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Coffee: When Brazil freezes over

Before the first frost hit São Paulo and Minas Gerais – the primary producing states in Brazil – in late June, coffee prices had already firmed up to multi-year highs (Chart 1). Brazilian coffee production has a two-year cycle, and the 2021-22 marketing year is the off year. The drop in production was expected to be particularly weak when compared with the historical norm. Then came a series of frosts.

The first frost was relatively tame, and a glance at Chart 2 shows that, in itself, would not have wreaked much havoc. In fact, the market actually sold off. It seemed that there was a premium built in that encompassed both cyclically weak output and the ever-present potential for a frost at that time of year.

Then came the July 20 killer frost, the likes of which has not been seen since 1994, and in the space of just five trading sessions, the market shot up by 60¢ per pound. To be sure, as we will explain below, the impact for coffee supplies was material. Nevertheless, that was the high – at least for the moment.

Testing the resolve of speculators, we believe the sharp selloff that ensued can be directly tied to the increase in margins. On July 23 the exchange raised the initial margin to $7,500 per contract from $4,000. Then on July 28 it was raised again, to $9,500. Over the next two weeks about 9% of the open interest was shed.

Estimates of the damage caused by the frosts vary widely, but there seems to be a consensus that 20% of all trees were affected. Although more than half of the crop was harvested before the first frost hit, much of the fruit that remained unharvested will be lost. Moreover, the trees themslves can become compromised from frost, and that would include the trees that were already harvested. That effect is far reaching and can last for two to three seasons.

Before the frosts, estimates for total 2021-22 Brazlian coffee production – Arabica and Robusta – averaged 52 million bags, down about 22% from the previous season. Estimates for frost-induced crop losses vary widely – anywhere from 2 million to 6 million bags.

Another key factor peculiar to the coffee market: For most agricultural products, a crop failure means that the resulting spike in prices will create an incentive to overproduce in the next crop year. While that could happen in coffee as well, it takes three to five years for new coffee trees to bear fruit. And that assumes farmers will take that route. More likely, however, there have been reports that farmers intend on replacing some coffee plantations with soybeans or corn, given the multi-year high prices those commodities are trading at. Rather than gamble that coffee prices will remain high enough for long enough, planting alternative crops that will grow in less than a year seems to be a far more logical bet.

According to the International Coffee Organization, the 2020-21 marketing year ended with a production/consumption surplus of just over 2 million bags. Before the frosts, 2021-22 global production/consumption was expected to be roughly balanced, but obviously that is now out the window. Over the next few weeks, we expect to see more concrete estimates of the extent of the damage. Whatever the outcome of those forecasts will be, the supply side has become vulnerable, not only to the beans ruined by the frosts, but to future production, as illustrated above.

We are long coffee as per our December 29 recommendation. Raise stops to $1.70 per pound, basis December, close only.

[By Sholom Sanik, August 27, 2021]

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Chart 1 – ICE weekly coffee nearest contract

