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A spectacular Ivorian mid-crop sends cocoa prices tumbling

The sudden, two-day, $200-per-tonne plunge in cocoa prices back in mid-July was well warranted. Until early July the market assumed that 2005-06 Ivorian production would reach only 1.2 million tonnes, far shy of the record 1.4-million-tonne harvest of 2003-04 and not even as large as 2004-05 output of just under 1.3 million tonnes. When the mid-crop season began in the spring, local sources spoke about a record mid-crop harvest of 250,000 to 350,000 tonnes. Those forecasts were deemed unrealistic, but as arrival data started to creep above early-season estimates, it became clear that mid-crop output was going to create an historical anomaly. As of August 25, port arrivals stood at 1.325 million tonnes, which puts the mid-crop at over 400,000 tonnes.

The International Cocoa Organization (ICCO) has responded to this and other supply side developments and has revised its forecasts for the 2005-06 global balance sheet. The estimate for global output will jump to 3.5 million tonnes, up from the previous estimate of 3.3 million tonnes. This will be 3.8% above 2004-05 output of 3.37 million tonnes. Grindings are forecast to grow to 3.47 million tonnes, an increase of 3.6% over 2004-05 usage. After adjusting output for moisture loss, the production/consumption deficit will all but disappear, falling to 5,000 tonnes, a significant change from the previous estimate of 161,000 tonnes.

Another bearish supply-side factor is that despite poor insecticide coverage, 2005-06 Ivorian output was quite good – as illustrated. Now an industry organization has passed out insecticide – free of charge – to all farmers in the southern part of the country, where the majority of cocoa that makes it to port is grown. The amount handed out is enough to cover 624,000 hectares, just about the entire cocoa plantation area in the south. It does not include the rebel-controlled northern part of the country. Most of the cocoa grown in the north is smuggled and does not show up in official Ivorian export statistics anyway. So the new 2006-07 main-crop, which goes into harvest in about a month, holds promise for further improvements.

It is not clear what happened to the tail end of the main-crop harvest in Indonesia, but it seems that disease is a serious problem. Early in August, there was a story circulating that 25% of the crop was lost (over 100,000 tonnes), but we've seen nothing on that since. A loss of that size would be enough to neutralize the bearish situation in the Ivory Coast. What we do know is that exports for Sulawesi Island, the principal growing region, are down 21% over a year earlier for the January to July period. Although the problem could be related to a delay arising from moving beans through the system, we do know that there are issues directly related to the crop.

Mainly as a result of larger Ivorian output, the estimate for global ending stocks will increase to 1.415 million tonnes, or 40% of consumption, up from the previous estimate of 1.27 million tonnes or 37% of consumption. Still, stocks will be slightly lighter than last season's 42% of consumption.

European butter ratios have been slipping modestly, but are still hovering in the range that they've been in for some time, at about 2.4 times the London spot price.

Clearly, the sharp uptick in the Ivorian crop alters the very bullish picture we've been painting. Still, it is not as if this market's issues have disappeared. The political situation

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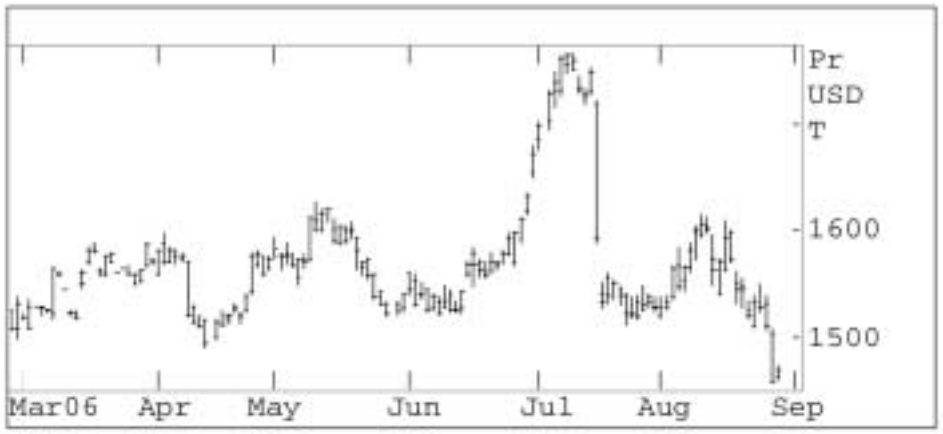
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in the Ivory Coast has not been resolved. There has been little disruption to the flow of cocoa beans since the civil war began years ago, but that does not mean that supply lines will not be vulnerable in the future. Migrant labor – vital for tending plantations and harvest the crop – remains an issue because workers are afraid of working in the country.

