April, average monthly output has been up only 1.8%.

The recovery in Chilean output may be slow, but the International Copper Study Group (ICSG) reports that through the end of May, the global balance sheet stood at a 15,000-tonne surplus. Of course, the ICSG reports are always dated, but more current data for the two major fundamental inputs show both improving Chinese demand and growing Chilean output.The recovery for both has not been extraordinary; rather, both have returned to trendline growth rates.

Our lukewarm bullish case on June 9 was based not only on disappointing Chilean output, but also on the expectation of a strong recovery in Chinese imports. While the former continues to support a continuation of a bullish supply-side case, to make the scenario complete, the latter, the single most important demand-side source, is questionable.

We therefore consider the supply/demand fundamentals to be neutral at this time. A study of trader activity shows clearly that commodity-fund participation drove prices to $3.20 per pound, a technical rally that perhaps was not warranted by the supply/demand fundamentals alone.

From the time of the breakout in December copper at $2.85 per pound in July, open interest increased by 65,000 contracts, or about 24%, to a record 337,000 contracts (Chart 3). The net-long fund position during this period jumped by 30,000 contracts.

At this time we advise liquidation of long positions in December copper, accepting handsome profits. The market is in the midst of correcting an extremely overbought condition.

[Sholom Sanik, September 14, 2017]

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Chart 1 – December copper



Chart courtesy Reuters

Chart 2 – Chinese imports of refined copper

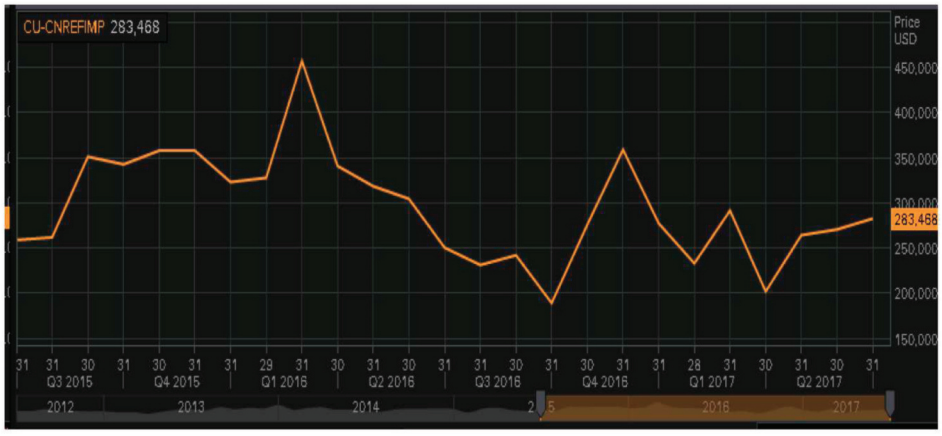


Chart courtesy Reuters

Chart 3 – COMEX copper open interest

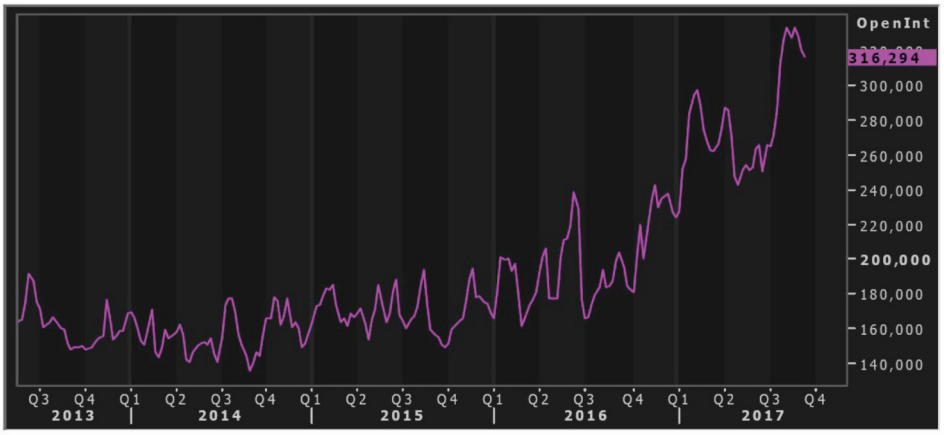


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SOYBEANS

A record US soybean crop and more to come from Brazil

August continued to be generally dry for most US soybean growing regions, leading analysts to lower their 2017-18 yield estimates heading into the September USDA crop report. The results took traders by surprise. The average guesstimate was 48.8 bushels-per-acre (bpa), with a low end of 47.1 bpa, down from the August estimate of 49.4 bpa. The USDA came in at 49.9 bpa.

