VM Group research for Fortis Bank Nederland

The Agricommodities Monthly

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Fortis Bank Nederland

Sugar Quarterly

VM GROUP

The Agricommodities Monthly is produced as part of a joint venture between Fortis Bank Nederland and VM Group

Welcome to Fortis Bank Nederland's Agricommodities Monthly. This new monthly report is intended to inform, educate and stimulate debate for the bank and its customers, especially those who have an interest in the respective commodity markets. This month we focus on the global sugar market and look ahead to prospects for the 2010-2011 season.

On a quarterly rolling basis we will provide in-depth analysis of three important agricommodities – cocoa, coffee and sugar – together with an overview of the other commodity markets included in this report. All feedback is welcome and we encourage you to circulate the report among your Fortis colleagues.

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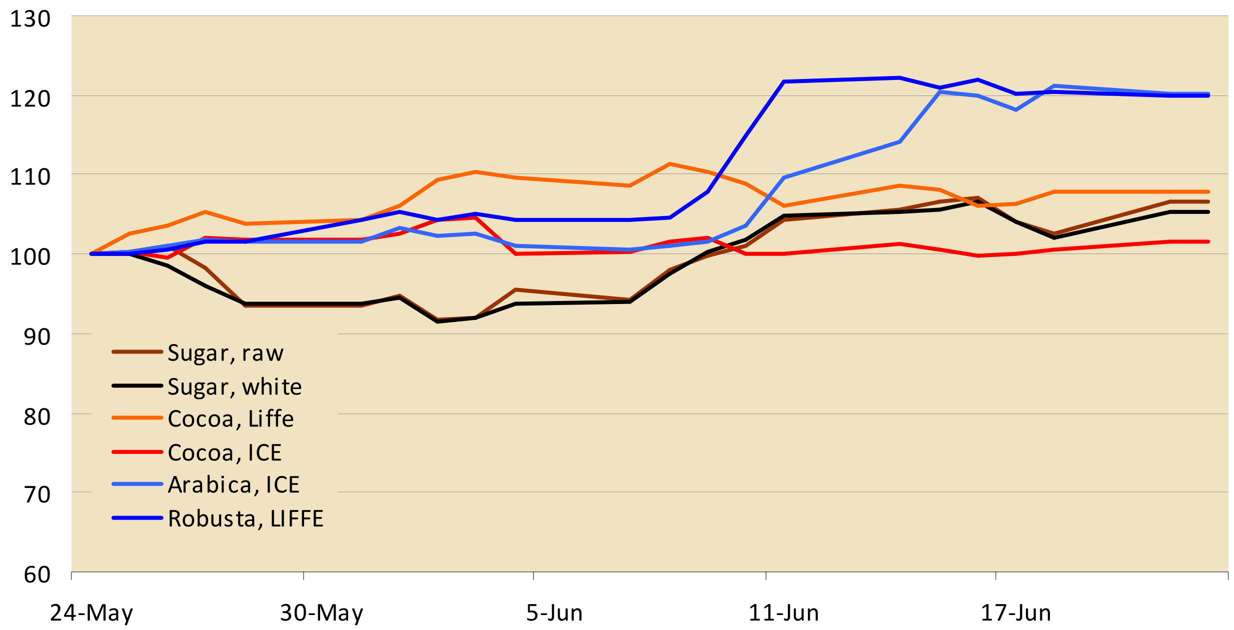
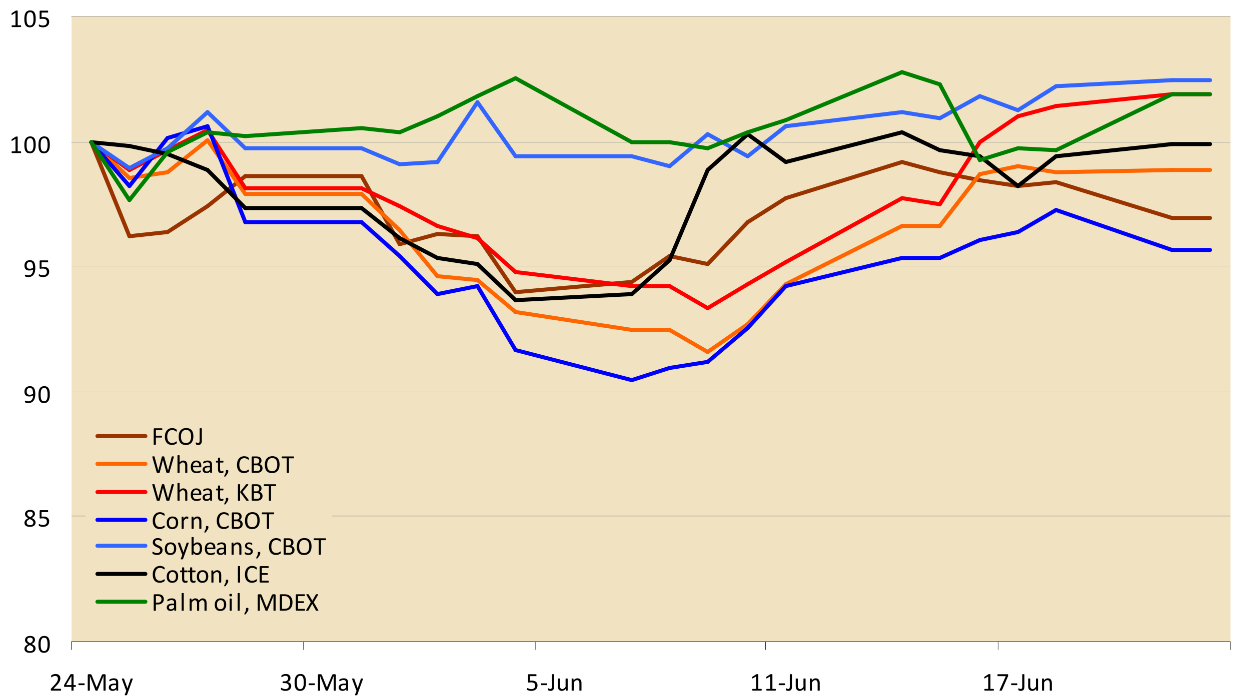
Selected agricommodity prices, past month: near-term contract, re-based to 100 at start-month

