

# ABN AMRO Agricommodities Monthly

Investment Research by VM Group August 2011

## ▪ Coffee Quarterly

[The Agricommodities Monthly](#) is produced as part of a joint venture between ABN AMRO Bank N.V. and VM Group.

This monthly report is intended to inform, educate and stimulate debate for the bank and its customers. This month we focus on the global coffee market.

### Analysts:

- **Gary Mead**  
E-mail: garymeadgary@gmail.com
- **Justine White**  
E-mail: justine@virtualmetals.co.uk
- **Laila Manji**  
E-mail: laila@vmgroup.com

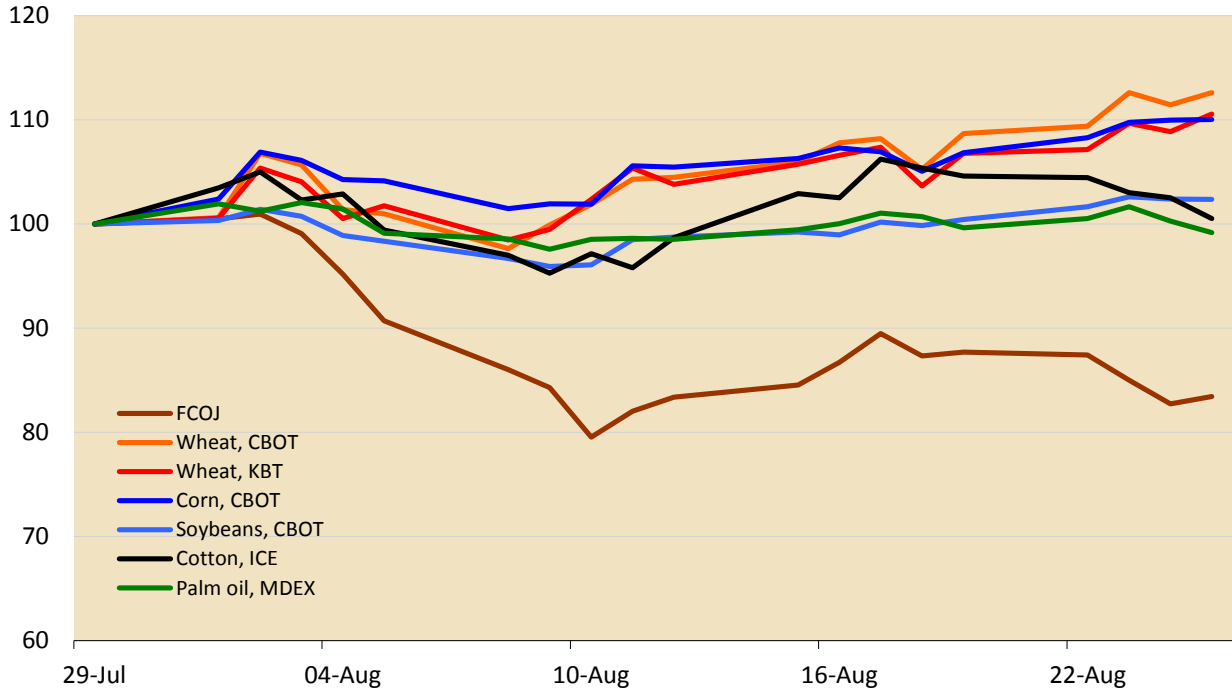


## Contents

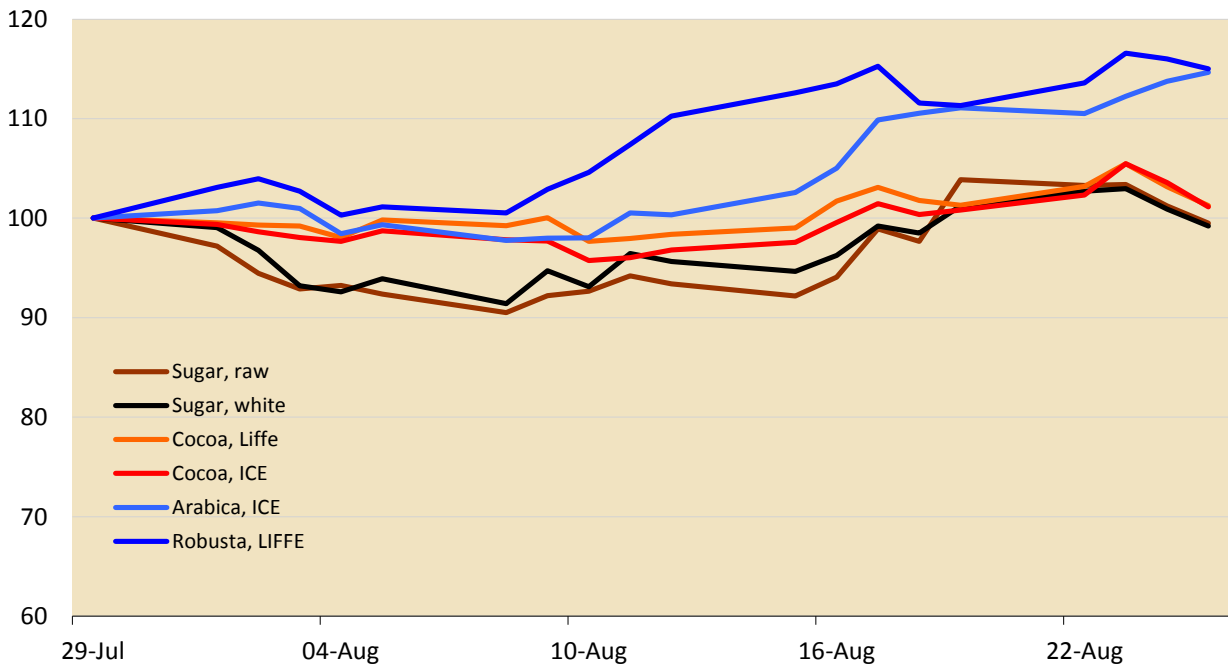
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Feature: US ethanol at crisis point .....	4
Coffee Quarterly .....	8
Coffee data .....	24
Weather watch .....	25
Cocoa .....	26
Sugar .....	28
Wheat & Corn .....	30
Palm oil & soybeans .....	31
Frozen concentrated orange juice .....	32
Cotton and wool .....	33
Fund activity .....	34
CFTC positions .....	35
About VM Group .....	37
VM Group disclaimer and copyright .....	38
ABN AMRO disclaimer and copyright .....	39

Selected agricommodity prices, past month: near-term contract, re-based to 100 at start-month

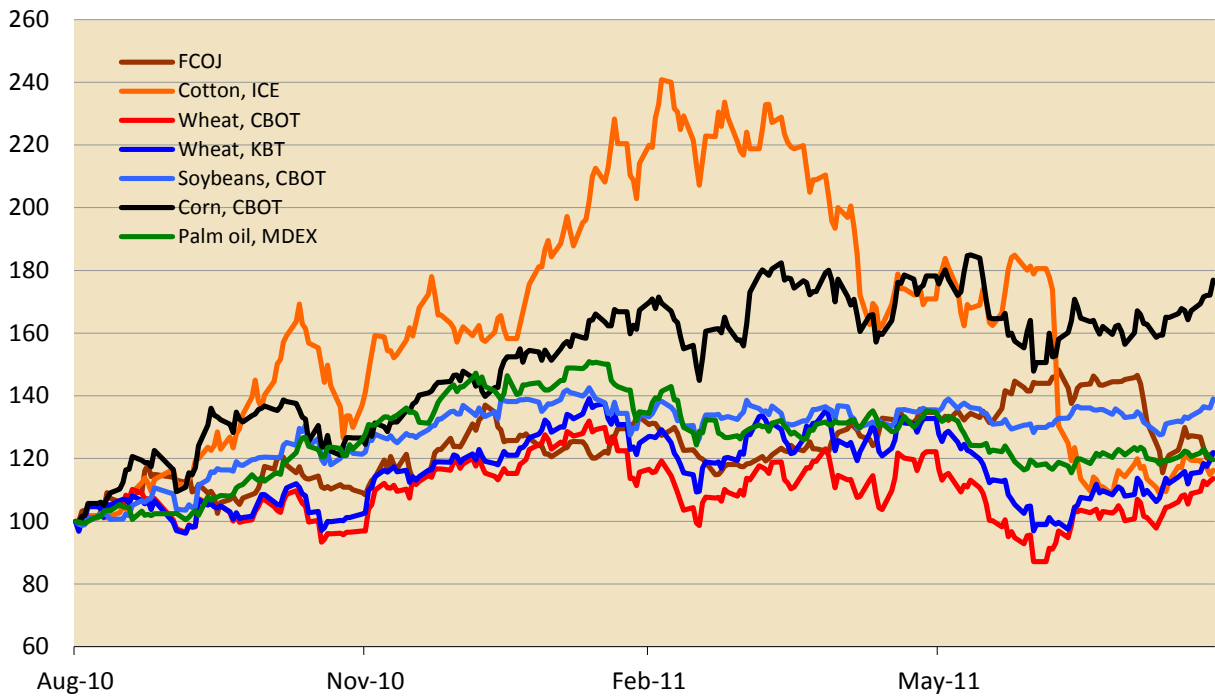


Source: VM Group

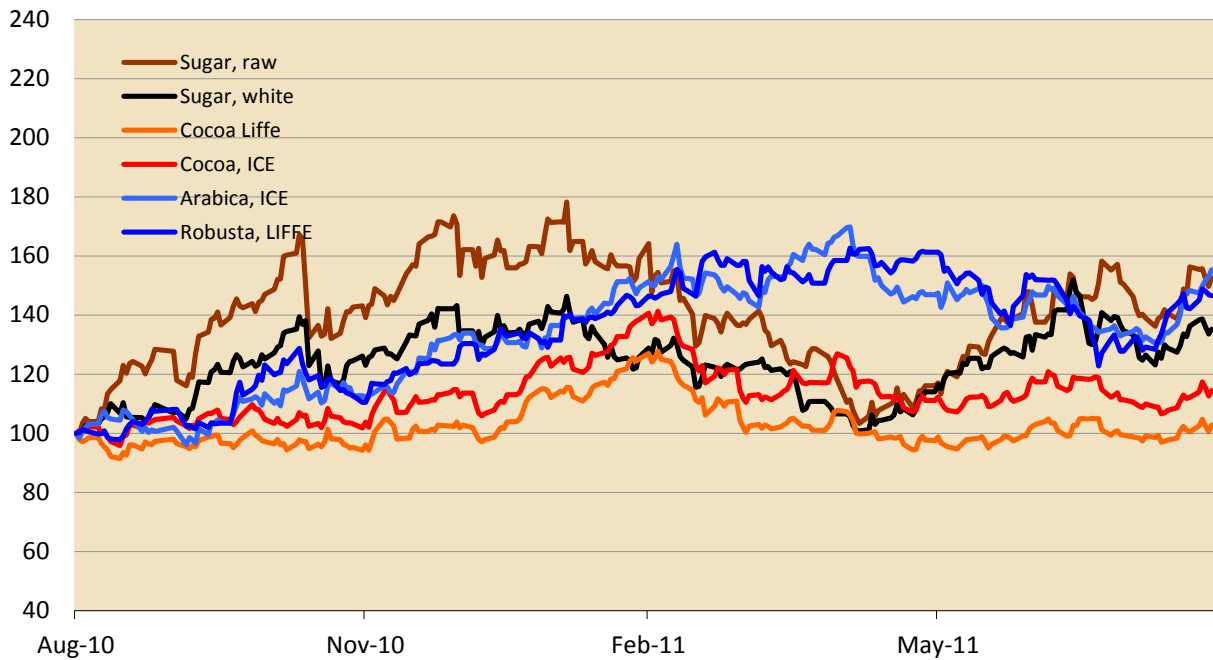


Source: VM Group

Selected agricommodity prices, past 12 months: near-term contract, re-based to 100, 12 months ago



Source: VM Group



Source: VM Group

## Feature

### US ethanol at crisis point

*Where did it all go wrong? The rise and fall of ethanol in the US public imagination has been nothing short of spectacular. Heralded as a saviour against foreign oil interests barely five years ago, the US Senate recently voted to pull the financial rug from under the ethanol industry.*

It wasn't always like this. The most recent glittering chapter in the history of ethanol stems from the late 1970s when, in the aftermath of the 1973 oil crisis, ethanol was identified as a potentially viable substitute for gasoline and certainly as an alternative fuel worth pursuing. The US 1978 Energy Tax Act confirmed this – by hitting gas-guzzling vehicles with higher taxes, and offering ethanol producers subsidies of 40 cents/gallon. A second energy crisis was triggered shortly after this, by the 1979 Iranian Revolution that swept the Shah of Iran into exile. Knowing that it had to protect its budding ethanol industry against foreign competition, the US introduced the Ethanol Import Tariff of 1980, which imposed a 54 cent/gallon tariff on imported ethanol.

These two pieces of financial armour (the producers' subsidy was subsequently increased to 45 cents/gallon by the 2005 Energy Policy Act) have underpinned the fiscal structure of the entire US ethanol industry and now amount to public subsidies worth \$6bn a year. Some would say this is a fair price to pay for increased energy independence, since the US ethanol industry has since developed into the largest in the world, producing an annual output of 13.2bn US gallons (50bn litres) of fuel in 2010. US ethanol production reached a record average 937,000 barrels per day (bpd) in early December 2010 and output levels have been above 880,000 bpd for most of this year.

#### **Ethanol production soars but US appetite limited**

But as US ethanol output has increased, the appetite for it as an alternative fuel has not kept pace. Producers have complained of an impending “blend wall” – the maximum amount of ethanol that can be blended into current gasoline sales at a 10:90 ratio. Taking a leaf out of the playbook of the second largest ethanol producer, Brazil, US supporters of ethanol have seen E85 (a mixture of 85% ethanol and 15% gasoline) as a way to leap across the blend wall and open up a much larger market. Central to this has been the adoption of more flexible fuel systems in US cars. But once again, US carmakers have proven to be slow to innovate new flexible fuel technology, which allows motorists to determine the quantity of ethanol they use in their fuel.

According to the US Bureau of Transport Statistics, there were 256m passenger vehicles in the country in 2008, a number that is boosted annually by about 5.5m. With an

estimated national flex fuel fleet of 8m vehicles, this accounts for well below 4% of the total number of cars on American roads. In stark contrast to the US experience, Brazilian motorists are long accustomed to driving flex fuel vehicles. By comparison in Brazil in 2010, there were 12.5m flex fuel vehicles operating out of a total car and light commercial truck fleet of 41m vehicles, or about 30% of the total. Significantly, flex fuel sales now account for almost 93% of all new car and light truck sales in Brazil. This disparity is at the heart of the differences between the US and Brazilian markets.

