ETF Securities Commodity Research: Short sugar and coffee

Summary

- Speculative positioning in both sugar and coffee appear over-extended.
- Brazil’s sugar production has risen and a healthy monsoon in India paves the way for a partial recovery in cane production.
- The abolition of the sugar production quota in Europe next October will weigh on global prices.
- Brazilian Arabica coffee output hit an all-time high in 2016, but prices rose as a result of Brazilian Real appreciation.
- With La Niña potentially back on the cards and weather in Brazil remaining favourable, the next season’s Arabica crop may surprise on the upside.

Sugar rally to run out of steam

Sugar has gained over 80% since February 2016 as the market is expected to have entered a second consecutive year of a production deficit. Prices are now trading at a 5-year high. The futures market has become very bullish. Net long positioning in the futures market hit an all-time high a few weeks ago and remains more than 2 standard deviations above its 5-year historic average.

We believe that this optimism is overdone. Sugar production in Brazil, which produces close to 25% of global output, is running close to 20% higher than last year. While there is some fear that the season could be cut short, we believe that higher prices will encourage mills to continue production. Indeed, the cane harvest, which is close to 70% complete, is also running 10% ahead of last year. Moreover, with sugar prices this high and weakness in oil prices, more cane could be diverted to sugar production over ethanol production.

India, the second largest producer of sugar, has received normal levels of rain this monsoon in contrast to the previous year’s failed monsoon. Reservoir levels have filled to around 75% as of October 20th, which is exactly in line with the 10-year average for this time of the year (and 128% of the corresponding period last year). Reservoir levels in the key cane producing areas was even higher. With most cane in India being irrigated, availability of reservoir water will be important for the following season.

EU to scrap sugar beet production quota

The EU is set to abolish its sugar beet production quota in October 2017. While the ICE Sugar No. 11 futures contract is based on the delivery of raw cane sugar, the greater availability of a close substitute could impact its price. Although the EU will eliminate quotas on production of sugar beet, it is not set to change tariffs on the import of raw cane sugar. Refiners in the EU are therefore more likely to use domestic beet for sugar
production. While this is more of a concern for next year, prices of raw cane sugar could begin to weaken in advance.

**Arabica price rises despite Brazilian production increase**

Arabica coffee prices have risen close to 40% since January and speculative positioning is over 1 standard deviation above historic average.

Brazil dominates Arabica coffee production and has a significant influence on the price of the commodity.

2016 Arabica coffee output from Brazil was the highest on record despite the fears that El Niño would hamper production. The Arabic harvest in Brazil was largely complete in September.

As the chart above indicates, coffee output in Brazil goes through biennial cycles: production rises in one year and falls in the next. The 2016 coffee crop in Brazil was a high year in the biennial cycle and 2017 will be a low year. Some of the recent price gains may reflect that we are about to enter a cyclical low year, but we caution that the pattern does not always hold (for example between 2012 and 2013).

We believe that more of the gains were driven by an appreciating Brazilian Real. The Real appreciated on the back of an impeachment of the Brazilian President. Barring any positive economic shock, we believe that most of the positive news for the Real is priced-in.

**Potential for favourable weather**

Weather conditions may have turned favourable for production in Brazil. Currently rain is progressing well in the south east of Brazil (where close to 90% of its Arabica is grown). That is important during the critical ‘flowering’ process. The amount of flowering determines how much coffee cherries will develop on each coffee bush.

NOAA has recently put La Niña back on ‘watch’ status again, raising its probability from 40% to 70% (after having reduced its probability only the previous month). La Niña promotes cooler Southern Hemisphere summer temperatures and could reduce the risk of heat damage to the crop as a result. While the weather pattern is not confirmed, if it does emerge it is expected to be relatively mild, minimising the risk of excessively cold weather. We believe that there is potential for an upside surprise in the size of next year’s crop.
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