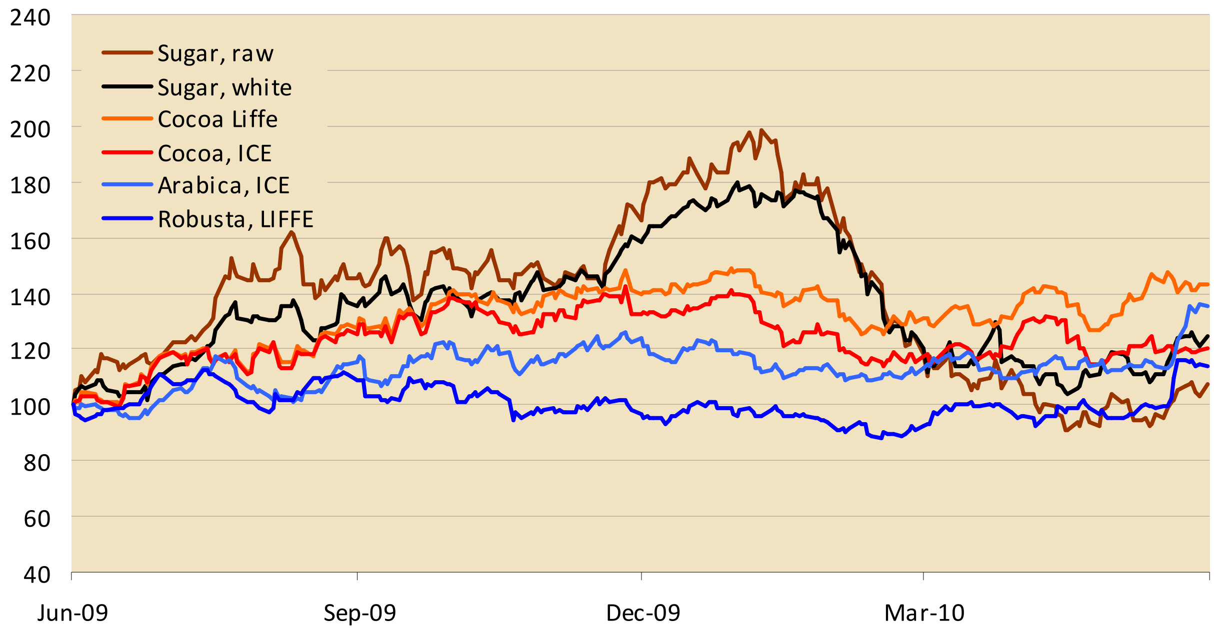


Source: VM Group

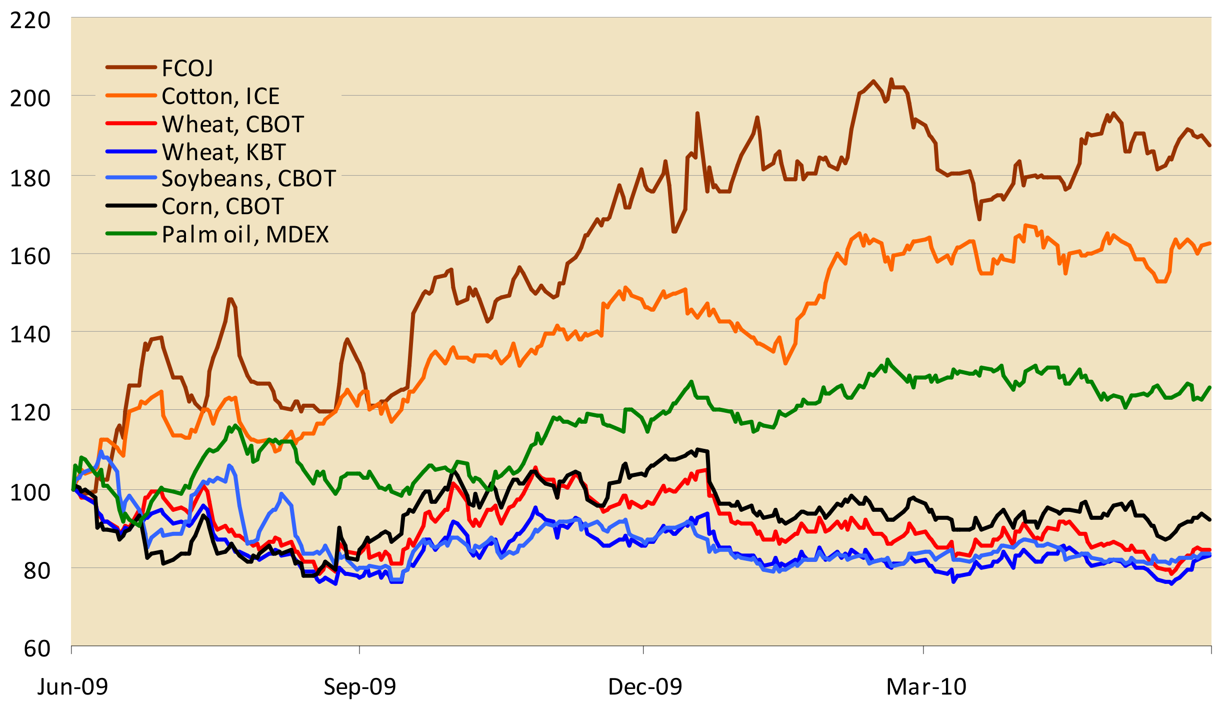


Source: VM Group

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



Source: VM Group



Source: VM Group

Feature

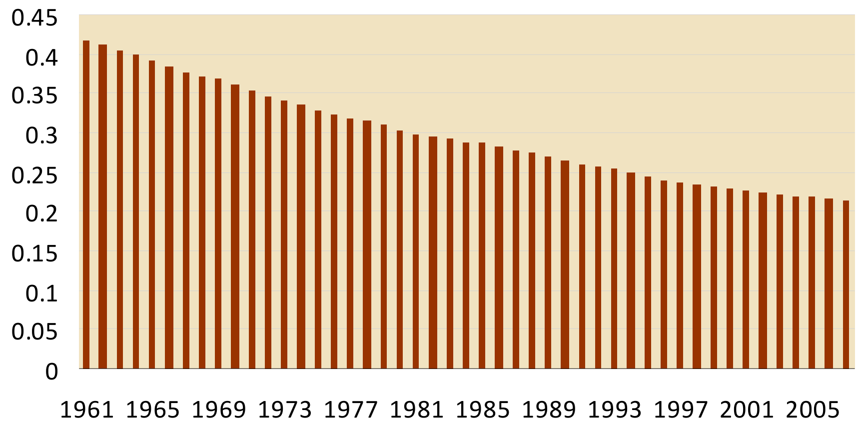
Huckleberry wisdom

"Buy land – they're not making it anymore": Mark Twain

Arable land is no longer simply something used for growing crops – it's also become a new asset class. Such is the advancing demand for agricultural crops that the global stock of good quality farmland is going to become increasingly precious. Is 'peak land' just around the corner?

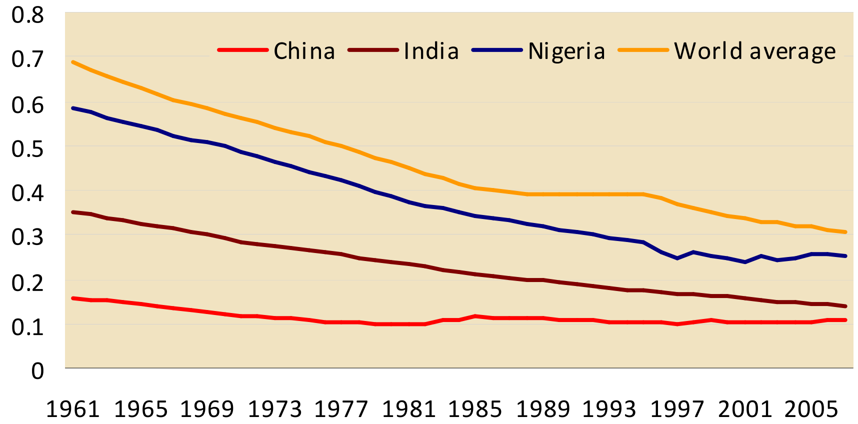
When Mark Twain was alive the horizon seemed endless, the rolling prairies seemed to go on forever, and the pumpkin pies were vast. Vicious fights were waged everywhere over arable land – not because it was scarce, but because violence was easier than the hard slog of making more land suitable for farming. Land prices were relatively cheap, costing as much in blood, sweat and tears as hard cash.

Arable land availability, hectares per capita, world average



Source: VM Group from FAO, World Bank

Arable land availability, hectares per capita: three cases of rapidly growing populations



Source: VM Group from FAO, World Bank

It's rather different today. Arable land is becoming scarce – and investors are taking notice. The International Food Policy Research Institute (IFPRI) estimates that over the last four years around 20m hectares of farmland worldwide have been snapped up or are in some stage of the acquisition process.