Although yields will be down 4.2% from last year's record 52.1 bpa, the crop will still reach a record 4.431 billion bushels (120.59 million tonnes), 2.9% above 2016-17 output, because of the massive acreage expansion. US farmers planted a record 89.5 million acres of soybeans, up 7.3% from 2016-17.

Prices dropped sharply on the news, but held just above this past summer's lows. Traders then shifted their attention to other matters, such as dryness in South America, where farmers are about to plant their 2017-18 crop. Some large US foreign sales also helped support the market, and within a couple of trading sessions the market erased the crop-report-induced losses.

Another notable item contained in the crop report was an upward revision to 2017-18 US exports of 680,000 tonnes, to a record 61.24 million tonnes. In the notes accompanying the report, the USDA cited "...increased supplies and lower prices..." as the reason behind the increased forecast. It is not a huge revision, but we're skeptical of the optimism regardless.

The USDA forecast for foreign sales would be just over 2% more than final sales for 2016-17. While it's still very early in the 2017-18 marketing year to draw any conclusions, the pace of new-crop sales does not support the USDA outlook at all. Soybean commitments stand at 16.9 million tonnes, that's 28% below last year at this time when commitments had already reached 23.5 million tonnes.

Aside from the USDA comments mentioned above, we assume that the higher export estimate is based on lower 2017-18 crop forecasts for Brazil and Argentina. Argentinean production has been steady the last couple of years, at 57 million tonnes, and is expected to be about the same this coming season. Brazilian output, however, skyrocketed in 2016-17, to a record-by-far 114 million tonnes, up 18% from 96.50 million tonnes in 2016-17.

The USDA is forecasting that Brazilian output will drop in 2017-18, to 107 million tonnes. We question that because recent private estimates are looking for Brazilian soybean area to expand by 2% as farmers shift away from corn to soybeans.

One could perhaps argue that the USDA is taking a cautious approach because the planting season in Brazil has been delayed owing to extreme dryness in key planting regions Mato Grosso, Paraná, and Mato Grosso do Sul. Perhaps the USDA is projecting that the US will maintain its export prowess because availability of Brazilian supplies will not be as plentiful as they were in 2016-17.

However, the USDA has been working with the 107-million-tonne estimate since the first estimate for the 2017-18 crop year was released back in May, and it was certainly meaningless then. Now that there is a better idea of soybean planting intentions, only a crop failure could derail Brazil.

We know from experience that whether it's North or South America – or anywhere for that matter – early-season crop fears most often dissipate as the season wears on. If anything, along with the estimates for expanded acreage, the mere fact that Brazil was able to produce such an extraordinary crop in 2016-17 predisposes us to believe that once the crop is harvested next spring, Brazil will again take export business from the US. As the crop makes its way into the ground – either sooner or later – we are confident that the 107-million-tonne estimate will grow.

Global ending stocks were lowered a tad from the August estimate, to 28.3% of consumption, below last year's 29%, but still near record highs.

This South American weather rally should be used as an opportunity to establish short positions in January soybeans, currently trading around $9.85 per bushel. Place initial buy stops at $10.35, close only.

[By Sholom Sanik, September 15, 2017]

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Chart 4 – January soybeans



Chart courtesy Reuters

COCOA

Ivory Coast production tops 2 million tonnes

Cocoa prices peaked in late 2015 at $3,400 per tonne. After plunging to below $1,800 per tonne, the market sits smack in the middle of an eight-month range (Chart 5). Where to from here?

Bears had it right in assuming that 2016-17 Ivory Coast output would be spectacular. Port-arrival levels seesawed throughout the main-crop season – falling behind year-ago levels and then creeping back above. With the mid-crop harvest now complete, total main- and mid-crop arrivals stand at more than 2 million tonnes, 10% above the previous record set in 2014-15 and 35% above 2015-16.

Ghana also blew away early-season forecasts. Analysts have been looking at production of 850,000 tonnes, but purchases declared to government regulators now stand at 950,000 tonnes.

Nigeria had an off season, producing only 250,000 tonnes, down from early-season estimates of 350,000 tonnes, because of widespread Black Pod disease. As illustrated, though, bountiful crops grown by its neighbors compensated.