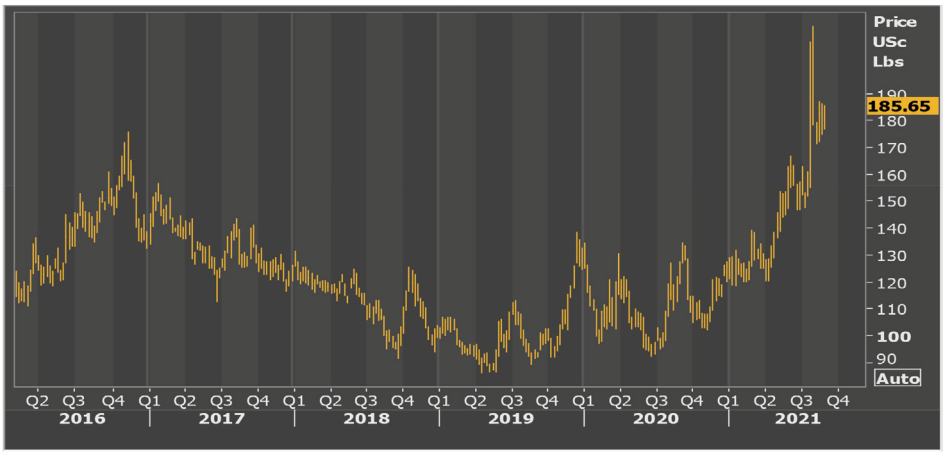


Chart courtesy Reuters

Chart 2 – ICE December coffee

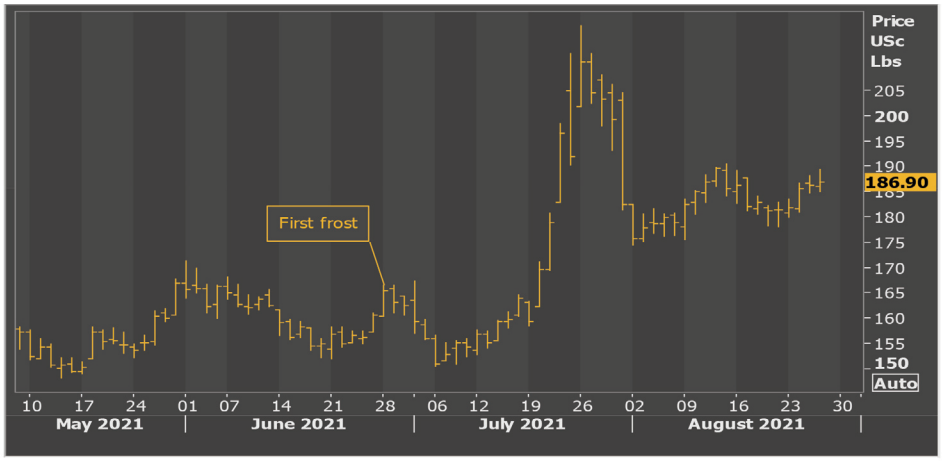


Chart courtesy Reuters

CORN

Has the corn bull run its course?

Corn prices peaked during the 2021-22 planting season and have trended lower since. Events such as the surprise lower 2021-22 US yield estimate in the August USDA crop report triggered momentary rallies. The average of analysts' estimates was 177.6 bushels per acre (bpa), but the actual figure came in at 174.6 (bpa). The reaction rally was brief, and selling continued.

Heading into the September crop report, the average guesstimate for US yields was 175.8 bpa, with the actual figure coming in at 176.3 bpa. Not a huge miss, but the headline sent December corn to a four-month low. Strangely, by session's end, the market rallied to close 20¢ per bushel off the day's low.

We were a bit surprised that the yield result was higher than expected because the weekly crop progress reports, which are as current data as you can get, had been trending lower. From mid-July, the good-to-excellent portion of the crop dropped 6 percentage points, to 59%. The monthly USDA crop data are collected over a longer period, so we assumed that the October yield estimate would fall back towards the August estimate. Perhaps, once traders had a chance to digest the data, it would explain why the market closed so well on the day of the report.

There have been two bullish developments over the past several months. The worst fears regarding the Brazilian crop have been realized. The USDA revised 2021-22 output down 1 million tonnes from August, to 86 million tonnes. But some private forecasters have estimates out that are as low as 82 million tonnes.

In addition, any substitution for carbohydrate feed that normally comes from wheat will be close to non-existent this coming year.

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Arguably the single most important determining factor for corn prices going forward is Chinese buying. And from that corner, the signals are mixed. The off-the-charts old-crop purchases ended months ago. With a combination of small purchases and cancellations, Chinese purchases of US corn since April 1 have been flat. New-crop purchases have totaled 10.7 million tonnes in this period, but those purchases happened in a three-week cluster in May, with no purchases since. New-crop commitments to all destinations stand at 24 million tonnes, which is well above historical norm for the start of a new marketing year. Of that total, 11.9 million tonnes are Chinese purchases.