Although the US government is encouraging the adoption of flex fuel vehicles through incentives to individual drivers and by offering filling station owners up to \$30,000 to install new flex fuel pumps on their forecourts, there are serious structural changes taking place in the US new car market. Even though the US driving population is steadily increasing (offering the prospect of more vehicle sales to both domestic and foreign carmakers), American drivers are keeping their cars for longer than they used to. The average age of vehicles in the US is now about 9 years compared with just five years in the late 1960s. This will extend the period the flex fuel fleet in the US reaches critical mass well into the 2020s.

The speed at which flex fuel vehicles become the norm in the US will depend partly on the economics of motoring and partly on infrastructure constraints. Since ethanol contains less combustion energy than gasoline, motorists will need to monitor the price of not one but two fuel prices to determine the optimum cost-effective mixture. In Brazil, the rough yardstick is to increase the ethanol mix only when ethanol prices are 30% lower than gasoline. When this rule of thumb is applied to the US however, the economics of biofuels do not really stack up in favour of the motorist. In central Los Angeles in late August – California has the greatest concentration of flex fuel vehicles in the US – standard gasoline was priced at \$3.75/gallon while the price of E85 was just 3% lower at \$3.65/gallon. To the south of Los Angeles in the coastal resort of Oceanside, the price of E85 (at \$3.62/gallon) was actually higher than gasoline (\$3.61/gallon). Right now therefore, it is evident that the ethanol-gasoline price spread leaves much to be desired.

Nor is the necessary infrastructure in place in the US to sustain a biofuel transport economy there as yet although current US government plans will help finance the addition of 10,000 more E85 ethanol pumps (from the present 2,500 pumps) over the next five years. This may form the basis of an “ethanol highway” but it will not make much of an impression on a network that at the last count numbered 120,000 filling stations. It’s not even clear that a motorist could traverse the continental US using ethanol as a fuel or even an E85 mixture. If someone was adventurous enough to try this, they should avoid trying to fill up in Montana, where there are only two E85 stations, one of which is located on the Malmstrom Air Force Base and is reserved for the use of government personnel only. But if you are in nearby Great Falls, the only remaining E85 option in Montana is the

Best Oil filling station which opens 8am-5pm between Monday and Friday. Happy motoring indeed.

### **Flex fuel vehicles anything but new in the US**

Like many innovations in the US, the shift towards flex fuel vehicles has been side-lined for various reasons – and not for the first time. In fact, Henry Ford designed his first car, the Quadricycle, a hand-built vehicle in production for five years from 1896, to run on pure ethanol. Ford's first mass produced car, the 2.9 litre Model T which was in production from 1908 to 1927, was capable of running on standard gasoline, kerosene or ethanol or a mixture of any two of these. While this period of automotive design has stood out for its innovative track record, the choice of gasoline as a primary transport fuel emerged during the 1920s when petroleum output in the US soared, and the passage of the Eighteenth Amendment to the US Constitution paved the way for prohibition of the manufacture, sale and transportation of alcohol from 1920-33, effectively killing off the ethanol-as-a-fuel option.

### **Sugarcane trumps maize**

An important drawback in US ethanol production is the inherent inefficiency of maize as a feedstock. Sugarcane, which underpins the Brazilian ethanol industry, is five times more efficient than maize in producing combustible fuel and its superiority explains the stampede to produce sugarcane-based ethanol in Brazil. Many leading international oil groups are staking their claim to this burgeoning alternative fuel market by buying into local joint ventures which have been snapping up small, relatively-inefficient, cane producers. In late August, Brazilian oil group Petrobras outlined joint venture plans with privately-owned sugar and ethanol group Sao Martinho to expand an existing crushing plant in Quirinópolis, which they claim will be the world's largest ethanol plant by 2015. Total investment in this joint venture is expected to be 520m reais (\$324m).

### **The sting in the tail**

Ethanol feedstocks are basic agricommodities, and as such corn-based ethanol, just like sugarcane, will impact on the economics of food production, simply because if farmers are not growing maize, they will grow something else. The mandated production levels for ethanol in the US may have given the ethanol industry a level of crucial market support, but they have nevertheless continued to stoke the fires of the food-versus-fuel debate. For example, in late July this year, a Food and Agriculture Organization (FAO) report established a definite link between biofuel production and higher food prices. It noted that over the period 2000-2010, non-food uses of cereals made up 0.7% of the growth in world cereal consumption, out of a total growth of 1.8% over the same period.

Similarly, at the same time, the growth rate of consumption of vegetable oils for food fell on the previous decade, but the share of vegetable oils used by the biofuels industry more than doubled from 11% to 24%. However, just a few days after the FAO report was published, consultants from Informa Economics said there was no statistical link between increased ethanol production and rising food prices.

There is an even more ominous debate looming on the issue of ethanol. US ethanol prices briefly touched a five-year high in late July and were bumped up again in early August when the US Department of Agriculture trimmed its estimate for the country's corn crop. At the heart of these price rises were weather-related events so as well as the food-versus-fuel debate is the additional prospect of a weather-versus-fuel debate, one which cannot be settled through economic or political analysis. Increasingly it would appear that ethanol made from first generation feedstocks is not the ideal choice of fuel to replace traditional forms of energy like oil and gas. Although these fuels are costly – both financially and in terms of emissions – their supplies are as yet substantial and predictable. Ethanol, however, is increasingly expensive and production can be ravaged by erratic and often extreme weather events – and its production from food crops may be further contributing to famine in the poorest parts of the world.

The vulnerability of the US and Brazilian ethanol industries to adverse weather has yet to be quantified. Nevertheless, as global temperatures rise and rainfall patterns alter with the unpredictability of the El Niño and La Niña weather systems, the price of ethanol is going to be more volatile than most had expected.

So, how do you prise \$6bn in subsidies from the ethanol industry, especially in the run-up to a US presidential election where corn-growing states may prove to be the decisive battleground for the eventual winner? The answer essentially is that you can't. Lobbying by the oil and gas industry about the profligacy of the ethanol sector has certainly had an impact on US public opinion and most Americans want to see the huge subsidies curbed in some form. President Obama may already have seen the logic of weaning the ethanol industry off federal support in stages – by scaling back federal subsidies and by removing the import tariff that has protected the sector for more than 30 years. But it may take at least another presidential term, and maybe even another US presidency, before the American ethanol industry is forced to stand on its own feet.

*By Paul and Emily Hannon*

**Warren Robertson**

Head of Agricommodities  
tel: +44 (0) 20 3192 9275  
fax: +44 (0) 20 3192 9225  
warren.robertson@uk.abnamro.com

**Alex Parry**

Senior Coffee and Cocoa Broker  
tel: +44 (0) 20 3192 9272  
fax: +44 (0) 20 3192 9225  
alex.parry@uk.abnamro.com

ABN AMRO, Global Markets,  
5 Aldermanbury Square, London, EC2V  
7HR, UK

## Coffee Quarterly

### Weather and climate

The autumn should be free of any traces of La Niña. According to the US Climate Prediction Centre the outlook for the rest of the year is neutral, a relief after one of the most intense La Niña events in over ten years. However the outlook for 2012 is less placid, with the potential for La Niña to return. The return of a La Niña event would be most unwelcome in coffee growing regions of Indonesia and Colombia who are counting on weather conditions normalising in order for production to recover from the effects of the last La Niña event. The interim outlook for coffee in Central America and Mexico indicates favourable rains, although with an increase in tropical storm activity there is some threat of flooding. The outlook in Brazil remains favourable with no seriously cold temperatures expected in coffee areas. Weather in Colombia has been generally favourable for crop development. East African coffee growing regions have been predominantly dry, the last few weeks have seen rains in some regions but more will be needed soon.

### Supply and demand

While the fundamental outlook in major producers has not altered dramatically, external market conditions have taken a turn for the worse and the flight from risk seen earlier this month has put a damper on coffee investment. Often, weakness across softs has been driven by global macro-economic gloom rather than internal market forces. This is likely to continue, for as long as uncertainty clouds the global economic outlook soft commodities will fall into the 'riskier' class of assets and lose some of their popularity as a choice of investment. In some countries, inflation has become less of a concern now that economic growth expectations are being moderated. Yet there is still a case to be made for investing in certain soft commodities and coffee is certainly a case in point recently when potential returns elsewhere in the markets are looking grim and interest rates in advanced economies continue to stagnate. We appear to be at a crossroads right now – we could see bad news fatigue set-in and a possible return to risk which would benefit coffee and the rest of the agricommodity complex. We could also be seeing the tail-end of a slight hiccup in investment demand which might well be the beginning of a major sell-off, the likes of which were clearly seen during the last recession.

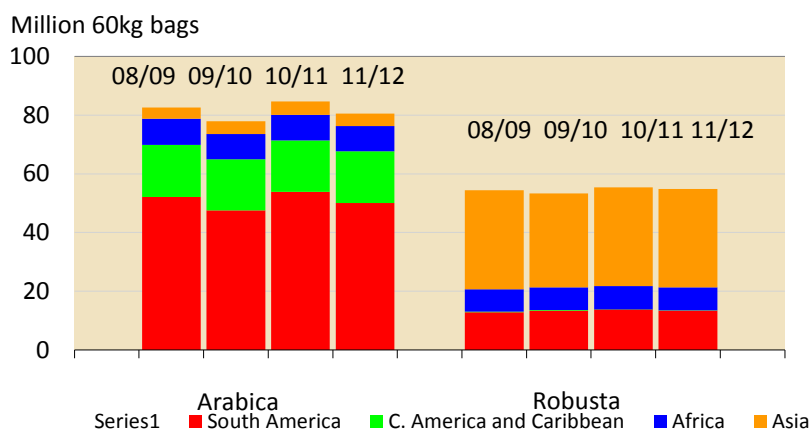
For the time being, we see no reason to alter our estimate for the global balance for the **2010-2011 season** now in its closing months, and retain our estimate of a projected arabica surplus of 5.64m 60-kg bags, and a global robusta surplus of 4.89m bags. Our estimate for total arabica production is held at 85.14m bags, with consumption at 79.50m bags; total robusta output we estimate will be 55.71m bags and consumption 50.82m bags. For the approaching **2011-2012 season** we still see output from South America

improving with a global arabica surplus for the October-September season (which we also apply to Brazil) of 0.69m bags based on a production estimate of 80.97m bags and demand of 80.28m bags. The robusta surplus is still forecast to drop from 2010-2011 levels to 4.07m bags with production of 55.39m bags and demand of 51.32m bags. The end of the most recent La Niña weather event will see the return to more normal output levels of both arabica and robusta.

### Coffee supply & demand balance, million 60 kg bags

	2009-2010		2010-2011		2011-2012	
	Arabica	Robusta	Arabica	Robusta	Arabica	Robusta
South America	47.49	13.36	53.88	13.82	50.00	13.40
Central America & Caribbean	17.50	0.23	17.48	0.03	17.70	0.03
Africa	8.55	7.75	8.77	7.85	8.61	8.10
Asia	4.36	31.95	4.56	33.65	4.21	33.50
Rest of world	0.45	0.36	0.45	0.36	0.45	0.36
<b>Total Production</b>	<b>78.35</b>	<b>53.65</b>	<b>85.14</b>	<b>55.71</b>	<b>80.97</b>	<b>55.39</b>
<b>Demand</b>	<b>79.02</b>	<b>49.68</b>	<b>79.50</b>	<b>50.82</b>	<b>80.28</b>	<b>51.32</b>
<b>Balance</b>	<b>-0.67</b>	<b>3.97</b>	<b>5.64</b>	<b>4.89</b>	<b>0.69</b>	<b>4.07</b>

Note: italics denote revisions to previous estimates



Source: ABN AMRO, VM Group

## Production

### Vietnam

Depending on the timely end of the seasonal rains, fresh beans from the new Vietnamese robusta crop are expected to start filtering through the market in late October, a month earlier than usual following a season of particularly favourable growing weather. Until then the flow of beans will be slow, as it has been for the last few weeks. While domestic supply is at a seasonal low and prices have been extraordinarily high, farmers or speculators are

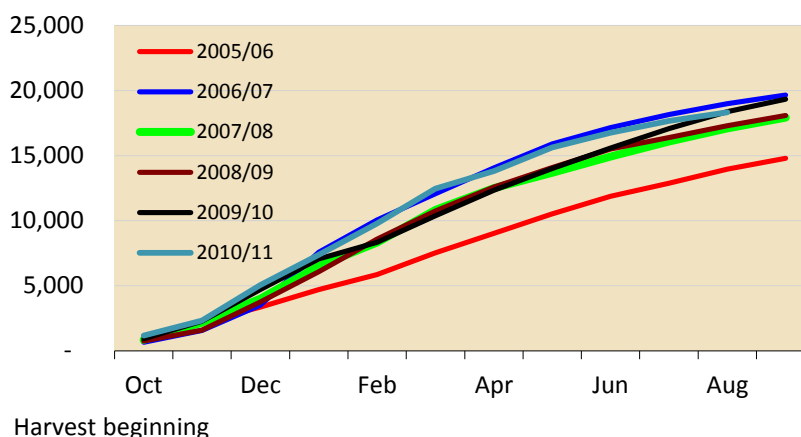
not being tempted to release the small amount of remaining stocks just yet. Exports for July fell to 882,000 60-kg bags, far lower than last July which recorded 1,483,000 bags. Premiums for Vietnam's current crop robusta beans have fallen from \$200 over London prices to closer to \$110 for shipments this month as the new season approaches. The recent low volumes should not affect the overall tally too much since export volumes at the start of the October-September season were well above average as farmers took advantage of high premiums.

The coming crop is expected to have benefited from very helpful climatic conditions as well as farmers' improved financial standing following consistently good prices. But although Vietnamese farmers may be flush with cash right now, the cost of coffee production has also risen substantially, so we should not overestimate how much additional investment is available. The costs of fertiliser and diesel have climbed and the Coffee and Cocoa Association (Vicofa) estimates that production costs may be up by as much as 30%. There has been renewed talk of the creation of a government supported stockpile of 300,000 tonnes, but this is unlikely to become a reality. The creation of a price support mechanism when prices are this high seems an impractical and rather expensive exercise at a time when farmers are not struggling. Local prices in Daklak are still high, in the 49,400-50,000 Dong/kg range (\$2.38-\$2.41/kg), but have fallen from record highs in May of 52,000 Dong/kg (\$2.50/kg). Rumours of an infestation of falling fruit disease have proved to be exaggerated with only a very small percentage of the total crop estimated to have been affected, according to local officials. There is still a risk that end-season rains could delay new crop supply. We expect 2011-2012 production of robusta to rise to 21.5m 60-kg bags.