The Food and Agricultural Organization (FAO) considers the true figure is at least 30m hectares. Government-backed sovereign wealth funds, reclusive hedge funds, and private pension funds are looking to profit from what is developing into one of the most promising investment opportunities around.

Total global arable land, without significant soil quality constraints, is currently around 1.4bn hectares, roughly 12% of the earth's total land mass. Prior to 1920, the world's farmland expanse grew faster than the population it needed to support. In retrospect, 1920 was a pivotal point; that year available arable land peaked at 0.48 hectares per capita, declining thereafter to an average 0.21 hectares per capita by 2007. The pace of contraction is slowing, but is likely in the next decade to drop to around 0.17 hectares per capita. The stock of global arable land is declining for a number of reasons. Much is being lost to urbanisation, some to desertification, and in many mature economies it's simply the case that an upper threshold has been reached. And if the planet is set on a rise in temperatures then other factors will come into play – not least declining water availability – and these will only add to the shortfall in land suitable for crop production. Investors are already paying premiums to obtain farmland in areas where there is better promise of stable water supplies.

The fundamental arguments in favour of investing in farmland are solid– supply is finite, while crop demand is steadily growing. This shouldn't be mistaken for a repetition of arguments so often trotted out in favour of commodity investment – a short-term opportunity on an anticipated supply crunch. Farmland values have their own independent upward mobility, and it's one for long-term investment. Investing in arable land requires a much longer-term perspective than is typical in speculative trading of commodities.

The multifaceted asset

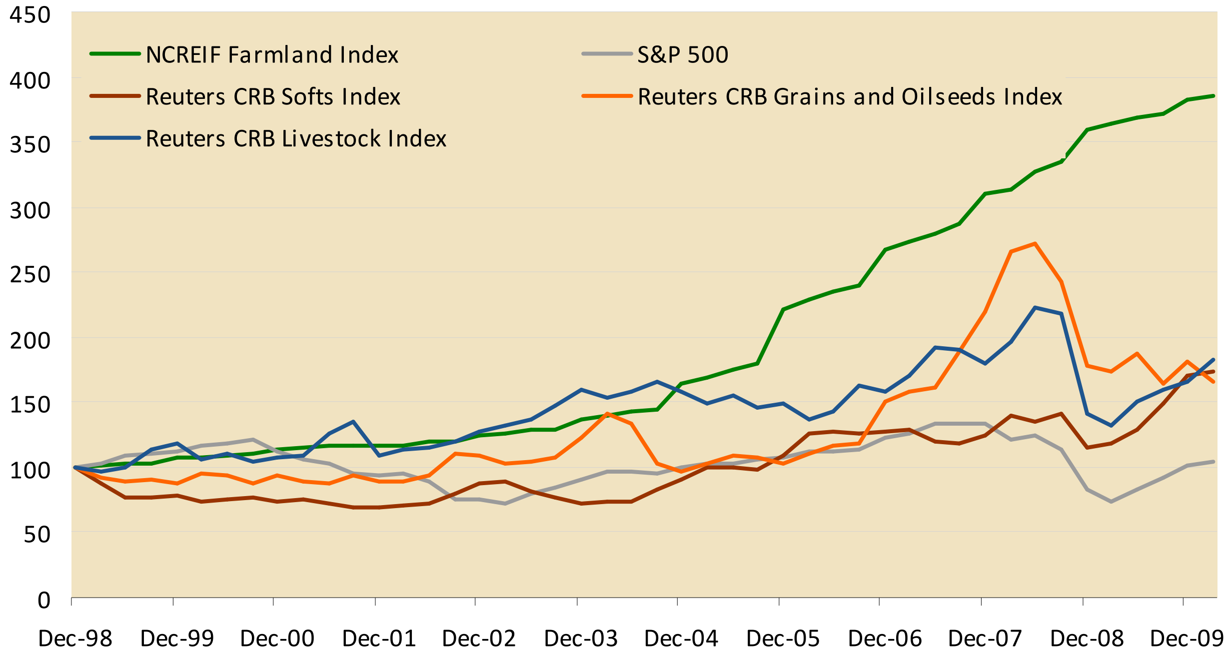
Apart from an entirely predictable flocking back to austerity (both personally and by government), one other inevitable consequence of the financial crisis of 2008 and the subsequent recession has been a yearning by investors for greater simplicity, combined with as much certainty as possible. But in a zero-interest rate environment they face a slim range of choices. The physical certainty of farmland is now clearly striking a chord in a world where esoteric financial products and endless chains of derivatives ran amok. It provides a relative safe haven and has proven its merits as an inflation hedge, a very real advantage in the present climate where quantitative easing has become a favoured strategy of central banks. Farmland values also show relatively low levels of volatility compared with more mainstream asset classes. An investment in arable land is also attractive as a portfolio diversifier, as it shows very little positive correlation with other asset classes, an increasingly rare trait in the commodity complex.

