ETF Securities Commodity Research:
Time to short sugar, coffee and soybeans

Summary

- Sugar, coffee and soybeans have made spectacular returns this year, but much of their gains have been driven by currency movements, particularly the Brazilian Real.
- With record production of Arabica coffee and soybeans expected in 2016/17 and a narrowing deficit in sugar, the rally is likely to come under pressure.
- If the Brazilian Real remains stable, we expect fundamentals to prevail and the price of these sugar, coffee and soybeans to decline.

Brazilian Real drives rally

The El Niño weather pattern led to a failed monsoon in India and unseasonably wet weather in South America in 2015/16. However at the time of onset of the adverse weather, the price of sugar, coffee and soy made only muted moves. The sharp depreciation of the Brazilian Real weighed on their performance as stocks of these commodities could be sold in US Dollars, providing millers and farmers with improved margins. When the Brazilian Real started to appreciate we saw the price of the commodities make substantial returns. Year-to-date, sugar, coffee and soybeans have returned 35%, 19% and 25% respectively.

Record coffee production

After two consecutive years of production decline, coffee output is expected to rebound to an all-time high. Brazil, which produces approximately 45% of global Arabica supplies has seen favourable rain during the flowering of its coffee bushes, setting the scene for a healthy crop. Although the beginning of the harvest has been slowed by rain, current dry and warm weather should allow for field work to catch up. Brazilian output is expected to rise by close to 20% in the current 2016/17 crop.

Elsewhere, production in Honduras (7% of global production) is expected to make a recovery after the planting of ‘rust-
resistant’ trees several years ago, which is helping to improve yields. The country has engaged in a renovation programme to protect its coffee from the rust-leaf fungus which has reduced production from Central America and Mexico for the past four years. Honduran production is likely to hit an all-time high of 6.1 mn bags (a 7% gain).

Sugar consumption is expected to rise by 1% globally, leaving the market in a production deficit despite the increase in supply. However, that supply deficit will narrow. While sugar stocks will continue to decline, they will remain above the long-term average of 31 million tonnes.

**Soybeans head for record production**

The Argentine soybean harvest in 2015/16, which is virtually complete, is expected to produce 8% less soybeans that the previous year as flooding in April and May spoiled the crop. Argentina provides approximately 20% of global production. Brazil (30% of global production) has seen its harvest remain close to the previous year’s levels. The 2016/17 year crop for Argentina and Brazil has not yet been planted.

The US 2015/16 crop was a record high. Although USDA projects a decline for 2016/17, we believe that their forecast remains overly conservative. By July 3rd 2016, 22% of the crop was blooming (8% ahead of last year) and 72% of crop was in good or excellent condition (10% better of last year). Moreover, planted acreage of soybean in the US has increased by 1%.

Speculative positioning in soybean futures stand more than 1.5 standard deviations above the 5-year average, highlighting that investor optimism remains elevated. We believe that the investor optimism is a response to the disappointing Argentine crop of 2015/16. While the 2016/17 Southern Hemisphere crop is not yet in the ground, our analysis of La Niñas indicate that weather conditions could be quite favourable for the crop this year.

**Downside risk to Real**

While difficult to predict the path of a currency that has been so volatile in the past few years, we believe that the good news about relative political stability (after the impeachment of the President Dilma Rousseff) has been largely priced in. Economic conditions remain challenging for the country and therefore limit significant further appreciation. We believe that currency appreciation will no longer be a meaningful catalyst for price increases in sugar, soybean and coffee for the remainder of this year and the crops will trade on their own fundamentals. Rising production should therefore be price-negative.
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