#### Vietnam monthly exports, 000 60kg bags

	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
October	1,117	650	833	750	917	1,167
November	1,067	917	1,333	833	1,367	1,150
December	1,167	1,933	1,833	2,167	2,417	2,733
January	1,350	4,067	2,500	2,333	2,350	2,333
February	1,167	2,500	1,833	2,500	1,283	2,400
March	1,667	2,000	2,500	2,167	2,050	2,683
April	1,500	2,000	1,667	1,833	1,950	1,333
May	1,500	1,833	1,167	1,500	1,667	1,833
June	1,333	1,250	1,250	1,417	1,583	1,117
July	1,000	1,000	1,167	883	1,483	882
August	1,083	833	1,000	900	1,300	
September	833	667	833	750	967	
<b>Total</b>	<b>14,783</b>	<b>19,650</b>	<b>17,917</b>	<b>18,033</b>	<b>19,333</b>	

### Cumulative Vietnam exports, 000 60kg bags



Source: ABN AMRO

### Brazil

*Our crop estimates for Brazil are based on an October-September season, which we apply globally. Thus we apportion three months of the country's July 2010-June 2011 output to our October 2009-September 2010 estimates.*

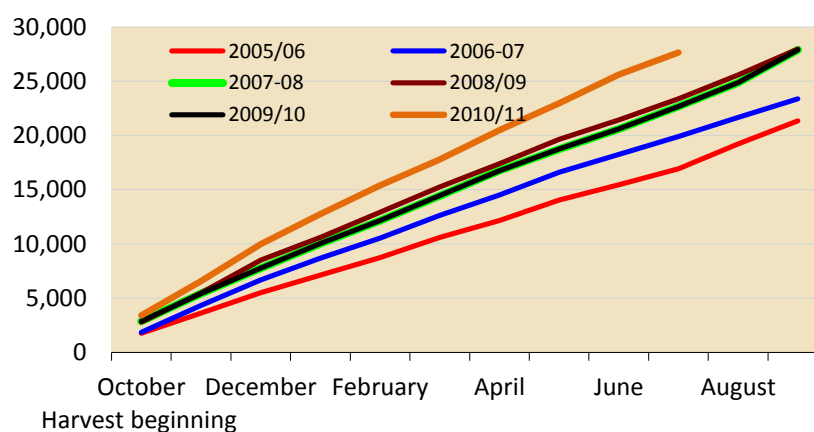
For an off- year the current Brazilian crop is going to be large, estimated by the official crop agency Conab at 43.5m 60-kg bags. The figure from exporters is slightly higher, at around 45m bags. The cold season is now coming to an end and the frosts that are always a threat have not materialised with any severity in recent months. Meteorologists' fears of a major frost occurring were higher this year than they have been for many winter seasons and provided some fuel for the rally in prices over \$3/pound in May. Some parts of Brazil's coffee growing regions were struck by a light freeze at the beginning of August however, the first major frost to occur since 2000. While plantations in Minas Gerais and Sao Paulo state were affected, only a small part of the crop is reported to have experienced any damage. Parts of Parana state, which has a smaller area planted to coffee suffered from a frost in late June, which reportedly affected 10-15% of the crop. Parana produces around 5% only of the total Brazilian coffee crop however, and as such these levels of frost damage will not have too great an impact on next season's crop.

Frost can potentially damage output up to a year after it occurs as it kills leaves, hampering a plant or tree's ability to photosynthesise and produce enough energy to bear fruit. The ultimate impact of the frost on the coffee crop will only be evident next year, when Brazil is due to produce a bigger "on-crop". For now though, the frost damage to date is not expected to be very significant. With the colder months of the Southern Hemisphere nearly over and the risk of frost receding, thoughts will now turn towards soil moisture levels, the danger of drought and subsequent ability of the trees to sustain the flowering and cherry set. Rainfall levels in major coffee growing regions have so far been on trend with levels recorded in 2010. Comparatively small amounts of Brazilian coffee

have made it onto the world market of late but this is no reflection of supply which remains ample, but rather an indication that farmers are financially comfortable enough and patient enough to hold-off on selling their produce as or until prices go higher. Exports of un-roasted green coffee fell by 19% in July to 1.77m bags from 2.19m bags exported in July last year. These exports generated \$532 million, 35% greater revenues than last July, a sign of higher prices but also of the continuing strength of the real.

Brazil's coffee farmers are well-financed and have been able to invest in fertiliser and fuel, although these inputs have grown more expensive. Domestic inflation is running at 6.87% according to July figures and in addition to higher fuel and fertiliser costs farmers are starting to encounter far higher labour costs. As workers are increasingly attracted to the prospects of better wages and potentially less back-breaking jobs in urban areas, wages on coffee plantations have been rising. Wages for coffee-pickers have reportedly climbed by as much as 50% in some growing regions over the past season. Reports suggest that wage payments can amount to around 50% of the price farmers receive per bag of coffee, a substantial input cost. Those farmers who can afford to do so are beginning to mechanise the bean picking process and while mechanical harvesters are expensive they can lower production costs dramatically and increase output in the long run

#### Brazil monthly exports, 000 60kg bags



Source: ABN AMRO

#### Cumulative Brazil monthly exports, 000 60kg bags

	2007/08				2008/09			
	Arabica	Conillon	Other	Total	Arabica	Conillon	Other	Total
October	2,256	238	371	<b>2,865</b>	2,572	197	206	<b>2,780</b>
November	2,122	122	306	<b>2,550</b>	2,588	104	195	<b>2,694</b>
December	2,017	51	280	<b>2,348</b>	2,863	153	233	<b>3,017</b>
January	1,895	47	324	<b>2,266</b>	2,047	43	195	<b>2,090</b>
February	1,827	35	253	<b>2,115</b>	2,297	41	191	<b>2,338</b>
March	1,872	159	272	<b>2,302</b>	2,281	33	226	<b>2,314</b>
April	1,906	131	706	<b>2,317</b>	2,096	68	212	<b>2,164</b>
May	1,480	208	339	<b>1,974</b>	2,045	183	222	<b>2,228</b>
June	1,428	140	229	<b>1,868</b>	1,677	115	212	<b>1,792</b>

July	1,498	282	202	<b>2,073</b>	1,837	131	215	<b>1,969</b>
August	1,589	297	305	<b>2,191</b>	2,076	133	196	<b>2,209</b>
September	2,369	315	328	<b>3,012</b>	2,255	131	197	<b>2,386</b>
<b>Total</b>	<b>22,259</b>	<b>2,024</b>	<b>3,914</b>	<b>27,880</b>	<b>26,634</b>	<b>1,333</b>	<b>2,500</b>	<b>27,980</b>

	2009/10				2010/11			
	Arabica	Conillon	Other	Total	Arabica	Conillon	Other	Total
October	2,470	67	251	<b>2,788</b>	3,000	113	292	<b>3,404</b>
November	2,258	52	229	<b>2,539</b>	2,816	93	242	<b>3,151</b>
December	2,174	79	252	<b>2,505</b>	3,046	73	288	<b>3,406</b>
January	2,172	38	226	<b>2,436</b>	2,469	64	238	<b>2,770</b>
February	1,989	22	217	<b>2,228</b>	2,376	49	240	<b>2,664</b>
March	2,320	37	250	<b>2,606</b>	2,200	183	235	<b>2,383</b>
April	1,967	19	269	<b>2,254</b>	2,121	318	262	<b>2,703</b>
May	2,086	128	269	<b>2,483</b>	2,086	128	266	<b>2,480</b>
June	1,631	159	285	<b>2,075</b>	1,965	405	281	<b>2,652</b>
July	2,018	155	269	<b>2,441</b>	1,514	261	258	<b>2,033</b>
August	2,438	132	207	<b>2,777</b>				
September	2,774	155	288	<b>2,929</b>				
<b>Total</b>	<b>26,297</b>	<b>1,042</b>	<b>3,012</b>	<b>30,062</b>				

Source: ABN AMRO

## Central America and Mexico

Barring any major weather disruptions Central America is likely to record improved output in the 2011-2012 season as higher prices have encouraged greater investment in farm inputs which should pay-off. The only country which may not accomplish this production surge in coffee is El Salvador, where local officials anticipate a decline in production in 2011-2012 of around 20% to 1.30m bags. This is not necessarily a sign of long term decline – coffee trees there will merely undergo a natural recovery phase and can expect to turn to higher production levels during the following season. We expect the dip in El Salvador's crop to be less drastic and that its coffee output will be 1.50m bags, down from 1.65m bags in 2010-2011. We estimate July exports from Central America of 1.33m 60 kg bags, a substantial increase on levels of 1.1 m bags in the same month for the previous season

Mexico, Peru, Guatemala and Honduras all expect production to increase in the 2011-2012 season. Honduras expects an increase in its coffee output of around 10% over 2011-2012 and we see production climbing slightly less from 3.6m bags in 2010-2011 to 3.75m bags in 2011-2012. Following a major government drive to encourage planting together with enticingly high prices, Hondurans have made good use of spare agricultural land – a luxury not available to most other producers in the region who must instead struggle with replanting existing coffee farms. It is now estimated that 70,000/ha of new land will be opened up to coffee growing. The new plantations will take some time to come into production but will definitely ensure that output from Honduras continues to grow.

Coffee exports from Guatemala were up over 10% in July at 315,720m bags according to Anacafe, the national producers' association. Anacafe will be assisting Guatemalan coffee farmers to invest in improving the productivity of their farms and to gradually boost output over several years by renewing trees. Compared to the struggle Colombia is undergoing to

bring production back on line, a gradual approach appears more favourable than the large scale replanting of trees, especially as small scale producers will not be able to make-up the loss in income that would result from a total overhaul. Smaller scale coffee farmers will have access to low interest loans to facilitate investment repayments are at rates of 6.5%, lower than national interest rates of 8.5%. The story of Central American coffee for now seems to be one of incremental improvement – farmers and governments have gained confidence on higher prices and are responding steadily. This should prevent a repetition of the “price spike, production surge, price crash” pattern that has marked the history of coffee production in the region.

### Central America & Mexico exports, 000 60kg bags

	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
<b>October</b>	350	412	481	400	366	374
<b>November</b>	408	421	423	371	562	430
<b>December</b>	648	608	680	593	988	699
<b>January</b>	966	1,034	1,253	1,056	1,602	1,121
<b>February</b>	1,361	1,316	1,520	1,357	1,571	1,264
<b>March</b>	1,574	1,954	1,721	1,915	1,279	1,570
<b>April</b>	1,532	1,658	1,934	1,671	1,666	1,645
<b>May</b>	1,717	1,816	1,768	1,750	1,473	1,66
<b>June</b>	1,421	1,537	1,592	1,555	1,265	1,471
<b>July</b>	1,215	1,301	1,402	1,229	1,098	1,327
<b>August</b>	956	1,198	1,116	1,104	864	953
<b>September</b>	609	731	536	701	405	
<b>Total</b>	<b>12,756</b>	<b>13,985</b>	<b>14,427</b>	<b>13,701</b>	<b>12,958</b>	

Source: ABN AMRO

### Colombia

Colombia continues to struggle to raise its coffee production to levels seen prior to a mass replanting drive to revive the coffee sector. This was expected to be the season of recovery following two successive years of poor output, but it appears now that production will only slightly increase from 2009-2010 levels of 8.66m bags if there is any increase at all, well below the long-standing average for annual output of between 11-12m bags. Output fell to 530,000 bags in July, 33% down on levels recorded for July 2010; exports were also down by 25% year on year to 458,000 bags. Earlier in the 2010-2011 season heavy rains wreaked havoc with coffee plants during their critical flowering phase, affecting the March-September *mitaca* or mid-crop and producing widespread infestations of *roya* fungus. The Colombian government recently reduced their output target by 5% to 9m bags but in order for coffee farmers to achieve this production level, they will have to maintain a robust crop every month for the remainder of the season. This optimism is based on an improved weather outlook for the country, with drier conditions expected to prevail until at least mid-September according to IDEAM, the government weather office.

According to official estimates production is expected to be 7.5m bags for the 2010-2011 crop, thus far.

Prior months of heavy rainfall should provide sufficient soil moisture to sustain the current crop through a dry patch which will provide the necessary stress coffee needs to prompt flowering. This final co-operation of favourable weather conditions will be helpful, but will it be enough? Luis Genaro Munoz, head of the Colombian Coffee Growers Federation has said that prospects for the 2011-2012 harvest are looking brighter, however even if production does recover to the levels the government anticipates, prices of ICE Futures arabica may not yet lose some of their gains built-up on concerns of scarcity of finer grades. If we see another season of production closer to the 8 Mt mark the effect on Arabica prices would be buoyant.

### Colombia monthly production and shipment, 000 60kg bags

	2007/2008		2008/2009		2009/2010		2010/2011	
	Production	Shipment	Production	Production	Shipment	Production	Production	Shipment
October	1,129	893	939	1,129	893	939	807	584
November	1,520	1,050	933	1,520	1,050	933	979	784
December	960	921	1,105	960	921	1,105	1,116	1,100
January	1,400	1,010	876	1,400	1,010	876	908	815
February	1,090	1,160	868	1,090	1,160	868	764	659
March	872	921	765	872	921	765	779	884
April	886	900	345	886	900	345	523	574
May	820	1,187	702	820	1,187	702	673	645
June	1,046	886	685	1,046	886	685	471	572
July	891	836	582	891	836	582	530	458
August	715	588	397	715	588	397		
September	777	904	467	777	904	467		
<b>Total</b>	<b>12,106</b>	<b>11,256</b>	<b>8,664</b>	<b>12,106</b>	<b>11,256</b>	<b>8,664</b>		

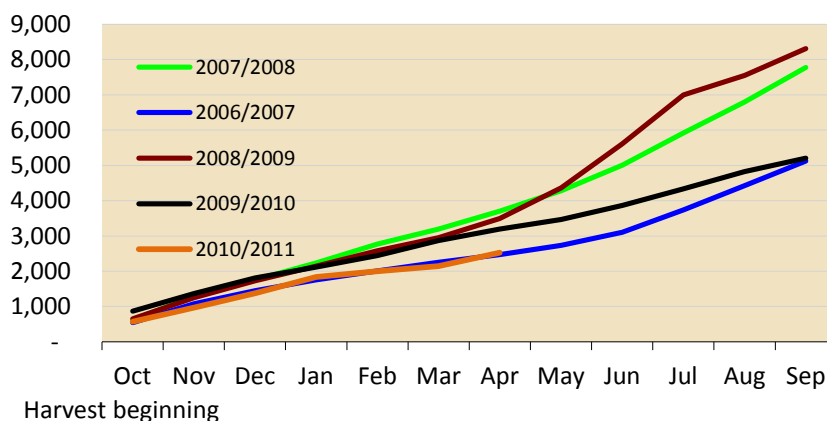
Source: ABN AMRO

### Indonesia

Coffee output in Indonesia continues to be affected by the unusually long rainy season experienced over the last harvest period. The draw-down in stocks is resulting in far lower export volumes than were seen last year. Exports from Southern Sumatra were down 40% in July, compared to 2010 levels, falling to 21,116 tonnes from 35,044 tonnes. The Indonesian Coffee Exporters Association expects 2011 exports to drop to 300,000t. Crop yields are also reported to be lower than normal and the scarcity of beans has elevated premiums to record levels of over \$400 on London prices. While local supply has been cut by unfavourable weather, domestic consumption continues to grow and higher bean imports are likely as domestic roasters may not find availability locally. The USDA Foreign Agricultural Service anticipates this increase in green coffee bean imports to be substantial, from import levels of 200,000 tonnes in 2010 to 250,000 tonnes this year. With La Niña now behind us an improved growing season can be expected which would see a return to normal output levels. The dry season in 2010 was almost non-existent but this

year flowering has reportedly been good. Premiums may stay resilient at levels over \$200 over London prices but these too will fade, particularly once more of the Vietnamese crop is released. The next Indonesian harvest is due to start at the beginning of 2012.