Carryover stocks are not going to take the dive we expected, but at best, global inventories are balanced. We cannot say that there is a screaming bullish case, but prices have fallen to account for the new developments. Funds have liquidated a good chunk of their net long position. We are cautious buyers. *[August 30, 2006]*

Chart 1 – December cocoa



Courtesy Reuters

SUGAR

Underestimating Brazilian ethanol consumption

Sugar prices have plummeted 35% since early July, mainly because the major producing countries were swift to respond to prices not seen in decades.

Brazilian cane area was expanded by about 7% for the 2006-07 season. The harvest is now in full swing, and forecasts are calling for a bountiful crop. The most recent estimate is for a cane crop of 423 million tonnes, 8.2% larger than the 2005-06 crop.

The ratio of sugar *vis à vis* ethanol output is expected to increase sharply in favor of sugar. Anticipation of rising demand for ethanol was one of the primary reasons behind the bull market, and the Brazilian sugar industry's decision to produce a higher ratio of sugar than ethanol makes sense of the dramatic drop in prices. Early estimates are calling for the cane crop to yield 29.8 tonnes of sugar, compared with 26.7 million tonnes in 2005-06 – a 12% jump. Ethanol output is estimated at 17.8 billion liters, only 5% higher than 2005-06 production of 17 billion liters, a scant increase when compared with the increase in sugar production.

India – the world's second largest sugar producer – also saw sugar area expand wildly. The 2006-07 marketing year begins with the harvest in October and is estimated to yield 22.5 million tonnes, up from 19 million tonnes in 2005-06, representing a complete recovery from two drought-plagued seasons in which output barely reached 13 million tonnes.

Other significant producers, such as Russia and the Ukraine, are expecting large crops as well. The only exception is the EU, where sugar subsidy reforms are already taking a bite out of the market. Less efficient producers cannot survive, and as a result, beet area was down 6%, while raw sugar output should fall by about 25%.

All the major sugar analysts are talking surplus for 2006-07. Czarnikow and Kingsman are looking at a 3-million-tonne surplus. The International Sugar Organization estimate is forecasting a surplus of 2 million tonnes. It is not difficult to whip oneself into a bearish frenzy.

The bull market brought with it explosive open interest growth, from a range of 150,000 to 200,000 contracts to the 500,000 contract level. This is not as extraordinary an event as it might seem on the surface, because sugar (as well as other agricultural commodities) has become an energy market in addition to a food market, which will naturally attract a new class of hedgers. Thus, the fact that a 7¢-per-pound drop in sugar prices leaves open interest barely-budged at 497,000 contracts is not surprising and does not mean that commodity funds and other trend fol-

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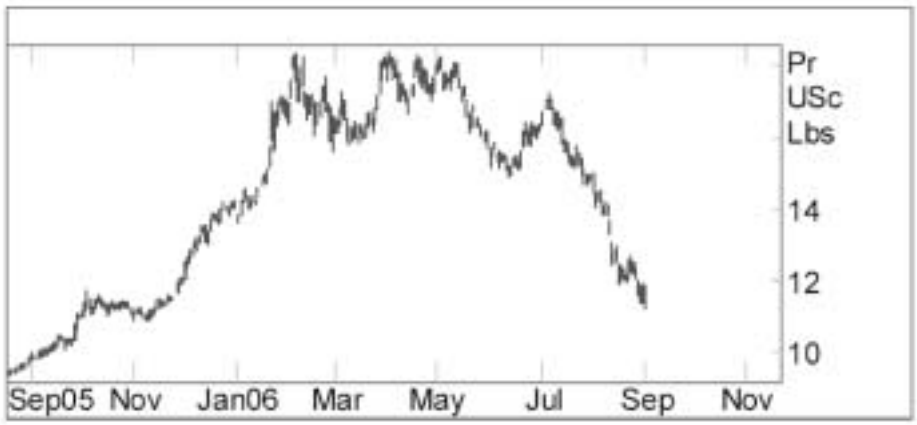
lowers have not liquidated stale long positions. In fact, the net-long position has dwindled to 27,000 contracts according to the September 1 CFTC report, compared with a high of close to 100,000 contracts when the market was near its peak. This is to be expected and on its own cannot be construed as bullish

Having explained the slide in prices, we believe that the structure of the market is not as bearish as the headlines and price behavior would have us believe. When the Brazilian government dropped the mandatory 25% ethanol gas blend back in March, it clearly had a direct impact on ethanol consumption – as was the intention. But the ethanol industry and the environmental lobby are pressuring the government to return to a 25% ethanol blend. After successfully alleviating the tightness in the domestic ethanol market and bringing prices down to one-year lows, the government is likely to return to the higher ethanol blend, because the ultimate objective is to reduce both harmful emissions and reliance on petroleum.

