

Softs to face tighter fundamentals; key risks remain

Softs had a strong last quarter. We expect these markets will see tighter fundamentals going into 2020, which should support prices. However, the key risk for coffee and cocoa is the significant amount of speculative buying we've already seen, which could be an obstacle for further upside



A farmer inspects the sugar beet crop

Sugar returns to deficit

The global sugar market is set to return to a deficit of around 6.1mt in the 2019/20 season, having spent the last two seasons in surplus. The change has been driven by lower year-on-year output from the likes of India, Thailand, the EU and Central-South Brazil. Declines in India, Thailand and the EU are due to a combination of poor weather and lower planted area. In CS Brazil, the reduction is driven by the fact that mills in the region continue to favour ethanol production over sugar.

Given the deficit outlook for this season, prices have been fairly well supported over 4Q19, although one might believe that given the scale of the deficit, prices should be even stronger and speculators should be holding far fewer bearish positions than currently. So why the disconnect between tightening fundamentals and prices/sentiment?

There are several factors keeping the lid on sugar prices

There are several factors which are keeping the lid on sugar prices:

Firstly, we have come out of a two-year surplus period, where we saw a significant build-up in stocks, and so we would need to see a drawdown in these levels before we can get overly bullish about the market.

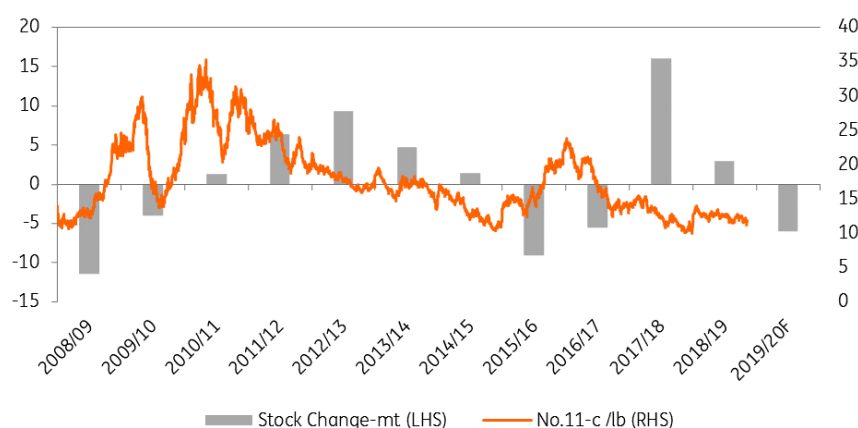
Secondly, India is key for market sentiment. While India is set to see a smaller crop this year - output is estimated at around 26.9mt, which should leave the domestic market fairly balanced this season - they have entered the season with significant stocks levels equivalent to around 55% of annual domestic consumption. These stocks will remain a risk to the world market and so prices are unlikely to move significantly above export parity levels unless the world market needs this sugar. For the moment, it seems, it doesn't.

Thirdly, ethanol/sugar dynamics in Brazil should cap prices. Given that global stocks are still high, we do not believe there is a need for sugar prices to trade above ethanol parity levels. If this were to happen, mills in Brazil would likely allocate more cane to sugar production rather than ethanol. Ensuring sugar prices remain below this parity would help draw down global stocks.

Finally, with Brazil historically the largest sugar producer in the world, prices can be influenced by moves in the Brazilian real, and this year we have seen considerable weakness in the BRL. This appears to have held back global sugar prices which are priced in USD. Further weakness in the BRL could weigh further on sugar prices, although saying that our LatAm economist believes that while there is the potential for further weakness in the near term, we should see some strength in the long run.

We do hold a mildly constructive view on the market and are forecasting that No.11 will average USc13.30/lb over the course of 2020 as we move deeper into deficit. Obviously, key to this assumption is that we do not see any surprises when it comes to production and government policy.

Global sugar stock change vs. No.11 sugar price



Source: FO Licht, ISO, ING Research, Bloomberg

Spec-fueled coffee rally

It has been quite the year for the coffee market, with Arabica initially trading to multi-year lows on the back of a large surplus in the 2018/19 season. The broad weakness we've seen in the BRL has also weighed on the market. These two factors have done little to support sentiment, and speculators have remained largely bearish Arabica for most of the year. However, prices rallied as much as 30% from their 4Q19 lows in the final stages of the year as speculators ran in to cover their shorts. The International Coffee Organization's deficit forecast of 500k bags in 2019/20 is supportive, which is largely driven by the Brazilian crop being in its 'off year' for the biennial crop cycle. Other forecasts for the current season suggest the deficit will be even larger.

Demand has also been robust, with coffee shipments having increased 8.1% YoY to 129.4m bags in 2018/19, largely on the back of stronger exports of Arabica from Brazil. Lower Arabica supply this season, along with stronger demand, has not only been constructive for outright prices but also the Arabica/Robusta spread.

There are worries about the impact of October's dry weather in Brazil on the 2020/21 crop. Brazil's upcoming season will be the higher-yielding season which should naturally see stronger output. But there will be plenty of attention on how much of an impact the dry weather has had on the crop. From a speculators' perspective, they clearly appear uncomfortable with this uncertainty, and hence the reason behind the large amount of short covering we have seen recently.

Grinding away the cocoa surplus

The cocoa market has not missed out on the strength seen across the softs complex. London cocoa prices have rallied as much as 30% from the lows seen at the end of January this year. The International Cocoa Organization estimates that the 2018/19 season saw a deficit of 21kt, which is in contrast to their previous expectations of an 18kt surplus. That balance shift was predominantly driven by stronger demand numbers. Cooperation between the Ivory Coast and Ghana to impose a floor price of US\$2,600/t has also been supportive for prices.

The minimum floor price and living income premium of US\$400/t is likely to provide support to the market in the short term, but in the long run, these stronger prices do risk bringing additional supply onto the market.

The cocoa market has not missed out on the strength seen across the softs complex

The largest producer Ivory Coast plans to cap output at 2mt in the 2019/20 season, which would be around 200kt lower than what they are estimated to have produced in 2018/19. The key test will be how regulators monitor and cap output; we believe it will be difficult to limit production. Furthermore, a cap could potentially lead to increased smuggling of beans into neighbouring Ghana.

Stronger grinding numbers have been driven by Asia, with quarterly figures this year from the Cocoa Association of Asia showing double-digit percentage growth through until September. Europe and North America have not benefitted from the same level of growth, and have in fact

seen declines in some quarters this year. For 2020, the balance for the market will be largely dependent on whether Asian cocoa demand can hold up. Sustaining this growth might be difficult moving ahead, given the higher price environment weighing on processor margins.

Speculative positioning in London cocoa suggests that they are potentially reaching their limits. Speculators hold a net long of almost 78k lots, levels last seen in 2015, and not too far off from their record net long of almost 90k lots back in 2015.

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