#### Indonesia monthly exports, 000 60kg bags



Source: ABN AMRO

#### Indonesia monthly exports, 000 60kg bags

	2007/08				2008/09			
	Arabica	Robusta	Other	Total	Arabica	Robusta	Other	Total
October		606	15	621		622	26	648
November		642	19	660		601	2	603
December		459	13	472		477	1	478
January		471	13	484		404	9	412
February		526	10	536		430	12	442
March		410	8	419		361	9	369
April		496	16	512		509	33	542
May		559	21	580		840	24	864
June		702	25	726		1,214	43	1,258
July		888	26	914		1,356	29	1,385
August		859	18	877		516	32	548
September		930	43	973		745	22	767
<b>Total</b>		<b>7,547</b>	<b>227</b>	<b>7,774</b>		<b>8,075</b>	<b>241</b>	<b>8,316</b>
	2009/10				2010/11			
	Arabica	Robusta	Other	Total	Arabica	Robusta	Other	Total
October		838	33	871		577	13	590
November		479	14	493		380	12	392
December		432	11	443		392	22	414
January		309	5	313		443	17	460
February		311	9	320		157	14	171
March		412	15	427		125	21	145
April		326	5	331		359	13	373
May		267	1	269				
June		396	4	400				
July		465	1	466				
August		489	3	492				
September		377	2	379				
<b>Total</b>		<b>1,317</b>	<b>47</b>	<b>1,806</b>				

Source: ABN AMRO

## Uganda

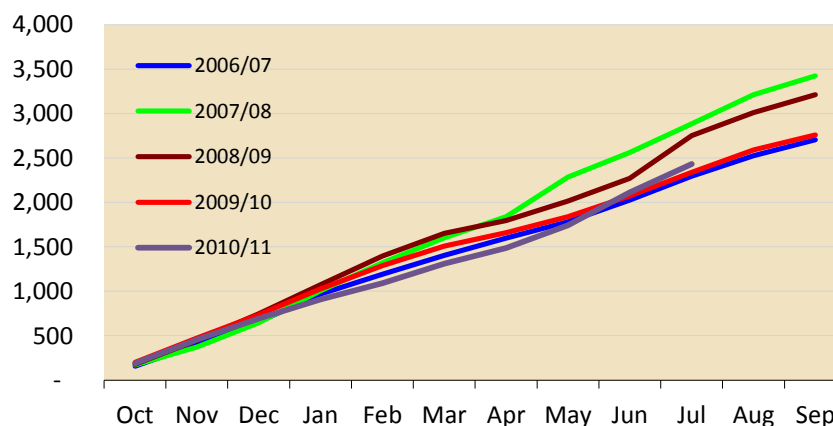
The outlook for coffee exports in 2010-2011 has taken a slight turn for the better. On-going drought in the central and eastern coffee producing regions led the Uganda Coffee Development Authority to slash export projections to 2.67m 60-kg bags but this forecast has now been raised to 2.8m 60kg bags, in line with 2009-2010 volumes. Exports in July were robust, at 375,843 60kg bags. The increase in production volumes is mostly the result of a good harvest in the south and south-western growing areas of Uganda which account for 45% of the country's coffee output, and is also due to farmers selling reserves while farmgate prices strengthened. In June farmers earned \$53m from their coffee exports, a large increase on June 2010 earnings of \$23m, bearing in mind the Ugandan shilling has weakened against the dollar while world prices for coffee have strengthened. A good harvest from the south and south-western coffee regions should make up for lagging production in the eastern and central regions. It is unlikely that we will see production reach 2008-2009 levels but it does seem possible that we could at least see production remain in line with 2009-2010 output, with stronger export volumes in the last few months of the season ending in October.

### Uganda monthly exports, 000 60kg bags

	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
October	122	155	173	180	199	188
November	183	251	199	267	273	268
December	180	249	273	299	264	237
January	229	316	361	329	290	215
February	166	222	318	321	264	185
March	156	213	279	257	218	185
April	147	192	237	143	153	218
May	123	185	444	221	177	177
June	187	245	278	254	235	253
July	176	269	325	482	266	371
August	176	231	324	260	250	320
September	159	179	213	199	170	
Total	2,003	2,706	3,424	3,211	2,759	

Source: ABN AMRO

### Uganda monthly exports, 000 60kg bags



Source: ABN AMRO

### Kenya

Average auction prices for higher graded Kenyan coffee beans have recently increased, compensating for a decline in prices for lower graded beans to bring most recent average auction prices to \$490.56. Higher graded beans are growing more expensive as they prove increasingly difficult to come by following a season of poor growing weather in Kenya. The growing season which is coming to auction now saw adverse weather conditions not conducive to the development of good quality beans. It is likely that a shortage of beans will become more apparent in the next few weeks, which will provide further support for prices for higher grades. The crop seems to have come through the risky June-July window, when temperatures are lower and pests have a tendency to strike, relatively unscathed. There have been no significant reports of Coffee Berry Disease this season but we aren't in the clear zone yet as the state-owned Coffee Research Foundation has warned of a potential attack of the potentially damaging Thrips pest later in the season. With plants already under stress following poor weather this would be disastrous for output.

### India

India's Coffee Board has reported that coffee exports increased 41.6% over the period from October to August, coming in at 313,270t. Shipments to Germany and Italy are on the rise. We anticipate a 2010-2011 robusta crop of 3.4m bags. India's Coffee Board estimates that total production this season will be some 299,000 tonnes, a slight increase on the 2009-2010 season's output of 289,600t. Recent reports of lower than normal monsoon rainfall recorded in the coffee growing state of Kerala are likely to be a short term concern and may not necessarily threaten output, as normal monsoon rain conditions are expected to prevail.

**Coffee production by regions on Oct/Sep harvest year, million 60kg bags**

	2009-2010		2010-2011		2011-2012	
	Arabica	Robusta	Arabica	Robusta	Arabica	Robusta
<b>South America</b>						
Bolivia	0.15	0.00	0.15	0.00	0.15	0.00
Brazil (estimated from seasonality)	34.46	13.06	39.83	13.52	35.85	13.10
Colombia	8.25	0.00	9.00	0.00	9.25	0.00
Ecuador	0.40	0.30	0.40	0.30	0.40	0.30
Peru	3.50	0.00	3.80	0.00	3.60	0.00
Venezuela	0.73	0.00	0.70	0.00	0.75	0.00
<b>Latin &amp; Central America</b>						
Costa Rica	1.65	0.00	1.60	0.00	1.57	0.00
Cuba	0.13	0.00	0.13	0.00	0.13	0.00
Dominican Rep	0.55	0.00	0.60	0.00	0.60	0.00
El Salvador	1.10	0.00	1.65	0.00	1.50	0.00
Guatemala	3.60	0.01	3.80	0.01	3.80	0.01
Haiti	0.40	0.00	0.40	0.00	0.40	0.00
Honduras	4.00	0.00	3.60	0.00	3.75	0.00
Mexico	4.40	0.20	4.10	0.00	4.25	0.00
Nicaragua	1.42	0.00	1.35	0.00	1.45	0.00
Panama	0.25	0.02	0.25	0.02	0.25	0.02
<b>Africa</b>						
Burundi	0.20	0.00	0.50	0.00	0.50	0.00
Cameroon	0.15	0.75	0.15	0.75	0.15	0.75
Central African Rep.	0.00	0.10	0.00	0.10	0.00	0.10
Dem Rep Congo (DRC)	0.05	0.50	0.05	0.50	0.05	0.50
Ethiopia	5.50	0.00	5.25	0.00	5.25	0.00
Guinea	0.00	0.25	0.00	0.25	0.00	0.30
Ivory Coast	0.00	2.25	0.00	2.25	0.00	2.35
Kenya	0.70	0.00	0.90	0.00	0.90	0.00
Madagascar	0.05	0.60	0.05	0.60	0.05	0.60
Rwanda	0.40	0.00	0.40	0.00	0.40	0.00
Tanzania	0.80	0.25	0.90	0.20	0.75	0.20
Togo	0.00	0.20	0.00	0.20	0.00	0.20
Uganda	0.30	2.80	0.50	3.00	0.50	3.10
Zimbabwe	0.10	0.00	0.07	0.00	0.06	0.00
<b>Asia</b>						
India	1.60	3.25	1.60	3.40	1.50	3.30
Indonesia	1.00	8.00	1.25	8.25	1.00	6.75
Papua New Guinea	0.00	0.45	0.00	0.40	0.00	0.40
Philippines	0.95	0.10	0.90	0.10	0.90	0.10
Malaysia	0.40	0.60	0.40	0.60	0.40	0.60
Thailand	0.01	1.05	0.01	0.90	0.01	0.85
Vietnam	0.40	18.40	0.40	20.00	0.40	21.50
<b>RoW</b>	0.45	0.36	0.45	0.36	0.45	0.36
<b>Totals</b>	78.05	53.50	85.14	55.71	80.97	55.39

Source: ABN AMRO

## Consumption

Lower international coffee prices are starting to filter down to consumers, in a sign that retail demand is a potential concern. US coffee maker J M Smucker reduced coffee prices by 6% across a wide range of products. Smuckers are one of the biggest coffee brands, and upped their prices by nearly 40% from May 2010 to May 2011 when arabica prices hit a 34-year peak over \$3/pound on ICE futures. Kraft upped their prices by over 50% during the same period, and have just announced cuts of 6% on wholesale prices. Smuckers are usually a front-runner in setting retail price trends but we could see further cuts from other major coffee brands which would be a welcome respite for consumers now bracing for a potential double dip recession. Coffee consumption remained relatively resilient over the grim 2008/2009 period, but another downturn may affect consumption more substantially. The impact of government austerity measures to target unsustainable debt ratios in the UK and Europe, which are likely to include some form of higher taxation, would have a real impact on disposable incomes. Recent GDP data for Germany, a sizeable consumer, indicated that growth there stalled in the second quarter of this year, up just 0.1%. The shift carries more weight as it emanates from Germany which has been seen as one of the stronger economies in Europe. The economic outlook for a politically gridlocked EU does not seem good and while many of these countries are mature coffee markets with entrenched consumption habits it is undeniable that another season of economic pain will have some impact. In the US where another bout of quantitative easing is being touted, the impact on consumer incomes may not be as great.

Consumption in emerging markets continues to grow, albeit incrementally. Starbucks are reportedly planning to expand their presence in China but the significant expansion of foreign firms' presence in the market is still constrained by high barriers, and persistently high import taxes on coffee beans remain a deterrent. As incomes rise and more Chinese nationals engage in opportunities to study abroad at foreign colleges and universities, which often have fewer barriers to entry than domestic ones, the coffee culture in the mainland is expected to expand as students return with a taste for coffee-drinking – but this will take years to make a sizeable impact on world markets. There is certainly room for growth however as Chinese coffee consumption is estimated at just 3 cups per person per year right now, according to the Beijing Coffee Industry Association, far below world averages.

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**Seasonal usage: major consumers, estimate, million 60 kg bags**

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	2008-2009	2009-2010	2010-2011	2011-2012
<b>EUROPE</b>				
France	5.80	5.83	5.85	5.80
Germany	10.50	9.90	10.20	10.10
Italy	5.80	5.70	5.70	5.65
Other EU	15.50	15.61	15.75	15.50
Poland	2.30	2.37	2.37	2.35
FSU	3.10	3.51	3.51	3.50
Other Europe	7.70	7.80	7.90	7.75
<b>AMERICAS</b>				
Canada	2.80	2.82	2.82	2.80
USA	21.00	21.90	22.00	22.00
Brazil	18.10	18.20	18.50	19.90
Mexico	2.10	1.96	2.20	2.25
Colombia	1.50	1.47	1.47	1.50
<b>ASIA</b>				
India	1.70	1.67	1.72	1.75
Indonesia	2.50	2.70	2.90	3.10
Japan	7.70	7.71	7.71	7.70
Philippines	1.40	1.39	1.40	1.40
South Korea	1.50	1.52	1.52	1.55
<b>AFRICA</b>				
Algeria	2.40	2.31	2.31	2.31
Ethiopia	2.00	2.00	2.00	2.00
Rest of world	12.30	12.37	12.50	12.70
<b>Total</b>	<b>127.70</b>	<b>128.75</b>	<b>130.33</b>	<b>131.61</b>

Source: ABN AMRO

## Comment

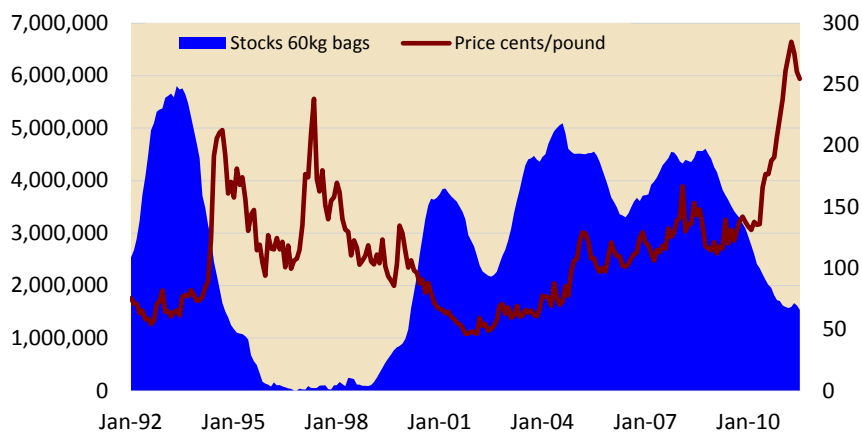
While coffee markets have suffered along with many others from a case of summer malaise, stagnation has been staved off by some quite volatile conditions with thin volumes producing exaggerated price moves. The innate volatility of a relatively sparsely traded market has been exacerbated by large swings in external market sentiment. Prices broke the \$3 barrier at the end of April this year but have since fallen away from these levels. The threat of a Brazilian frost has faded and we have little fresh fundamental news which would indicate imminent supply tightness that is not already priced in. In addition there has been a substantial withdrawal of investment from commodities, still perceived to be a more risk-laden asset class than others. Yet despite the external gloom and lower volumes coffee prices have managed to hold up relatively well.