Indonesian production is of greater concern down the road. Plantations are aging, and farm land is being diverted to palm crops. Output peaked at about 500,000 tonnes several years ago and has been in steady – and probably perpetual – decline. Production for the current marketing year is estimated at 290,000 tonnes, down from 340,000 tonnes the previous season. The processing industry is being fed by ever-expanding foreign purchases of beans, primarily from West Africa. Imports are estimated to triple over last year's total, to 180,000 tonnes.

Regardless of Nigeria's poor showing and Indonesia's fall from grace, the Ivory Coast's performance leaves the market well supplied heading into 2017-18. According to the International Cocoa Association (ICCO), global output is estimated to have grown by 18.1% in 2016-17, while demand increased by just 3.7%. The production/consumption surplus will be 371,000 tonnes, resulting in a 1.78 million tonne carryover, or 41.6% of consumption. That compares with an average of 36.7% for the three previous seasons and is up from early-season ICCO estimates.

The harvest of the 2017-18 Ivory Coast main-crop has begun. Ample subsoil moisture and a well-balanced mixture of rain and sunshine bode well for the new crop, though it is extremely early to make any accurate predictions. One noted analyst has stated that it would be optimistic to expect 2016-17 to reach this season's levels and is therefore forecasting a 10% drop in output. The weather at key junctures this past season was extraordinarily favorable, and it would be a stretch to anticipate the same conditions for two consecutive years.

Even if West African production were to slip back somewhat over the next 12 months, the market will be well supplied with carryover stocks as large as they are. Butter prices are steady, but powder prices have been falling, so there's no strong motivation for processors to increase purchases.

The supply/demand fundamentals remain clearly bearish. Regardless, of how bearish – or bullish – the long-term outlook for a market may be, short-term price movements are often dictated by other factors. Commodity funds own a massive net-short position and over the past few weeks have been covering shorts (Chart 6). Perhaps the fund community is concerned about the improbability of a repeat performance for the 2017-18 Ivory Coast crop.

In any case, the protective buy stop at $2,050 per tonne we recommended on July 4 is very close to current market levels. Honor the stop, but stay closely tuned.

[By Sholom Sanik, September 28, 2017]

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Chart 5 – Weekly ICE cocoa

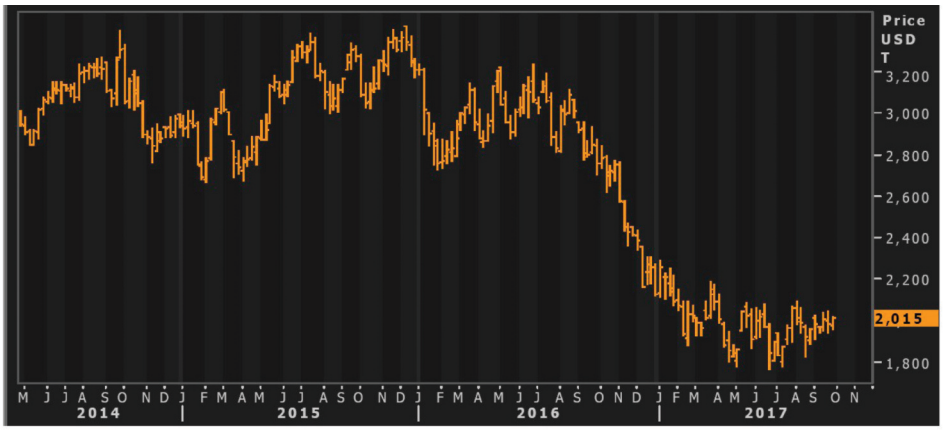


Chart courtesy Reuters

Chart 6 – Cocoa: Commodity fund net-short position (bar)