In summary, US ending stocks for 2021-22 are estimated at 9.5% of consumption. That's up from the current season's 7.9%, but still well below the average carryout we saw in the mid-2010 years of 15%. Competition from South America will be compromised, as illustrated, and that certainly makes the relatively low US carryout a vulnerable factor for the supply side. But without continued support from Chinese buying, the bull market might just be over. The USDA has discounted this possibility by lowering its forecast for 2020-21 US exports to all destinations by 10%. This may turn out to be a modest downward revision for US corn exports if the Chinese buying spree turns out to have been a single-season phenomenon. However, if their forward purchases are any indication, perhaps they are just taking a breather and will still be in the market for US corn.

We are still long December corn. Our $5.00 per bushel close-only stop came dangerously close to being triggered on the day of the September crop report – but it was not. Maintain the stop.

[By Sholom Sanik, September 13, 2021]

Chart 3 – ICE December corn

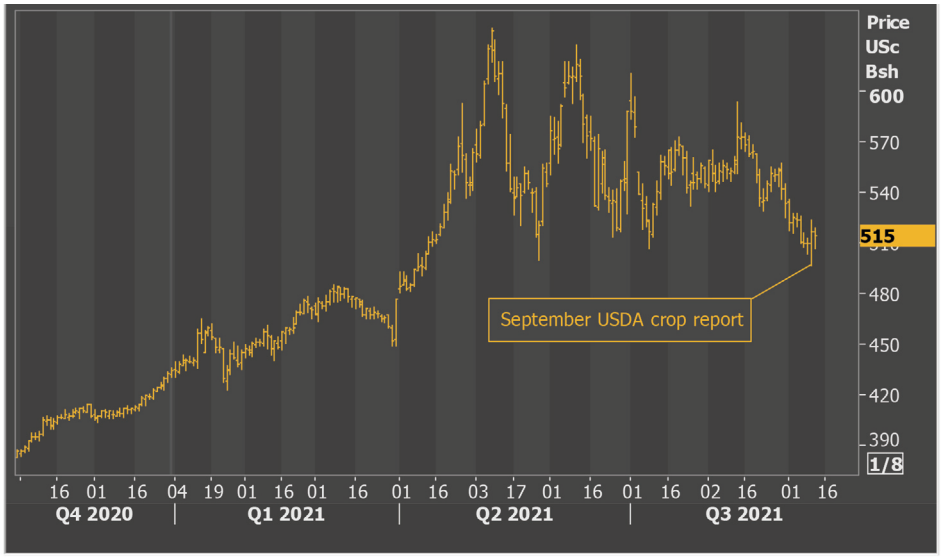


Chart courtesy Reuters

COCOA

Ghana could subdue any bullish development

Cocoa prices have been on a tear, gaining as much as $400 per tonne, or close to 20%, since mid-July (Chart 4). To be sure, there is no supply tightness. The West African mid-crops are just about complete. Ivory Coast produced a record crop. Port arrivals for 2020-21 stand at 2.179 million tonnes, more than 100,000 tonnes above last year at this time and just a bit more than the record achieved in 2018-19.

The spotlight, however, is on Ghanaian output. With a few weeks remaining in the 2020-21 marketing year, production estimates stand at 1.1 million tonnes, well above even the most optimistic early-season forecasts. Over the past few seasons, average production was 850,000 tonnes.

Why, then, the rally? The recent strength in prices could be attributed to two factors.

On the supply side: At one point precipitation needed for the new crop was below average. But more recently, that situation improved. Besides, the subsoil moisture level from the previous season is adequate to compensate for a dry spell.

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Moreover, the coming season is expected to be an off year because after three consecutive years of bumper harvests, farmers will rest trees that have been high producers. One estimate puts the drop in output at 10%, or more than 200,000 tonnes. That is a significant number and, if realized, could prove to be bullish. However, in light of the surprising results from Ghana, we do not consider this to be a major factor, at least until we begin to see fresh arrival data in the coming months that bears evidence that this is actually happening.

On the demand side, market participants are betting on an uptick in grindings. After several quarters of anemic grinding data, traders anticipate that third-quarter results from all four grinding regions – Ivory Coast, Asia, EU, and North America – will show a marked improvement.