In robustas, selling from origin is at a seasonal low, but there is no major concern about a potential shortfall. Instead we are likely to see a draw on certified stocks which are still readily available and arguably a much cost effective source of stock. The relative strength

in coffee prices is an attraction to origin but their comfortable financial standing and prospect in arabicas of \$3 coffee again is persuading many to resist the temptation to cash in just yet. After a run of good prices, farmers are capitalised enough to hold off on selling. On the other side, the summer has seen little commercial buying but this is likely to change soon. While there have been ample opportunities to extend futures cover at the dips of recent weeks and roasters are now generally well positioned until the autumn or in some cases beyond, longer term physical coverage will now become a more pressing concern.

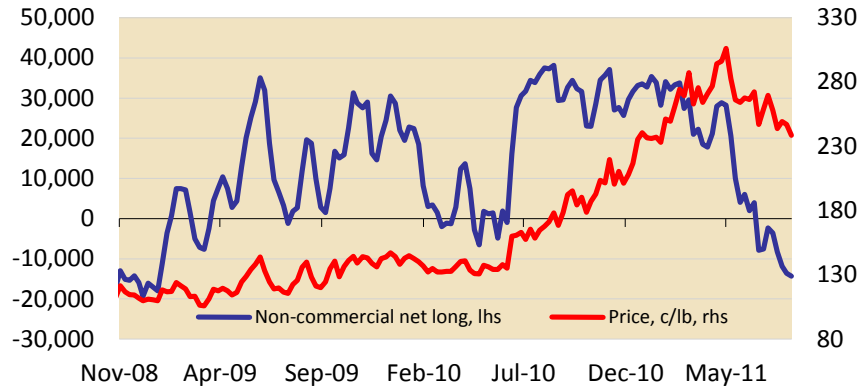
Considering this absence of commercial involvement and true to a growing trend across commodity markets, the activities of funds hold sway. Short covering has halted a drop in prices. We have seen sizeable moves in the combined non-commercial and non-reportable position in ICE Futures. Speculative investment levels have consistently fallen in recent weeks, the combined non-commercial and nonreportable net position has been creeping shorter and shorter, however the last weeks saw a reversal of that trend, and according to CFTC data the combined non-commercial and nonreportable net position increased from being short 14,532 lots on August 9 to a short of 963 lots on August 23. Index funds have had to trim their coffee exposure to 36,740 as of August 23 after starting the year at 49,485 lots.

#### US certified coffee stocks, bags v. Price



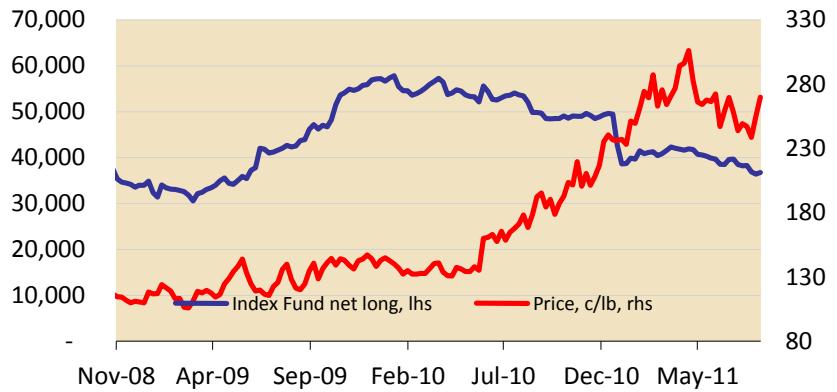
Source: VM Group, ABN AMRO

**Non-commercial net long on ICE Futures US, lots and coffee price, cents/pound**



Source: ABN AMRO

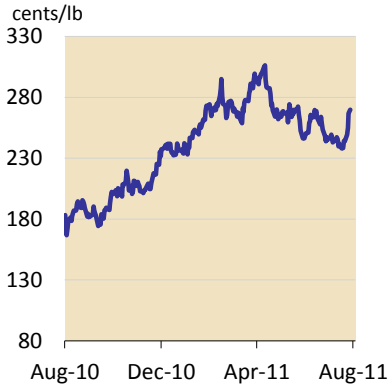
**Index fund position on ICE Futures US, lots and coffee price, cents/pound**



Source: ABN AMRO

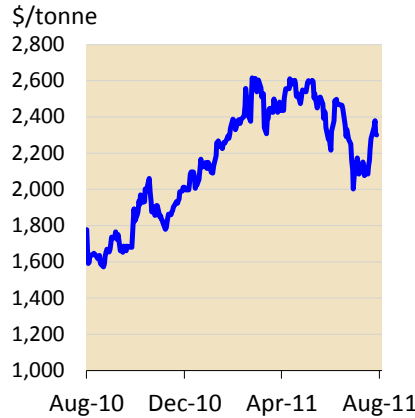
# Coffee data

Arabica price, ICE Futures US, c/pound



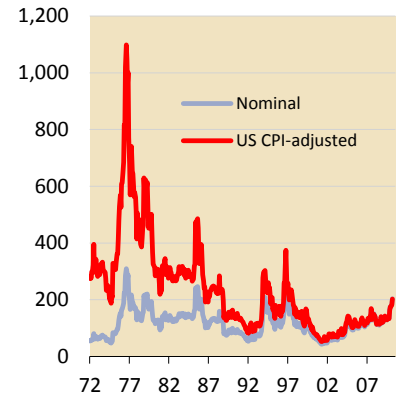
Source: VM Group, ICE Future US

Robusta price, NYSE Liffe, \$/tonne



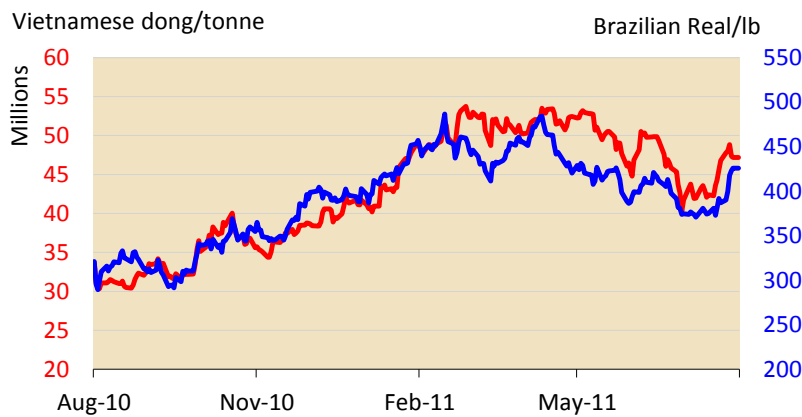
Source: VM Group, NYSE Liffe

Arabica price, ICE Futures US, nominal and real, c/pound



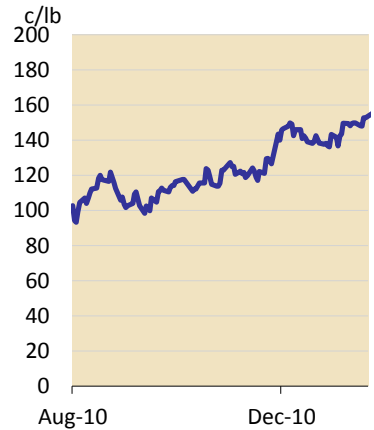
Source: VM Group, ICE, Dept. of Commerce

Coffee price, Brazilian Real and Vietnamese Dong



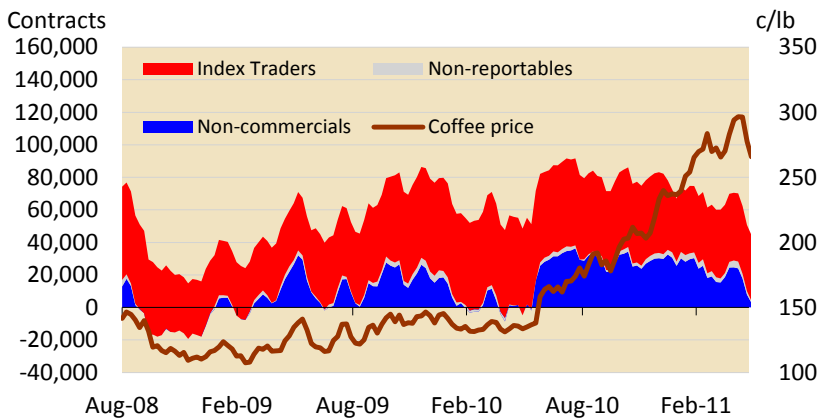
Source: VM Group, ICE Future US, NYSE Liffe, Reuters

Arbitrage between ICE Futures US and NYSE Liffe: 1st month contract



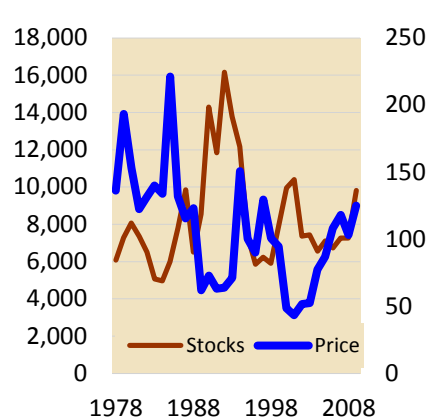
Source: VM Group, ICE, NYSE Liffe

Coffee, ICE Futures US, non-commercial and index fund speculation, lots



Source: CFTC, VM Group

ICO stocks and price



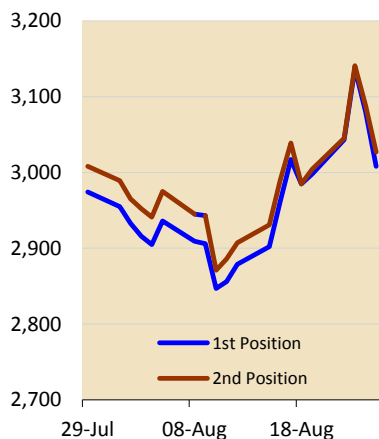
Source: ICO, VM Group

## Weather watch

- **North America:** More dry conditions are expected over corn and soybean growing regions in the Midwest, yields are likely to suffer as a result. Drought conditions across parts of the Southern Plains are also expected to trim production of hard winter red wheat. Farmers in North Carolina are assessing damage caused by Hurricane Irene, the storm caused extensive flooding and damage to poultry farming operations and tobacco fields.
- **South America:** The threat of frost damage to crops has receded with mostly dry conditions seen to benefit the development of the centre-south sugar cane crop. There are some preliminary projections for a return of a weaker La Niña event over the next few months which could potentially trim grains output if it brings abnormally dry conditions.
- **Asia:** Monsoon rains were slightly below normal levels in the week to August 24 but overall this season has seen adequate rainfall. The India Meteorological Department has projected August-September rains to be just below normal levels but sufficient to ensure adequate crop development. Heavy rains in the north are expected to be favourable for sugar cane development.
- **Europe:** The progress of the wheat harvest in Germany has been hampered by abnormally wet conditions, but most European spring-wheat growing regions are forecast to return to more favourable conditions this week.
- **Africa:** Weather conditions have been favourable for the developing cocoa crop in West Africa. There is some concern that persistently dry conditions across the Horn of Africa could start to affect the coffee crop there, dry conditions should be monitored.

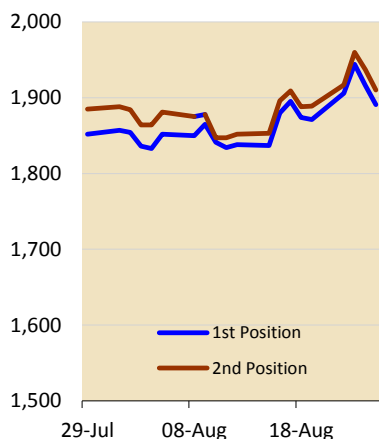
## Cocoa

Cocoa price, ICE Futures US, \$/tonne



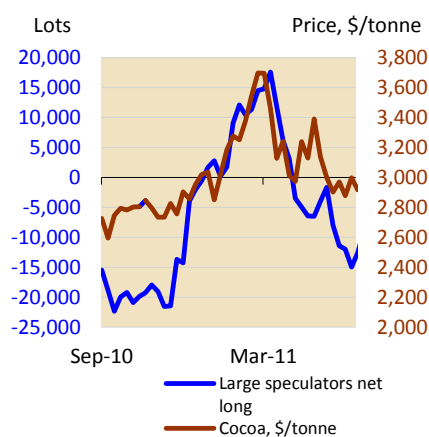
Source: VM Group

Cocoa price, NYSE LIFFE, £/tonne



Source: VM Group

Cocoa speculation, ICE Futures US, lots and price



Source: VM Group

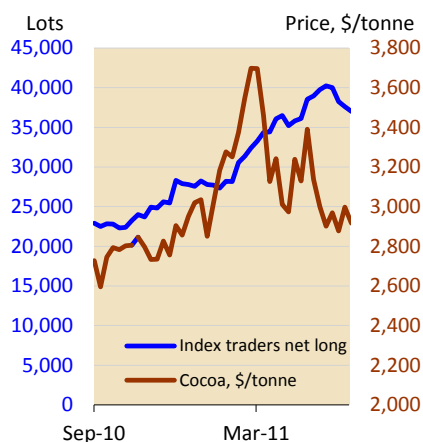
### News

- **Aug 22:** Cocoa arrivals at ports in Ivory Coast hit levels around 1,388,000 tonnes, an increase of 23% on arrivals recorded in July last year. This does not include some arrivals which have yet to be declared, the actual tally could reach 1,400,000 tonnes.
- **Aug 17:** Cocoa grindings in Brazil increased 18% in July to 20,445 tonnes from 17,293 tonnes in July 2010.
- **Aug 15:** According to the Indonesian Cocoa Association exports could fall by 40% this season, after adverse weather conditions caused pests and disease to take hold of the crop. Heavy downpours in the critical growing region of Sulawesi created ideal conditions for the return of Vascular-streak Dieback, a potentially devastating crop disease. According to industry data, cocoa bean exports from Sulawesi fell 70% in July, to 13,434 tonnes from 44,552 tonnes in July 2010.
- **Aug 12:** Total cocoa production in Cameroon climbed to 236,701 tonnes in the season which ended on July 31, according to estimates from the National Cocoa and Coffee Board. Exports reached 202,721 tonnes, an 18% increase on 2010 levels of 172,177 tonnes.
- **Aug 12:** Cocoa grindings in Malaysia were down to 72,089 tonnes in the second quarter of this year, 4% lower than for the same period last year, according to the Malaysian Cocoa Board. Grindings are expected to continue to be low as factories work through inventory.