This limited correlation with mainstream asset classes also means that farmland is a strong defensive play. Farmland does well if agricultural commodity prices go up, as income from outputs increases, but it can also perform well as an asset based on other income streams. According to Jeffrey Conrad, President of Hancock Agricultural Investment Group, which has invested an estimated $1bn in farmland so far and has plans for more, outlined the attraction to the new class of investors seeking long-term profits: "In the age of derivatives and evaporating valuations, farmland is gold with a cash flow."

As well as outputs, prices for which can be erratic, returns from farmland come from rental rates and appreciating values of the land itself. Returns for developed world farmland have held up well since 1990, even during the most severe recession of the last 80 years. In the UK, farmland values have been resilient. According to property consultants Strutt & Parker, UK farmland prices are up by 18% so far this year, from £2,129 per hectare to £2,158 per hectare; British farmland prices have risen by 134% in the last 10 years. Strutt & Parker estimates that prices could rise by a further 40% to 2015, on tight supply, which has dwindled from 78,104 hectares in 2008 to 57,870 hectares in 2009. Real estate advisors Savills, in their January 2010 Farmland Value Forecasts, reported

£7.5bn in applicant funds for the purchase of UK farmland, which at current prices would equal the total area of UK farmland publicly marketed over the last six years.

Performance of NCREIF[1] Farmland Index versus other indicators (rebased to 100, 1 Jan 1999)



Source: VM Group, NCREIF

Sound investment – or agro-colonialism?

Farmland is not valued equally the world over however, and as an asset class displays great variance in risk return structures. Besides the swelling ranks of investors interested in buying into established markets, there are a growing number of investors willing to shoulder the cost and the risk of green-field investment in undeveloped farmland. In Brazil, farmland prices have appreciated at 11%-20% a year since 2001. South America and Africa are proving especially popular spots for land buyers, particularly those with some form of financial backing from states less well endowed with productive land. South-South partnerships in the sector are also on the rise, with the partnerships between the likes of COFCO (China National Cereals, Oils and Foodstuffs Corporation), the Singapore-based agricultural trading house Olam, Savola and Almarai, (Saudi Arabia-based) and JBS (the Brazilian-based food industry giant). IFPRI estimates that governments are spending between $20bn-$30bn a year on land purchases in developing countries; this bill is only going to get bigger before it peaks.

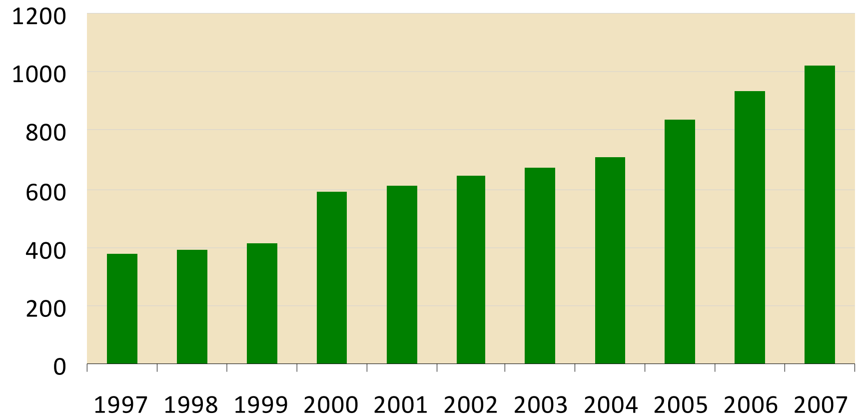
Other models of investment – whether sovereign wealth funds, government-private partnerships and more frequently governments on their own – are also pursuing significant agricultural land deals in foreign countries. Arid conditions in the Gulf countries, chronic drought and urbanisation in China and exploding populations and a mistrust of markets after the food price crisis in India are just some of the reasons that these countries are pursuing rental or purchase

[1] NCREIF: The National Council of Real Estate Investment Fiduciaries (US based). Its farmland index is a measure of investment performance of a large pool of individual agricultural properties acquired in the private market for investment purposes, so is an indicator for how well private investment in farmland performs. Many properties owned for investment purposes by pension funds are included in this index.

agreements of farming land in Africa, Eastern Europe and Asia. Hard data as to the extent of such investment in overseas arable land are limited, and many of the deals are less than transparent. And there have been some cases that have badly tarnished the issue, perhaps the most notorious being the attempt by South Korea's Daewoo in 2008 to lease 1.3m hectares of land in Madagascar for 99 years to grow animal feed and biofuel feedstock, mostly from corn and palm oil. The deal – for around half of the country's total arable land – could best be described as ill advised. About 70% of Madagascar's 20m population lives below the poverty line, and most of them are highly food insecure and dependent on foreign aid for their nutritional needs. The decision by the Madagascan government to prioritise the animal feed and energy needs of a comparatively rich country over its own people's food requirements – for profit – was roundly rejected by the Madagascan populace and in March 2009 Madagascar's government fell as a consequence, and the deal was promptly cancelled.