Product prices, particularly cocoa butter, have been rising (Chart 5), which incentivizes processors to ramp up bean purchases. Over the past month, there has been evidence of strong activity in some regions. In August, Ivory Coast processors increased bean purchases by 20% year-over-year.

The International Cocoa Organization has been raising its 2020-21 production/consumption surplus forecast all season long. In its latest revision, global production is estimated to have grown by 8%, to 5.14 million tonnes, while grindings are expected to have climbed by only 3.3%. The surplus was revised to 230,000 tonnes, up from the previous estimate of 165,000 tonnes. In May that estimate was 102,000 tonnes. We believe that the end-of season spurt by Ghana was so extraordinary that we will see the final surplus estimate even higher.

The April 22 recommendation to lower stops on our short position to $2,550 per tonne yielded a breakeven trade. We now advise reestablishing a short position in March cocoa, currently trading at about $2,650. Place initial stops at $2,750, close only.

[By Sholom Sanik, September 23, 2021]

Chart 4 – ICE March Cocoa

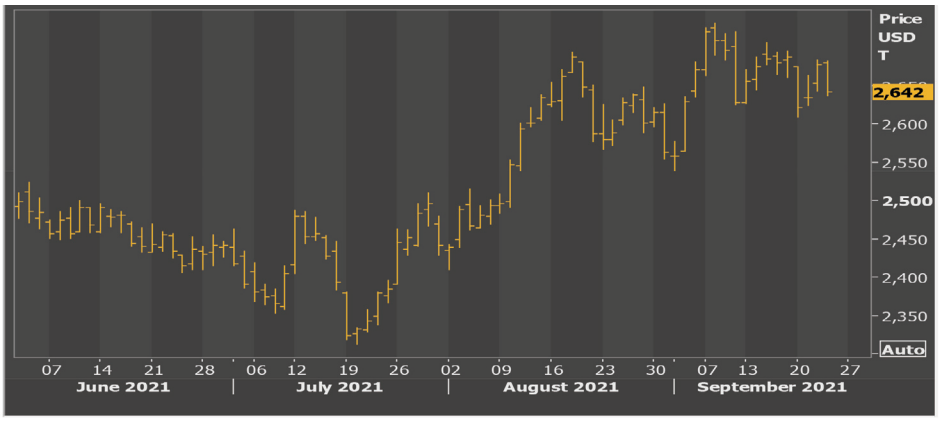


Chart courtesy Reuters

Chart 5 – Cocoa product prices

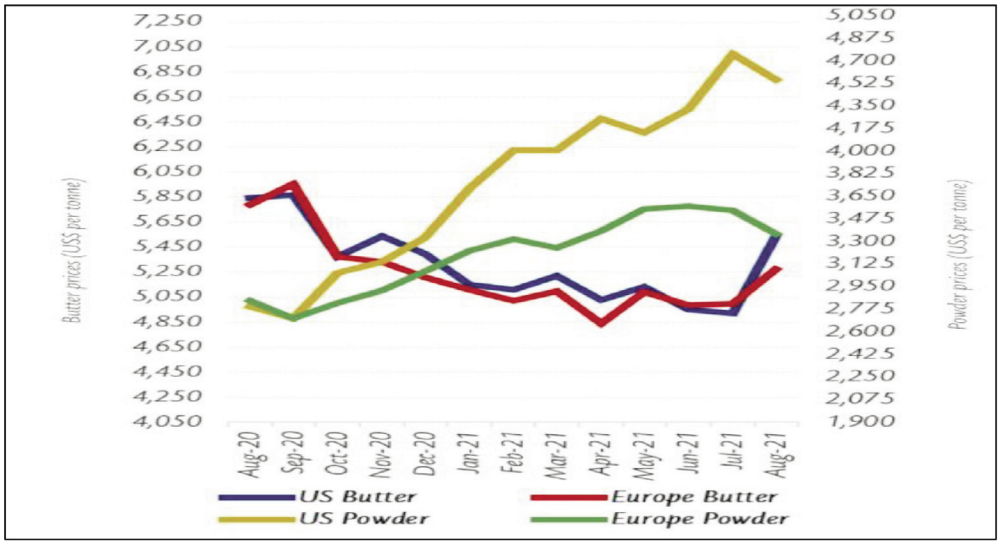


Chart courtesy ICCO

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SOYBEANS

Were 2020-21 Chinese soybean imports a flash in the pan?