### Short term outlook

Cocoa prices have been caught up in the headwinds of broader macroeconomic developments which have prompted a mass exodus from risk. While there has been little significant change in the fundamental outlook and as the summer doldrums linger on, prices are moving on outside signals. Trading volumes remain sparse with origin selling seasonally low and with the industry well covered for the next few months having taken advantage of price dips. Cocoa and the rest of the softs complex remain vulnerable to further selling should the macroeconomic outlook continue to deteriorate, but it appears that this effect is growing less pronounced. Considering how gloomy things look prices have held up remarkably well and have not strayed too far off \$3,000/tonne on ICE Futures. That is even more impressive, considering that we are in a year of surplus. According to CFTC data as of August 23 speculative investors in the non-commercial category trimmed their short position in ICE Futures cocoa to 12,844 lots from 17,017 lots, which had been the biggest short position seen in the non-commercial category since November last year. Open interest levels in cocoa have not tapered off substantially.

### Index fund position, ICE Futures US, lots



Source: VM Group

### Arbitrage between 2<sup>nd</sup> position contracts on NYSE Liffe and ICE Future US, \$/tonne



Source: VM Group

## Analysis

Cocoa butter prices are the lowest they have been in years while cocoa powder prices in Asia have climbed to their highest levels since 2000 at over \$5,000 per tonne. Processors in Asia are finding it difficult to secure buyers for their excess cocoa butter stocks, but powder demand continues to be strong. Cocoa butter ratios in Asia, a good indicator of demand for high quality chocolate products, have steadily fallen to reach lows of 1:10 times London prices. Grinders in Malaysia, Indonesia and Singapore all reported lower ratios as demand for cocoa butter from European manufacturers has been low over the summer. But butter prices could be set for a rebound, as at these enticingly low levels they could prompt producers to return to using cocoa butter instead of cheaper edible oils. Expectations are that as product demand in Europe picks up, butter ratios could climb from current lows of 1:10 times London prices to 1:30 times London prices.

The weather for major West African growers was near ideal this season, but the outlook for 2011-2012 is less promising with weather conditions already less co-operative. We expect a deficit of 93,000 tonnes for 2011-2012, a revision at this early stage seems premature although we may revisit this figure in our next Cocoa Outlook in October. During the darkest days of the last economic downturn cocoa demand was resilient, the threat of further economic pain will have an impact on investor interest in all commodities but it should not put too much of a damper on actual cocoa consumption.

### Cocoa supply & demand balance, 000 tonnes

	2008/09	2009/10	2010/11	2011/12
Africa	2,457	2,406	2,807	2,613
Americas	464	498	540	537
Asia	615	650	615	624
<b>Total production</b>	<b>3,536</b>	<b>3,554</b>	<b>3,962</b>	<b>3,774</b>
<b>Net production*</b>	<b>3,501</b>	<b>3,518</b>	<b>3,922</b>	<b>3,736</b>
Europe	1,540	1,580	1,589	1,589
Africa	590	597	549	641
Americas	737	811	835	846
Asia	599	637	722	753
<b>Total grindings</b>	<b>3,466</b>	<b>3,625</b>	<b>3,695</b>	<b>3,829</b>
<b>Balance</b>	<b>35</b>	<b>(107)</b>	<b>227</b>	<b>(93)</b>
End stocks	1,492	1,413	1,585	1,473
Stocks/grindings ratio**	43%	39%	53%	40%

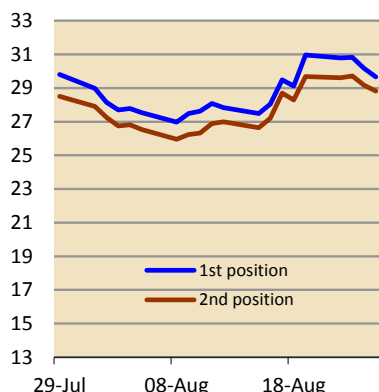
\*1% less than total production to account for a loss in weight due to reduced moisture during transport \*\* Stocks as a % of total grindings

Source: ABN AMRO

## Contacts

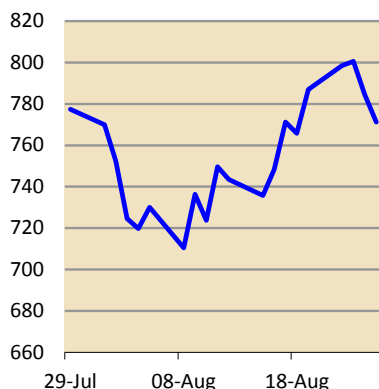
**Justin Grandison**  
Senior Cocoa Broker  
tel: +44 (0) 20 3192 9275  
justin.grandison@uk.abnamro.com

Sugar, raw, ICE Futures US, cents/pound



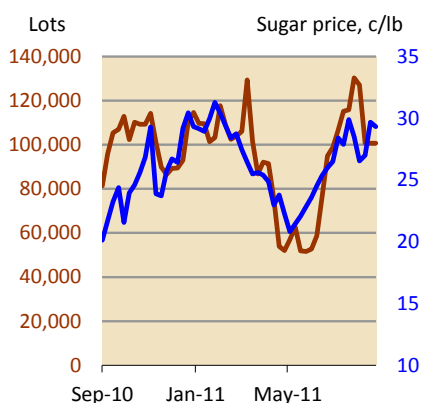
Source: VM Group

Sugar, white, NYSE Liffe, \$/tonne



Source: VM Group

Sugar speculation, ICE Futures US, lots & price



Source: VM Group

## Sugar

### News

- **Aug 23:** China sold 200,000 tonnes of sugar from state reserves, according to the National Development and Reform Commission. The auction was aimed at reducing the deficit and cooling domestic prices. Large sugar imports are expected in the next few months, these are likely to go straight into state reserves. China will face a sugar deficit of 2 Mt over the 2011-2012 season.
- **Aug 22:** Specialist consulting firm Canaplan revised their estimate for the Brazilian centre-south cane crush to 476 Mt, pegging sugar production at 28-28.5 Mt and ethanol at 19.8 billion litres.
- **Aug 22:** Sugar exports from Mexico are expected to decline as a drought earlier this year is likely to trim 2011-2012 output. The national sugar industry chamber expects production to decline from 5.85 Mt to 5 Mt, with export availability of 1.2 Mt. The Mexican Cane Workers Union earlier forecast production of 5 Mt.
- **Aug 18:** The Thai Sugar Miller Corporation estimates that sugar output will reach 10 Mt in the 2011-2012 season, an improvement on estimates given earlier this month by the Office of Cane and Sugar Board in Thailand for production of 9.2 Mt. Cane growing regions were flooded in July although the actual damage to the cane crop is not expected to be severe.
- **Aug 11:** In an unusual revision Unica, the Brazilian association of sugar and ethanol producers, forecast a centre-south cane crush of 510 Mt producing 31.57 Mt of sugar after output last season of 33.5 Mt. The forecast is 2.5% smaller than the last revision made in July. The agency expects a higher uptake of cane to sugar and a move away from ethanol. The portion of the harvest which will go into cane is now estimated at 48.1% up from 44.9% a year ago.
- **Aug 10:** According to the Russian Sugar Producer's Union the beet crop this season could reach 40 Mt, a 79% increase on production last season during which Russian agricultural lands suffered from severe drought conditions. This should provide 4.5 Mt of white sugar.
- **Aug 9:** Datagro forecast the current Brazil centre-south sugar crop at 31.9 Mt from 514 Mt of cane.

### Short term outlook

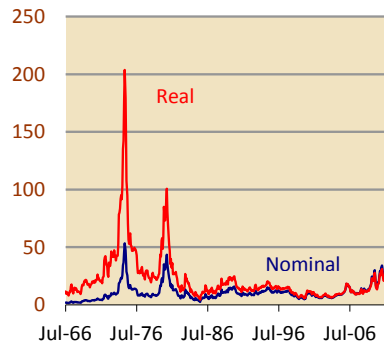
**How low can Brazil's centre-south crop go? The numbers from public and private sources keep getting smaller, now ranging from 476 Mt to 510 Mt. The aging cane profile has shown itself to be more vulnerable to poor weather, an early flowering prompted by frosts that struck in July has caused yields to fall as low as 70 tonnes/ha. Higher sugar prices have led to greater amounts of cane being allocated to sugar production at the expense of ethanol. With a national ethanol deficit looming Brazil's National Petroleum Industry has started to talk about mandatory stockpiles, a plan which seems unlikely to come to fruition. The combined non-**

**Sugar index fund net investment, ICE Futures US, lots**



Source: VM Group

**Real and nominal sugar price, cents/pound**



Source: VM Group

**Contacts**

**James Kirkup**  
 Director and Head of Sugar Brokerage  
 tel: +44 (0) 20 3192 9277  
 fax: +44 (0) 20 3192 9225  
 james.kirkup@uk.fortisgmk.com

**Laetitia Lacourte**  
 Senior Sugar Broker  
 tel: +44 (0) 20 3192 9277  
 fax: +44 (0) 20 3192 9225  
 laetitia.lacourte@uk.fortisgmk.com

VM Group  
 Tel. +44 20 7569 5930  
[info@vmgroup.co.uk](mailto:info@vmgroup.co.uk)

commercial and nonreportable net long in New York rose to 135,823 lots by August 23, from 117,058 lots a week earlier. Despite a supportive fundamental outlook prices remain vulnerable to selling on weakness in outside markets and with trading seasonally thin, we are likely to see more volatile conditions.

**Analysis**

China is expected to overtake Russia as the world's largest sugar importer this year following its fourth straight year of deficit. Domestic prices recently hit \$1,250/t as the country grapples with an estimated 3 Mt S&D shortfall. Some of the shortfall has been plugged with the release of 1.67 Mt of government stocks in 2010/11 whilst import licenses have been issued at the WTO minimum of 1.95 Mt. The Chinese government is keen to boost cane acreage through higher sugar prices, but at the same time is trying to tame inflation and there is divided opinion as to whether they will further increase import licenses. The drawdown in stocks has masked the actual rate of demand growth and even with improved output, higher imports can be expected. With production in Brazil lowered, Thailand and India will step into the breach. The Thai Sugar Milling Corp expects production of 10 Mt, but some Trade House estimates put this figure at closer to 11 Mt. Russia's beet crop, which produced a paltry 2.7 Mt of sugar in 2010, is expected to bounce back to produce up to 4.5 Mt of sugar. These improvements in production prospects from the major northern hemisphere producers should provide some price respite but the uncertainties surrounding Brazilian cane output this season and the next will likely cushion any decline going forward.

**Sugar balance, MTRV (October 2010-September 2011)**

	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Season total
Western Europe	11.73	2.76	0.03	1.54	<b>16.05</b>
Eastern Europe & FSU	4.27	1.31	0.22	2.10	<b>7.89</b>
North & C. America	3.41	8.46	3.61	4.38	<b>19.86</b>
South America	9.72	2.10	13.83	20.60	<b>46.24</b>
Africa	2.78	0.91	3.90	5.04	<b>12.62</b>
Asia	18.51	27.53	12.86	3.59	<b>62.49</b>
Oceania	2.06	0.01	0.01	2.06	<b>4.15</b>
<b>TOTAL SUPPLY</b>	<b>52.47</b>	<b>43.08</b>	<b>34.46</b>	<b>39.30</b>	<b>169.30</b>
Western Europe	4.82	4.88	4.95	5.01	<b>19.66</b>
Eastern Europe & FSU	2.78	2.82	2.86	2.90	<b>11.36</b>
North & Central America	4.92	4.98	5.06	5.12	<b>20.09</b>
South America	5.19	5.25	5.34	5.40	<b>21.18</b>
Africa	4.72	4.77	4.85	4.91	<b>19.25</b>
Asia	16.73	16.94	17.21	17.41	<b>68.29</b>
Oceania	0.40	0.41	0.41	0.42	<b>1.64</b>
<b>TOTAL DEMAND</b>	<b>39.56</b>	<b>40.04</b>	<b>40.69</b>	<b>41.17</b>	<b>161.47</b>
Western Europe	6.91	(2.12)	(4.93)	(3.48)	<b>(3.61)</b>
Eastern Europe & FSU	1.48	(1.51)	(2.65)	(0.80)	<b>(3.47)</b>
North & Central America	(1.52)	3.48	(1.46)	(0.74)	<b>(0.24)</b>
South America	4.53	(3.15)	8.49	15.20	<b>25.06</b>
Africa	(1.94)	(3.87)	(0.95)	0.13	<b>(6.63)</b>
Asia	1.78	10.59	(4.34)	(13.83)	<b>(5.80)</b>
Oceania	1.66	(0.40)	(0.40)	1.65	<b>2.51</b>
<b>TOTAL NET POSITION</b>	<b>12.91</b>	<b>3.03</b>	<b>(6.24)</b>	<b>(1.88)</b>	<b>7.83</b>

## Wheat & Corn

### News

- Aug 24:** According to the US Energy Information Administration corn ethanol production rose to levels of 904,000 bpd in August, an increase of 5,000 bpd. Domestic ethanol stocks are up to 18.24m barrels. Ethanol exports to Brazil are expected to increase to 1.4 billion litres this season.
- Aug 23:** Weather forecaster Commodity Weather Group forecast the US corn crop at 12.485 bn bushels, a downward revision from a prior forecast of 12.621 bn bushels based on the deteriorating weather outlook for growing regions.
- Aug 17:** The USDA made public new data on wheat plantings, which undercut a prior estimate for US plantings of 12.7m acres, putting actual acreage at 11.7m acres after farmers were unable to plant as much as planned during excessively wet weather conditions in some US states.