But there is nevertheless an onward march by cash-rich/land-poor (CRLP) states to strike deals with land-rich/cash poor countries. According to the FAO, some 10% of farmland in Africa is today either rented or has been sold to grow food for other countries, mainly Gulf States or Asian countries. More than 2.5m hectares have been bought or rented on long-term leases in just five African countries in the past five years, at a total cost close to $1bn. That's roughly $400 (€325) per hectare – which might turn out in a relatively short time to have been the bargain of the century.

US average cropland value, $/hectare



Source: VM Group from USDA

This process has been deeply contentious, as many of the deals have occurred in countries ruled by undemocratic and unaccountable regimes. China is involved – as always – but so are South Korea and India. The Indian government has lent funds to 80 companies to buy 350,000 hectares in Africa. But the major players right now are the Gulf States, and particularly Saudi Arabia. The Gulf region imports 60% of its food requirements and this figure is likely to rise simply because further desertification threatens 20% of the Middle East and North Africa, threatening what little productive land there is. After decades of attempting to become self sufficient in basic foodstuffs, Saudi Arabia has now thrown in the towel, turning its attention to joint agricultural ventures between Saudi companies and foreign host governments in order to conserve its own water supplies. The Saudi kingdom provides financing – in 2009, the facility stood at riyals 3bn ($800m) – for investments focusing on wheat, rice, sugar and soybeans. By 2016 it will produce almost no crops itself.

There has been a strong backlash against some of the more dubious land deals. Potential buyers and leasers of land have taken note of the extremely bad public relations' fallout from the Madagascan experience and are more wary of too cavalier an approach to land-for-cash deals, and the human impact of growing food for export in countries that are in some cases unable to adequately feed their own people. Further, the level of infrastructure investment required in many of these countries has begun to seem too high, forcing land-hungry states to look elsewhere. The Gulf States are increasingly looking at Eastern Europe, where arable land is still relatively plentiful and freehold rights are available. With land prices on average $2,000 per hectare, Eastern European land is more expensive than Africa but not prohibitively so. Although the average land purchase price in Africa may be about $400/hectare, once the necessary supporting infrastructure costs are factored in the average price is around $1,500-$2,000/hectare. Australia, too, is receiving increasing interest from land buyers. Other investment vehicles are looking at Asia; the Saudi-led Far East Agricultural Investment Company has invested $30m in buying leases in Cambodia, Pakistan, the Philippines and Vietnam for rice exports.

Peak land – and prices yet to peak

So while this process of wealthy countries buying or leasing agricultural land from poorer nations will certainly continue, future deals are likely to be extremely different from the kind of plunder that was attempted in Madagascar. Host countries are setting higher demands – for instance Pakistan and Iraq are firming up laws that would ensure that a proportion of crops grown for export on leased land are shared with their domestic markets. Companies are also adopting more sensitive strategies in their land deals; Lonrho, for example, which in 2009 secured land deals in Angola, Mali and Malawi totalling 150,000 hectares, is focusing on food production for domestic African consumption.

Despite a brief lull during the recession and its aftermath, crop prices have risen since 2005, and these higher-than-expected returns per unit of land are likely to continue. If food commodity prices keep rising, farm incomes will climb even at today's pace and scale of production. If, either through technological innovation or better agricultural practices, crop yields are improved, this enhanced capacity will lead to further increases in profitability, which in turn will further push up land values. In a world already struggling to grow sufficient food at affordable prices, and where the population is set to increase by a third – to 9bn people – by 2050, and energy needs can only go higher, buying farmland currently seems like one of the few win-win investment opportunities.

Sugar Quarterly

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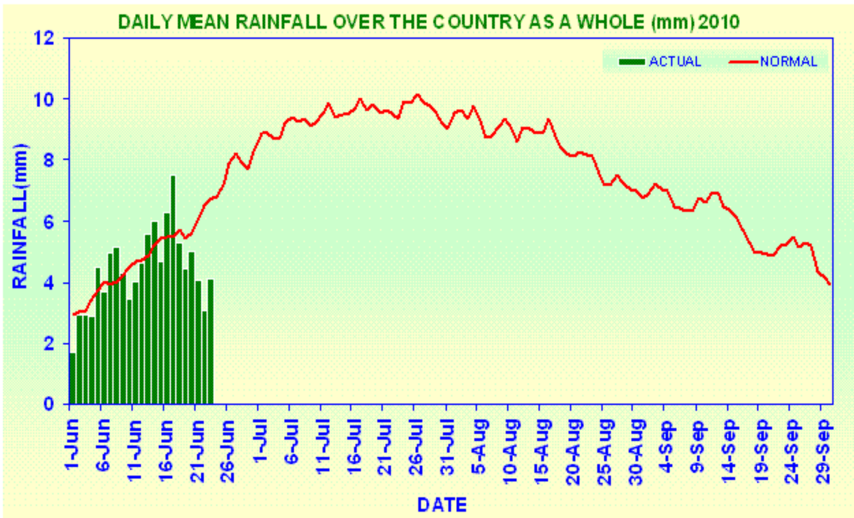
Weather and climate

Key to the supply-demand outlook for sugar in the 2010-2011 season will be the development of India's monsoon this year. As of late June the monsoon appeared to be proceeding normally; the India Meteorological Department (IMD) expects it will produce 98% of the long-term average rainfall for June-September, a significant rebound from last year's disappointing rainfall. The Director General of IMD said on 4 June that rainfall since the start of the monsoon had been 9.4% lower than a more normal monsoon. And on 24 June the IMD said that in the preceding week the rains were 21% lower than normal – bringing monsoon rains during the 1-23 June period (i.e. since the start of the monsoon) to 11% below the 50-year average.