The September 10 USDA crop report generated a modest rally in soybeans on inconclusive data. Bushel-per-acre yield for the 2021-22 crop now entering harvest was a tad higher than expected. The upward revision in exports was exactly equal to the downward revision in domestic consumption. Several weeks passed with prices stuck in a tight range (Chart 6). Then, on September 30, along came the quarterly stocks report.

The September quarterly stocks figure becomes the ending-stock estimate for the outgoing 2020-21 marketing year. The September 10 ending-stock estimate was 175 million bushels (4.76 million tonnes), and analysts were not expecting much change – the average guesstimate was 174 million bushels (4.73 million tonnes). But the actual number came in at 256 million bushels (6.96 million tonnes). Definitely a surprise. Prices fell over the following three sessions, challenging the June lows. The 81-million-bushel jump in 2020-21 stocks was attributed to an upward revision for both harvested area and bushel-per-acre yield.

It was easy to get swept up in the bearish sentiment of the headline. The revision pushes the estimate for 2020-21 stocks to 5.7% of consumption, up from 3.8%. And with the carryover to the new-crop, ending stocks for 2021-22 move up to 6.06% of usage from 4.2%.

Upon further analysis, and when viewed in isolation, the amount of soybeans "discovered" by the USDA may not be as burdensome as would appear from the reaction of traders. Chart 7 shows that after the trade-war and Covid seasons, which saw Chinese buying nosedive and inventories skyrocket, we have not really staged much of a recovery in carryover levels. In fact, all that was accomplished was a return to trendline US stock levels.

However, the relatively low carryover estimate will grow in a hurry if Chinese buying in 2021-22 disappoints, and we would then see much lower prices. And at the moment, the exuberance displayed by Chinese importers is not quite what it was last season.

China has been a steady buyer of new-crop beans, purchasing just under 12 million tonnes thus far. But that compares with 20.6 million tonnes at this time last year. New-crop commitments to all destinations stand at 24.3 million tonnes, compared with 38 million tonnes at this time last year – that's 36% behind 2020-21. The USDA forecast for sales to all destinations was revised upwards by close to 1 million tonnes in the September crop report, to 56.88 million tonnes, but that estimate is only 7.5% behind last year's final figure and certainly a far cry from what commitments are showing.

Of the 12 million tonnes attributed to the Chinese, close to 7 million tonnes have been clustered in a short period beginning in mid-August. So perhaps the buying is picking up some steam. Chinese domestic consumption and imports are estimated to grow by 5% and 4%, respectively, in 2021-22. In addition, there has been no output growth since the 2019-20 marketing year, so imports are crucial. In fact, output for the current marketing year as a percentage of domestic usage is estimated to fall to 16.1%, down from 17.4% in 2020-21. Still, seeing imports move into last year's range will present a formidable challenge.

Our long position in November soybeans, first established on April 28 with a $1,225 stop close, is perilously close to being triggered. Honor the stop, but keep close tabs on weekly Chinese imports.

[By Sholom Sanik, October 5, 2021]