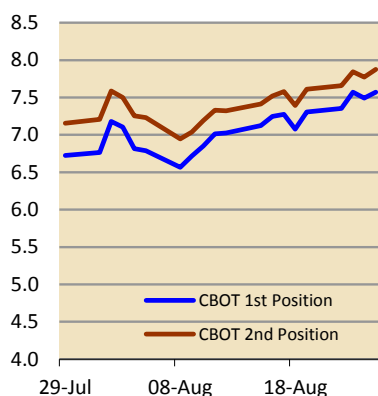
### Short term outlook

Grain prices have been supported by the worsening outlook for crops. Overall the grains complex has held-up remarkably well considering continued weakness in outside markets and the downward pressure exerted by the clouded outlook for the US and European economies. Corn prices have clung to the \$7.50/bushel mark, as concerns over the size and yield of the new corn crop persist. The release of new plantings data from the USDA which indicated lower acreage than anticipated, was supportive especially as 2010-2011 ending stocks are looking tighter. Spring wheat futures on the Minneapolis Grain Exchange have been well supported on concerns of a shortfall in the supply of high protein wheat, climbing up to \$9.16/bushel on worries that the drought in Texas and Oklahoma may have affected the size and quality of the crop there.

### Analysis

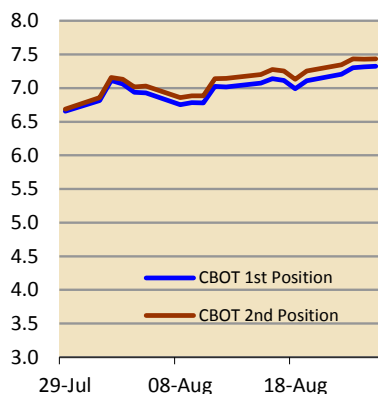
The USDA is expected to once more cut its yield forecast for corn following continuing drought in key growing regions. Early results of the much anticipated annual ProFarmer crop tour indicate that the harvest will likely be smaller and of poorer quality than originally estimated, with yields now potentially falling below 150 bushels/acre. The International Grains Council (IGC) has forecast that total world corn production for the 2011-2012 season will be 849 Mt, 10 Mt lower than a previously made forecast. Global wheat output is forecast at 677 Mt for the 2011-2012 season, 3 Mt higher than their previous forecast. Global grains consumption is still expected to outpace supply in the approaching season, and global corn consumption is forecast at 858 Mt. World wheat consumption will also exceed output by 6 Mt at 657 Mt.

Wheat, CBOT, \$/bushel



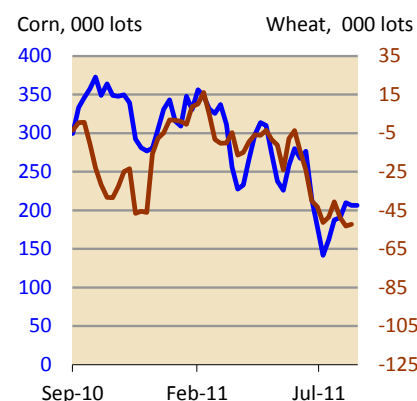
Source: VM Group

Corn, CBOT, \$/bushel



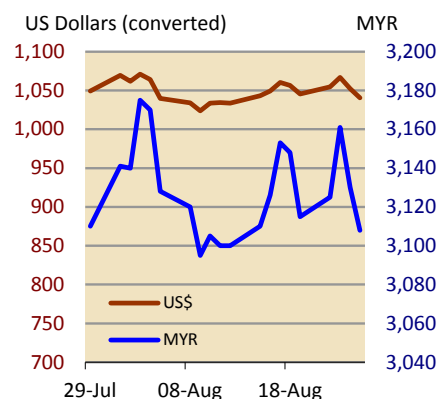
Source: VM Group

Corn and wheat speculation, 000 lots



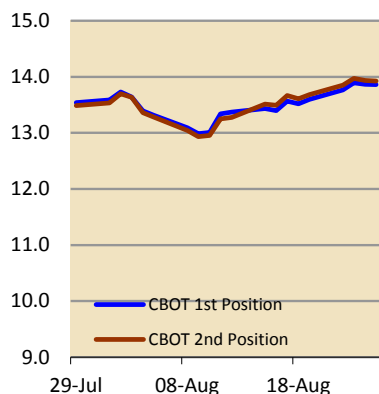
Source: VM Group

## Palm oil, BMDM, price/tonne



Source: VM Group

## Soybeans, CBOT, \$/bushel



Source: VM Group

# Palm oil & soybeans

## News

■ **Aug 25:** Indonesia has changed the structure of their palm oil export tax regime, from October 1 the maximum export tax for crude palm oil will be lowered from 25% to 22.5% while the minimum export tax will be raised from 1.5% to 7.5%. Crude palm oil futures fell on the news; the change in the tax structure could boost exports from Indonesia.

■ **Aug 23:** According to Hamburg based oilseeds analysts Oil World, Brazil will produce 73.3 Mt of soybeans during the 2011-2012 season, a slight decrease on a prior estimate of 73.5 Mt. Farmers are expected to plant more corn this season at the expense of soybean seedings.

■ **Aug 23:** China's July customs data showed a 24% increase in soybean imports on June levels to 5.35 Mt. The import volume is the highest recorded since December 2010.

■ **Aug 22:** The USDA rated the US soybean crop 59% good to excellent, 2% lower than a prior estimate and 5% lower than ratings for the crop at the same time last year.

**Aug 8:** The Malaysian Palm Oil Council estimates that palm oil production in Malaysia could climb to 18.1 Mt in 2011, up from 17.6 Mt last year. Indonesia's palm oil output is also expected to increase potentially by 1.7 Mt on 2010 output, to 23.9 Mt.

## Short term outlook

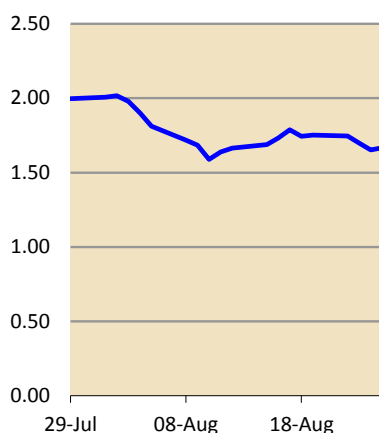
**Soybeans continue to find price support on the deteriorating weather outlook for the current US crop. Prices have seen some dips due to weakness in external markets but have performed well considering the de-risking seen in the broad sell-off in commodities earlier this month. Palm oil futures have been consistently lower, and the change in the structure of Indonesia's export tax regime is likely to prompt an increase in exports, especially as stocks have built up following weeks of lower demand. Palm oil prices have been partially supported by concerns about the US soybean crop but are vulnerable to further weakness – they have already fallen 20% since the start of 2011.**

## Analysis

Over the last few weeks the US states of Iowa and Illinois have recorded their hottest summer temperatures since 1955. The extent of the impact of the persistent heat and dryness on the US soybean crop in those areas is likely to be substantial, prompting a decline in both quality and output. Already lower crop ratings are starting to trickle in together with reports of far lower pod counts. This will provide support for soybeans and should isolate prices somewhat from any significant downwards pressure from the macroeconomic downturn. There are reports that South America may witness a return of La Niña conditions which could affect bean crops. The world has come to rely on consistently higher output from the region and any dip in production there would tighten the global balance.

## Frozen concentrated orange juice

FCOJ, ICE Futures US, \$/pound



Source: VM Group

### News

- **Aug 18:** CitrusBR, a Brazilian exporters' association pegs the Brazilian citrus crop at 375m boxes this year.
- **Aug 15:** Two private forecasts for Florida's 2011-2012 citrus crop have been made – both of which are on the lower end of the range expected. Writer and forecaster for the region, Elizabeth Steger expects Florida's crop to come in at 142m 90-lb boxes, while Louis Dreyfus' forecast is for 146m 90-lb boxes.
- **Aug 4:** The US National Oceanic and Atmospheric Association (NOAA) has upgraded its hurricane outlook from May 2011. It increased the probability of an above-normal season from 65% to 85% and raised the number of named storms expected to between 14 and 19. NOAA also raised the number of hurricanes expected to between 7 and 10, of which 3-5 could be major hurricanes. Although a major hurricane has not hit the US mainland since 2008, Florida and its orange crops remain highly vulnerable to hurricane damage and any storm there could threaten the 2011-2012 crop.

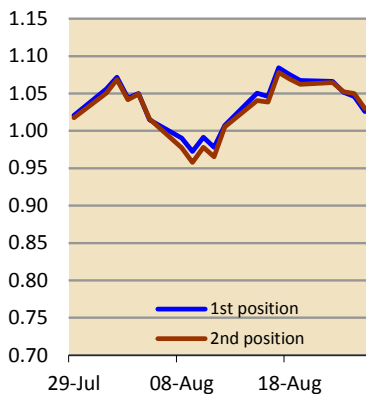
### Short term outlook

**August has been a rocky month for FCOJ. The early month NOAA upgrades in hurricane expectations were followed by investor liquidation on macroeconomic concerns, better than expected weather so far and weak retail demand. But then a combination of hurricane risk and lower than expected Florida crop forecasts from industry experts stoked supply fears. The USDA forecast will not be issued until 12 October. Currently, the expectation for the 2011-2012 citrus crop ranges from 140-150m 90-lb boxes. Larger fruit sizes and programmes to address greening appear to be responsible for the increases in the expected Florida crop on previous years. However, the size of the Brazil crop is – as ever – a more important question given its its high volumes of FCOJ exports. The USDA expects the 2011-2012 Brazilian crop to more than recover from last year's drought as citrus growing conditions there continue to be excellent.**

### Analysis

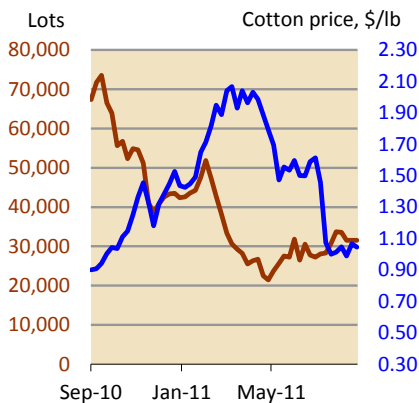
We are midway through the hurricane season – a high risk time for FCOJ futures' – and so far, Florida has escaped any extreme weather conditions. Although during 11-19 August Hurricane Irene looked to pose a real threat to Florida, that likelihood faded as NOAA's projections of the hurricane's path over the weekend of 20-21 August showed clearly that Florida would be spared, and that Irene would make landfall in the US in the Carolinas. The weather threat has not receded entirely, however. In early August, NOAA upgraded its expectations for the remainder of the hurricane season and now expects: "high hurricane activity" until October and storms to form "more frequently and become more intense than we've seen so far this season." If that happens we can expect volatility to return to the market in a hurry.

Cotton, ICE Futures US, \$/pound



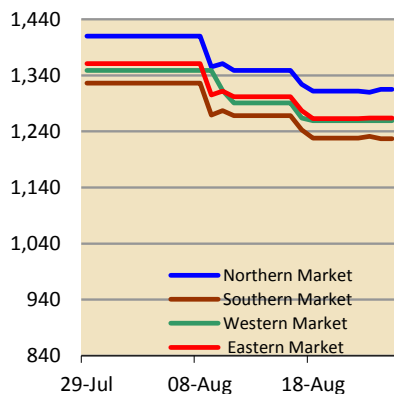
Source: VM Group

Cotton speculation, lots and price, \$/pound



Source: VM Group

Wool prices, Australian market, Aus c/kg



Source: VM Group

## Cotton and wool

### News

- Aug 26:** The USDA reports that cancelled orders exceeded sales for upland cotton for the week ended 18 August by 230,308 bales. The cancelled orders are mostly from overseas buyers.
- Aug 17:** Pakistan's Cotton Ginners Association estimates that excessive rains and flooding in the Sindh – a major growing province – could cost up to one quarter of the major growing provinces' crop of 4m bales.
- Aug 11:** USDA cotton crop report revises July estimates for the 2011-2012 US crop up by 550,000 bales to 16.6m bales.
- Aug 11:** China Cotton Association said cotton imports in July were 157,100 tonnes, up 30.89% on June. Chinese imports from January-July are down 13.3% on the same period in 2010 – at 1.48m tonnes.

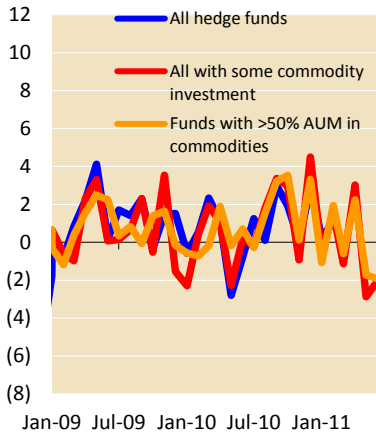
### Short term outlook

The on-going drought in Texas (and other US states) is likely to cause the USDA to reverse its optimistic August cotton report expectations – as crop ratings continue to fall and farmers abandon acreage planted to cotton. The USDA's first survey-based crop estimate already shows that 30% of the area in the state planted to cotton has been abandoned, and the crop is down 9% year-on-year. Continued high rates of cancellation of orders for export confirm that buyers also hold little hope for the US crop. Weather conditions elsewhere in the world do not appear to have been as severe during the recent cotton growing season, except for in parts of Pakistan, where the spectre of last year's floods has returned. Currently the heavy rains and flooding in key growing provinces of the country are not expected to be as severe nor lead to the same amount of cotton crop loss as in 2010 when 8.8m bales of cotton, or 8.3% year-on-year – of the 2010 crop were lost.

### Analysis

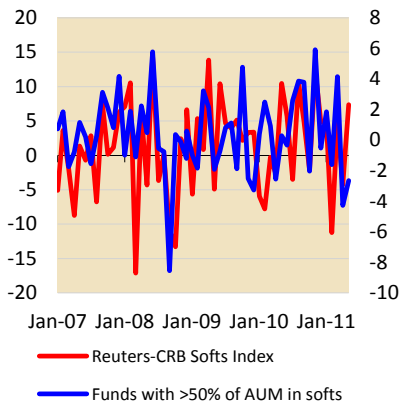
After the booming prices seen earlier this year, demand for cotton has fallen off since March. Retail prices remain vulnerable to consumer demand, which is falling as many buyers are opting for cheaper, manmade fibres. Chinese demand may have picked up in July but is still weak – H1 imports were 13% lower year-on-year. Reports that China's 2011-2012 domestic crop may be 10% up year-on-year due to good weather will likely lower import demand. Supply concerns from the US have been factored in to prices by now, suggesting that while there may be a period of volatility, cotton futures' prices are unlikely to do much - other than to continue to decline. Of course, if this is a boom and bust cycle then we can expect prices to rise again once the full impact of farmers abandoning cotton next season eventually registers on future supply expectations.