Current ethanol consumption in Brazil is about 1 billion liters per month. A 20% increase would bring usage to as much as 14.5 billion liters per annum. Exports for 2006 are estimated at 2.5 billion liters, but this is a growing market, and we can therefore safely assume that exports will continue to grow into 2007 and that just about the entire crop will be spoken for if the ratio rises to 25%. The assumption that the Brazilian sugar/ethanol production ratio will increase by as much as we quoted above is not realistic.

This is not enough to drive prices back to the highs, but we feel that the market has fallen too far, too fast. If the Brazilian output ratio is increased in favor of ethanol, it will eventually wipe out the global surplus. And then the market will be far more vulnerable to any production problems. We wait patiently for the market to stop falling, but we retain a long-term bullish bias. *[September 1, 2006]*

Chart 2 – October sugar



Courtesy Reuters

CORN

Growing foreign demand and domestic ethanol usage mean higher prices down the road

The August USDA supply/demand situation report dealt a further blow to an already weak corn market. Forecasts for the size of the 2006-07 US corn crop – originally slated to be smaller than average because of reduced acreage – have been creeping up all summer. The new estimate was 10.976 billion bushels, up from the July estimate of 10.74 billion bushels and above the average of analysts' estimate as well. The news sparked a 20¢-per-bushel selloff in the days following the release of the report (Chart 3).

While the US crop will definitely be considerably larger than we believed earlier in the season, the potential for tightness has not been alleviated. The move by US consumers to corn based ethanol is in full gear. Despite the accurate arguments by skeptics about poor cost effectiveness in terms of mileage efficiency *vis à vis* traditional petroleum-based fuels, the consumer is gradually but surely making the switch, and producers are investing serious capital in production and delivery facilities. The motivation may be environmental conscientiousness or an interest in limiting dependency on foreign oil imports. Either way,

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growth in ethanol usage has become a reality. Legislation varies from state to state, but some ratio of ethanol is now required to be blended with gasoline at about a third of all pumps in the US.

Consider the following statistics: According to the Renewable Fuels Association (RFA), average daily consumption of ethanol in the US was 395,000 barrels in June, 42% higher than one year ago. Output, on the other hand, was 318,000 barrels per day in the same period, up only 28% from a year earlier. Ethanol prices have leveled off in recent months, so we have to assume that there has been enough inventory to keep this relatively new market in balance. The RFA says that there is 21 days of supply in the pipeline. If demand continues to grow at this rate, it will only be a matter of time before the tightness re-emerges and spills over to the corn market.

Unlike the other agricultural markets we look at, such as soybeans and wheat, the US remains the dominant force in the corn market. There is no other country that will be able to meet the requirements of foreign feed buyers if the US begins to devote an increasing share of its corn crop to the fuel market, which would leave less exportable surplus.

The export sector is booming. With one reporting week left to the 2005-06 marketing year, US exporters have shipped a record 53.14 million tonnes of corn abroad, against a forecast of 53.34 million tonnes.

The new season is off to a good start. Early sales for 2006-07 stand at 8.5 million tonnes, compared with 5 million tonnes for 2005-06 early sales at this time last year. This makes sense of the USDA's early forecast for 2006-07 exports to reach a new record of 54.61 million tonnes.

According to the August USDA report, the US will grow 279 million tonnes, or 40% of the world's corn for the 2006-07 marketing year, and it will export 55 million tonnes, or 59% of world trade. Argentina is the second largest exporter with 11.5 million tonnes. After that is China, which sold 4 million tonnes last season and is expected to do the same this season. The USDA estimates, however, that China will run a 3-million-tonne production/consumption deficit, so we're not that confident that China will be a factor in world trade at all.

In any case, the increase in the estimate for the US crop was fairly insignificant in the grand scheme of things because the forecast for EU output fell by 3 million tonnes, and the estimate for demand was increased by 1 million tonnes. This left the estimate for 2006-07 ending stocks at 12.8% of consumption, up only slightly from the July estimate of 12.6%, but still sharply below last season's 18.3%.

In conclusion, if foreign demand remains on course and ethanol usage continues to grow at a healthy clip, we should find that the US farming community has underestimated world demand. Nevertheless it will be inspired to grow only enough to meet domestic and foreign needs if prices move much higher. Maintain sustainable positions at all times.

[September 5, 2006]

Chart 3 – December corn



Courtesy Reuters

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