But erratic starts to Indian monsoons are not unusual and it remains too early to be able to have a definitive picture. As of mid-June, according to the IMD, the monsoon had reached the key sugar producing state of Maharashtra, parts of Madhya Pradesh, the western state of Gujarat and the eastern states of Bihar and Jharkhand. A monsoon closer to the average ought to reduce India's sugar import demand – so long as Indian farmers opt to return to significant levels of sugarcane planting, which is a bit of an open question given the recent extreme price swings. In Brazil, where the 2010-2011 harvest and crush is now well underway, weather conditions have been good and have enabled the cutting of cane to proceed normally.

India's monsoon rainfall as of 24 June 2010



Source: IMD

Supply and demand

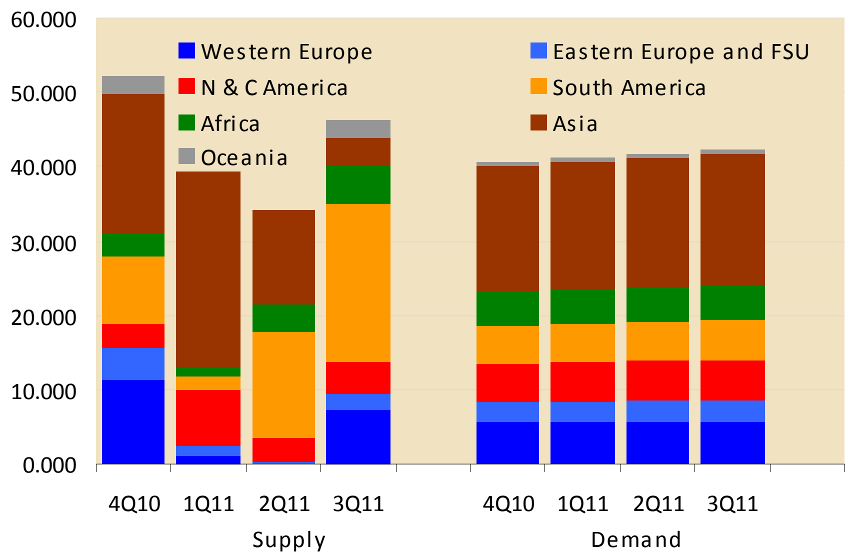
Our analysis of the global sugar market focuses on segmenting the supply-demand balance on a quarterly basis within an annual October-September global crop year. Our statistics are expressed as **metric tonnes raw value**, abbreviated to **MTRV**. Converting MTRV into million tonnes (Mt) white value incurs a 6% weight loss; so 1,000 tonnes of raw sugar converts to ~940 tonnes of white. In assessing the supply-demand balance, consumption is generally linear, across a calendar year and season, and slowly rising, due to demographic changes and population growth, while production is seasonal. **This report contains our first estimate of the outlook for 2011, up to and including Q3 2011.** By dividing the global sugar market this way we believe it will become clearer during the course of a season where the imbalances lie, and thus where excess supply and demand shortfalls are located and – crucially – at which points of the particular season. During the period from Q4 2010 to Q3 2011 – the 2010-2011 season – we expect an overall market surplus of 5.64 Mt to emerge, although along the way (particularly in Q2 2011, and then especially for India) there will be some points of deficit, and hence greater chance of price volatility, as the market struggles to interpret events. It's important to note that these estimates for sugar balances are *not* trade flows per se – not all countries that are in surplus will export, nor will all countries that are in deficit be importers. Rather, their intended usefulness is as a guide to where stress points are likely to emerge over the course of the next season.

As for what remains of the 2009-2010 season, we retain the view that the deficit has not disappeared but has been delayed, largely due to the deferral of demand from countries which have walked a tightrope, balancing rocketing domestic prices with an understandable reluctance to buy imported sugar at the exceptionally high international prices that existed at the start of the year. The pent-up demand from H1 2010 – we estimated in our previous Sugar Outlook, in March, a deficit of 5.68 MTRV for 2009-2010 – is now impacting the nearby cash market, where physical premiums to July futures remain strong, even as we approach the July expiry, and that has lifted the nearby spread structure from minus 53 points at the start of June to plus 60 as of 23 June. The deficits hanging over from the past quarter are now starting to spill into the market. Stocks within major consuming countries – India and Pakistan spring to mind but there are others – have been seriously depleted following the price spike.