### Hedge fund returns by commodity weighting



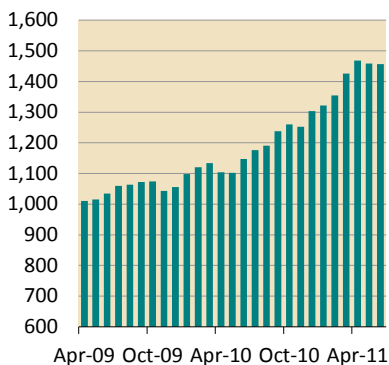
Source: VM Group

### Hedge fund returns in softs, % monthly



Source: VM Group

### Hedge funds AUM \$bn



Source: VM Group, BarclayHedge

## Fund activity

### News

- According to new data from Hong-Kong based AsiaHedge research start-up hedge funds in Asia received \$2.86bn in new money in the first 6 months of 2011. Of this inflow \$1.1bn went to multi-strategy funds. New funds in Asia raised \$1.1bn in the last 6 months of 2010, but recovered in the last half of the year. During the course of last year 95 new funds were launched in Asia, raising \$3.84bn.
- Hedge funds lagged the performance of the broader market during the first half of 2011. According to new data from Hedge Fund Research hedge funds produced an average return of 0.76% for the period. Despite continued macroeconomic turbulence the S&P 500 was up 6% over the same period. Commodity funds fared worst amongst the sample losing 3.80%, followed by global macro funds which lost 2.16% during the same period.

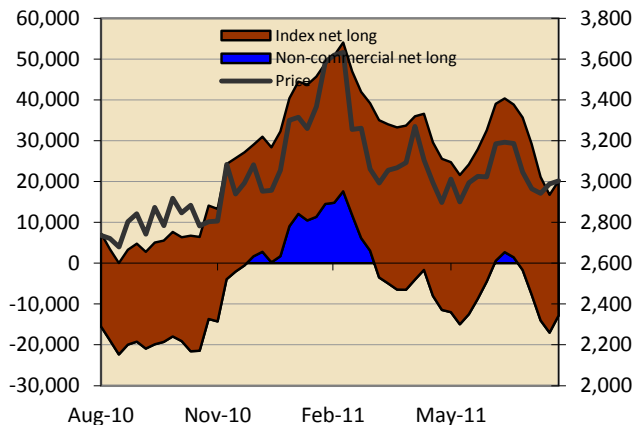
### Summer doldrums

June was not a kind month for hedge funds, as losses continued to plague the industry many managers have scaled back their exposure awaiting a favourable break in the chaos. Assets under management slipped again, down to \$1.457 trillion after average returns were once again reported to be negative. Funds in our database lost 1.29% in June on average. Those with some commodity exposure lost 2.06% and those with exposure to the commodity sector greater than 50% of their portfolio lost 1.92%. More specialised commodity funds were amongst the worst performers during June, softs funds lost 2.65%, followed by metals funds which lost 2.30%. Energy funds were only slightly better, producing negative returns of 2.27%.

# CFTC positions

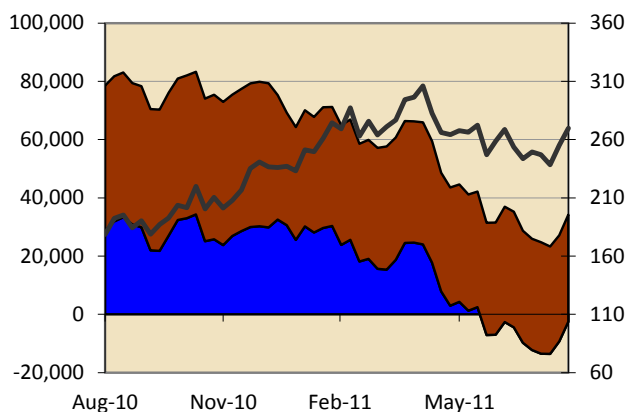
[If no non-commercial positions shown, the overall position is net short]

**Cocoa, ICE Futures US, lots & \$/tonne**



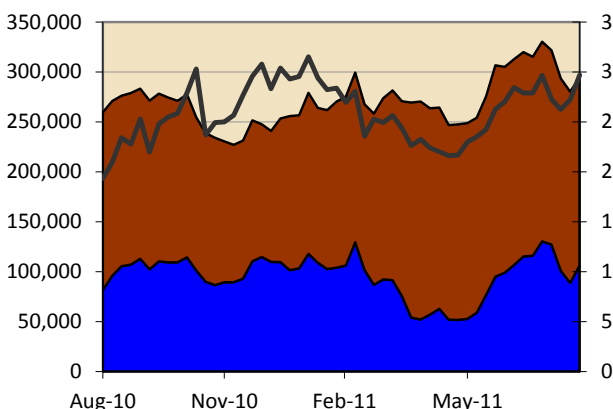
Source: VM Group, CFTC

**Arabica coffee, ICE Futures US, lots & cents/pound**



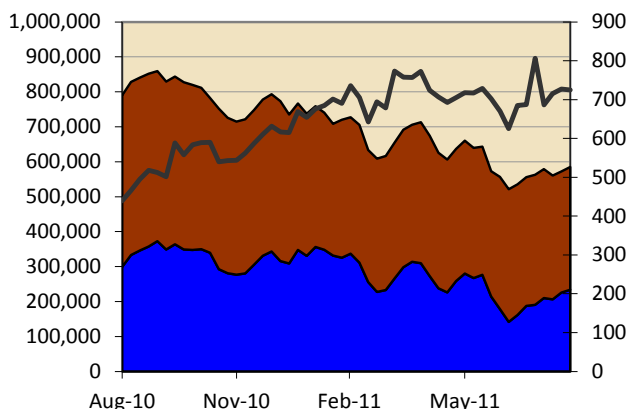
Source: VM Group, CFTC

**Sugar no.11, ICE Futures US, lots & cents/pound**



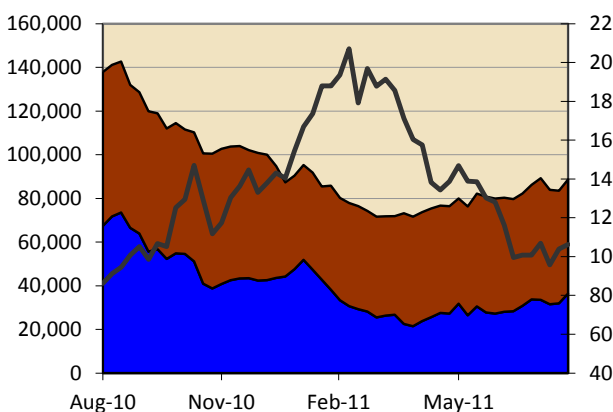
Source: VM Group, CFTC

**Corn, CBOT, lots & cents/bushel**



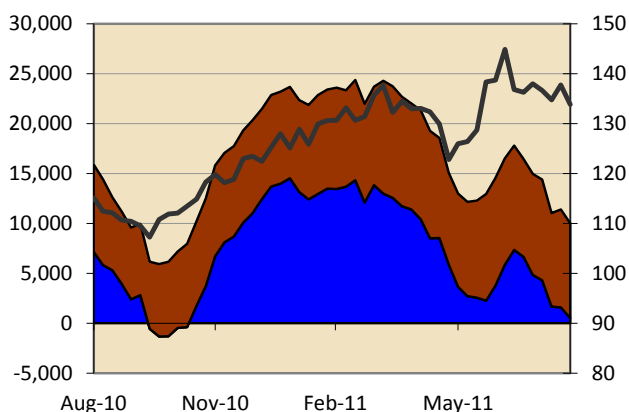
Source: VM Group, CFTC

**Cotton, ICE Futures US, lots & cents/pound**



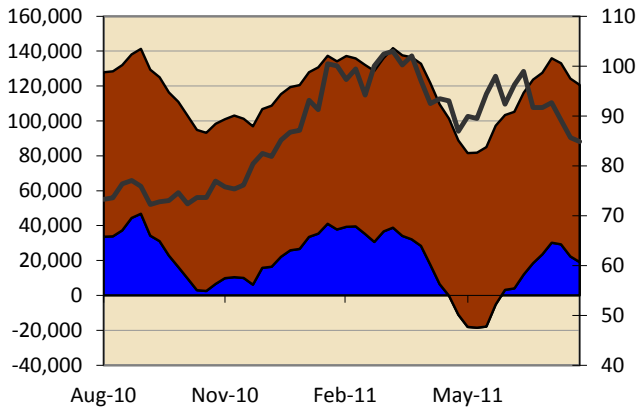
Source: VM Group, CFTC

**Feeder cattle, CME, lots & cents/pound**



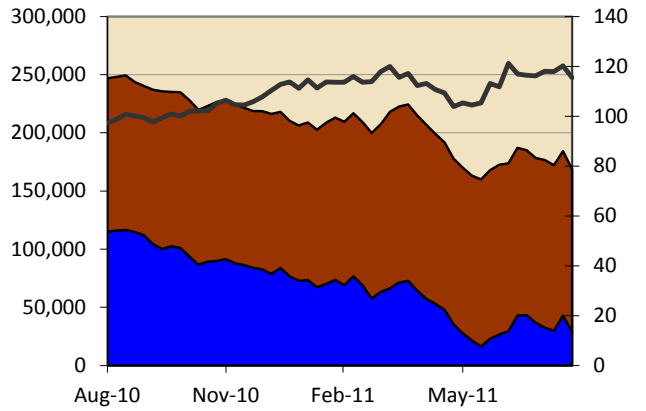
Source: VM Group, CFTC

**Lean hogs, CME, lots & cents/pound**



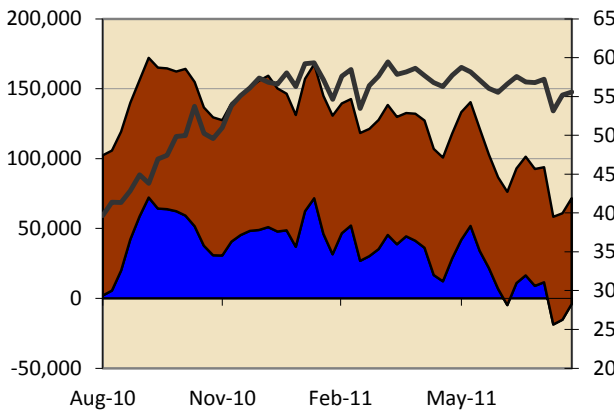
Source: VM Group, CFTC

**Live cattle, CME, lots & cents/pound**



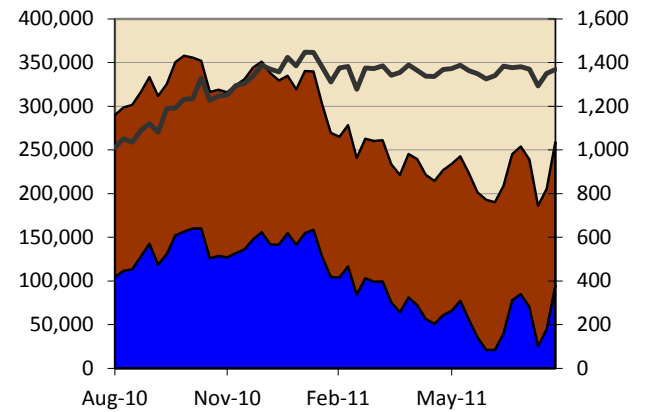
Source: VM Group, CFTC

**Soybean oil, CBOT, lots & cents/pound**



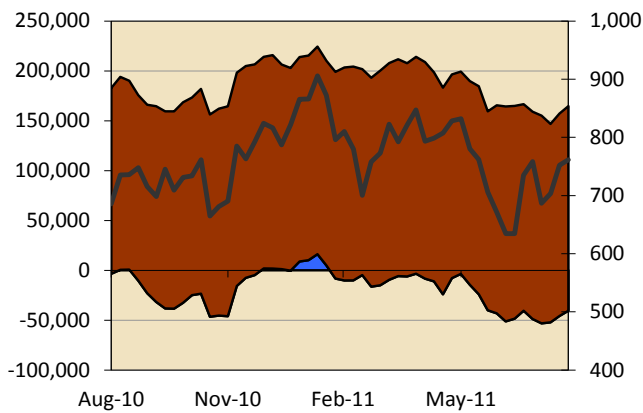
Source: VM Group, CFTC

**Soybeans, CBOT, lots & cents/bushel**



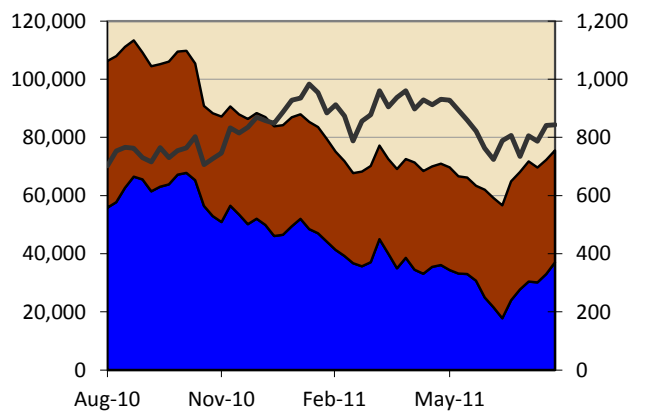
Source: VM Group, CFTC

**Wheat, CBOT, lots & cents/bushel**



Source: Source: VM Group, CFTC

**Wheat, KCBT, lots & cents/bushel**



Source: VM Group, CFTC

## About VM Group

VM Group is a commodities research consultancy that covers not just conventional energy, but also renewable energy, carbon, base and precious metals, and agricommodities. The VM Group comprises a uniquely skilled team that is highly experienced in the analysis of the fundamentals of commodities and their geopolitical impact and contexts.

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To see further how we can meet your research and consulting requirements, please email: [info@vmgroup.co.uk](mailto:info@vmgroup.co.uk)

VM Group  
100-101 Ashmill Street  
London NW1 6RA  
Tel: +44 20 7569 5930  
Fax: +44 20 7569 5931

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