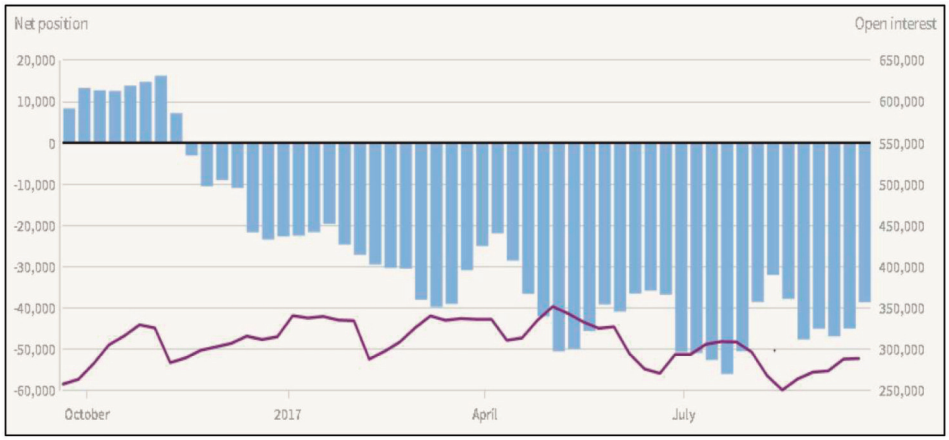


Chart courtesy Reuters

CORN

Can global corn supplies be tightening?

The statistical event of the summer for corn was the August 10 USDA crop report. After a summer of hot and dry weather, analysts were looking for a sharp drop in 2017-18 corn yields, to 166.2 bushels per acre (bpa), down from a record 2016-17 yield of 174.6 bpa and the July estimate of 170.6 bpa, but the USDA came in at 169.6 bpa. For the balance of the month, corn prices would fall by as much as 40¢ per bushel, taking out a one-year low. Prices now remain near the bottom of the ensuing consolidation (Chart 7).

The release of the September crop report had a similar backdrop, but the result was not nearly as dramatic. Analysts still believed that perhaps the USDA was too optimistic with its August estimate and that more timely surveys would show lower yields. But once again, the yield came in higher at 169.9 bpa against an average guesstimate of 168.2 bpa. Despite a 3.3% acreage reduction and a 2.7% drop in yields, the crop will still be the third largest on record.

An interesting news item that will definitely *not* impact the market in the near term, but could have widespread implications down the road: The Chinese government announced that it would introduce an ethanol program similar to those in Brazil and the US. By 2020, all vehicles would have to use a fuel blend that would require 10% ethanol.

The motivation of the program is to reduce the country's corn stocks, which were accumulated by the government in an effort to boost farmer income. The divergence in estimates of the size of the stockpile between the government (85% of usage) and the USDA version (34% of usage) is very wide. Either way, inventories are burdensome. While 2020 seems far away, it should affect the 2018-19 balance sheet as

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processors will begin to produce ethanol for the 2019-20 marketing year.

China has always been self-sufficient in corn. However, over the past two seasons, domestic feed consumption has increased materially, which has resulted in a production/consumption deficit. Using the USDA stock estimate, that has already whittled down inventories by close to 30%. While there is ample supply now, the Chinese balance sheet should tighten over the next two years.

Of greater concern in the near term, though, are problematic weather conditions in South America. In 2016-17 excellent crops in Brazil and Argentina moved both counties to a new plateau among corn-producing exporters, with output increases above previous highs of 16% and 41%, respectively.

For Brazil, lack of rain has resulted in deficient subsoil moisture, which at this point means that 2017-18 corn area should be smaller than last year because the optimum planting period for the summer crop has been shortened. Argentina has the opposite problem, but the outcome will be similar. Excessive precipitation has left corn fields soggy and has delayed the planting season.

USDA estimates for Brazilian and Argentinean output are loosely based on expectations of a repeat of 2016-17. The September crop report forecast 95 million tonnes and 42 million tonnes versus 98.5 million tonnes and 41 million tonnes, respectively.

As with most weather scares, the initial reports are drastic. It's just too early to know. Were there to be a significant reduction in South American crops, however, it would matter more than it would have a couple of years ago.

The global balance sheet for corn has run a production/consumption surplus since 2011-12 – precisely the reason we've been in bear market since. Even using the USDA's early South American forecasts, global demand has expanded sufficiently to leave a production/consumption deficit, which will draw down stocks to 19.15% of consumption, compared with 21.4% in 2016-17 and 22.2% in 2015-16.

We have been on the sidelines in corn, although we've kept a slightly bullish bias because huge crops have been no match for the growth rate of demand (see *Focus on Futures*, August 18). The Chinese ethanol story is a tad futuristic, but the potential for smaller crops in South America would be a potent factor in drawing global inventories down further.

We therefore recommend a low-risk trade as the market creeps along the floor of the range. Buy March corn, currently trading at $3.60 per bushel. Place initial stops at $3.40, close only. *[By Sholom Sanik, October 4, 2017]*

Chart 7 – March CBOT corn



Chart courtesy Reuters

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