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Chart 6 – November soybeans

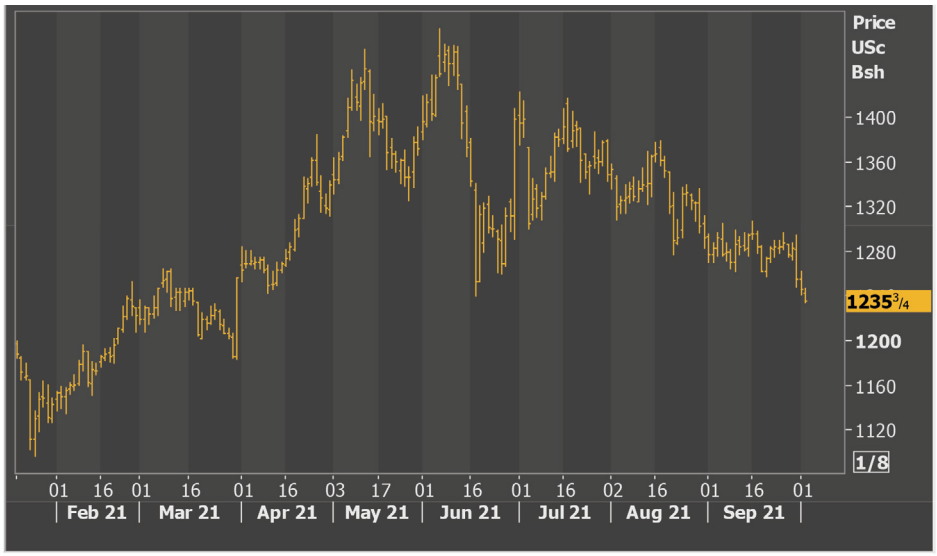


Chart courtesy Reuters

Chart 7 – US soybean ending stocks as a percentage of consumption

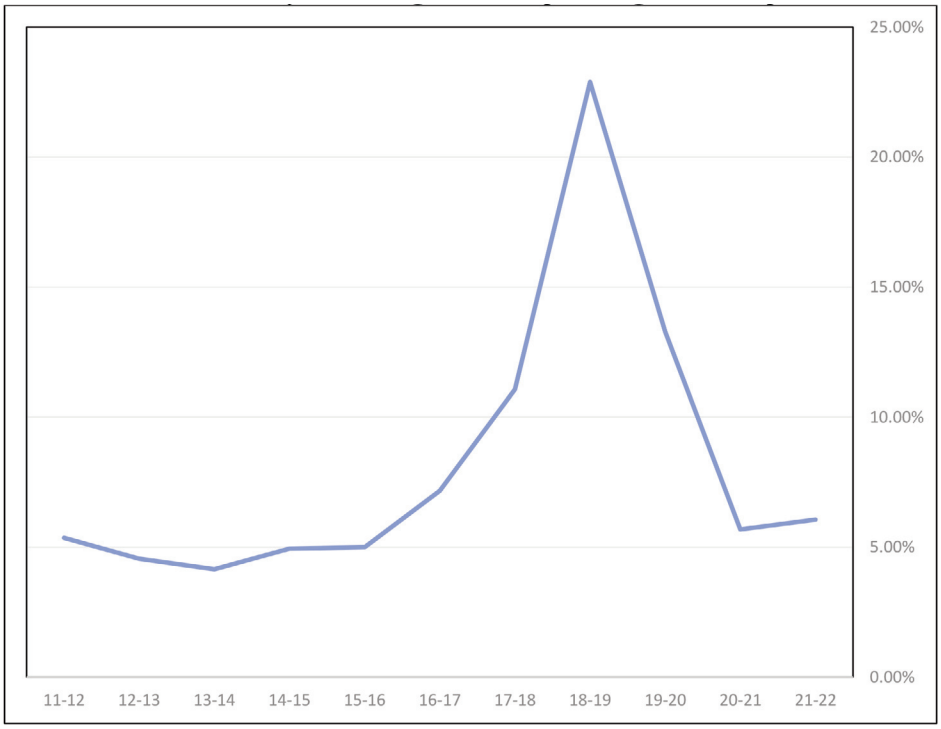


Chart source: USDA

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Subscription Enquiries for
Friedberg's Focus on Futures
Suite 600
220 Bay Street
Toronto, Ontario, Canada M5J 2W4
Telephone: 416-350-2913
Fax: 416-364-0572

All enquiries concerning trading accounts should be directed to:
Friedberg Mercantile Group Ltd.
Suite 600
220 Bay Street
Toronto, Ontario, Canada M5J 2W4
416-350-2903
Attn: Sholom Sanik

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