Sugar balance, MTRV

	Q4 10	Q1 2011	Q2 2011	Q3 2011	Season total
Western Europe	11.17	1.01	0.04	7.34	19.56
Eastern Europe & FSU	4.39	1.31	0.24	2.20	8.14
North & C. America	3.17	7.67	3.32	4.29	18.46
South America	9.16	1.91	14.29	21.25	46.61
Africa	2.98	1.04	3.52	5.04	12.59
Asia	18.86	26.44	12.82	3.83	60.92
Oceania	2.41	0.01	0.01	2.41	4.84
TOTAL SUPPLY	52.13	39.40	34.24	46.37	171.10
Western Europe	5.53	5.60	5.69	5.76	22.58
Eastern Europe & FSU	2.78	2.82	2.86	2.89	11.35
North & Central America	5.19	5.26	5.34	5.41	21.20
South America	5.04	5.10	5.18	5.24	20.55
Africa	4.54	4.60	4.67	4.73	18.54
Asia	17.05	17.26	17.54	17.75	69.59
Oceania	0.41	0.41	0.42	0.42	1.65
TOTAL DEMAND	40.54	41.04	41.70	42.19	165.47
Western Europe	5.64	(4.59)	(5.65)	1.59	(3.02)
Eastern Europe & FSU	1.61	(1.51)	(2.62)	(0.69)	(3.22)
North & Central America	(2.03)	2.42	(2.02)	(1.11)	(2.74)
South America	4.12	(3.19)	9.11	16.01	26.06
Africa	(1.56)	(3.56)	(1.15)	0.31	(5.95)
Asia	1.81	9.18	(4.71)	(13.92)	(8.67)
Oceania	2.00	(0.40)	(0.41)	1.99	3.18
TOTAL NET POSITION	11.59	(1.64)	(7.46)	4.18	5.64

Source: Fortis Bank Nederland



Asia

Asia balance, MTRV

	Q4 10	Q1 2011	Q2 2011	Q3 2011	Total
Asia	1.81	9.18	(4.71)	(13.92)	**(8.67)**
Bangladesh	(0.33)	(0.21)	(0.34)	(0.36)	**(1.24)**
China	0.25	1.53	(1.25)	(2.65)	**(2.14)**
India	2.62	6.48	(1.23)	(6.29)	**0.54**
Indonesia	0.19	(1.02)	(0.44)	0.15	**(1.11)**
Iran	(0.23)	(0.24)	(0.55)	(0.64)	**(1.65)**
Japan	(0.47)	0.08	(0.40)	(0.59)	**(1.38)**
Malaysia	(0.02)	(0.03)	(0.03)	(0.03)	**(0.10)**
Pakistan	0.21	0.20	0.18	(1.17)	**(0.55)**
Philippines	0.04	0.03	0.03	0.02	**0.12**
Thailand	0.86	3.65	0.85	(0.56)	**4.80**
Other Asia	(1.31)	(1.31)	(1.55)	(1.80)	**(5.96)**

Source: Fortis Bank Nederland

Note: The table above should not be taken to suggest that Thailand may switch to being a net importer in Q3; at that point in the season it is 'off crop', and will be consuming sugar from stocks. This is true for a number of producers and exporters.

For Asia overall, our estimate for the balance in the 2010-2011 season suggests that, as the region moves towards its 'off' crop period by Q3 2011, the deficit clearly surges – and that period is when we can expect much of the overall 8.6 Mt deficit to be covered by imports.

India

According to Indian government data released on 18 June the total area given to sugarcane planting as of that date was 4.52m hectares, a rise of 11% from the same date last year. This rise is however probably insufficient to produce the 24-25 Mt of sugar necessary to meet domestic demand in the 2010-2011 season, even if yields per hectare are better, thanks to better rainfall. It might be that Indian farmers, increasingly wary of the wild swings in sugar prices, are holding back from a return to sugarcane.

In any case, we think the sugar market in India will be tight for much of the 2010-2011 season, with that tightness manifesting itself particularly in Q2/Q3 2011. Even with a good monsoon during June-September, this year there is still the opaque matter of India's true stock levels. According to ISMA, the Indian Sugar Mills Association, stocks at the start of October 2009 were 4.4 Mt (white value), sufficient to cover slightly more than a couple of months of domestic demand, whereas the Indian government has typically aimed at stocks sufficient to meet around six months of demand. Other sources – which remained suspiciously anonymous – told Reuters at the end of May this year that India's sugar inventory was 11.4 Mt, 36% lower than the same time last year. These stocks, it was affirmed, did *not* include any imported sugar. We have our doubts that they are that high – but barring the chance of counting the number of sacks in state-owned warehouses, reliably objective data is, as usual, scanty. Choosing not to rebuild stocks when prices have collapsed from their peak earlier this year would be most unwise, as that would court the risk of a disappointing monsoon in June-September 2011, whereupon the cupboard might quickly be bare.

Meanwhile India's farmers are deliberating their options. In the 2009-2010 season they have watched as prices first soared and then collapsed. In Maharashtra, India's leading sugar producing state, the price of the most traded S-variety of sugar has fallen 40% since reaching (in early January this year) a record high of Rupees 3,972.30 ($85.90) per 100 kg. Farmers don't much care for these kinds of extreme price swings, and this may be a partial explanation of the relatively small percentage rise in their sugarcane plantings so far this year.

The physical tightness India faces over the coming season is acknowledged by the ISMA, which recently revised upwards its estimate for India's total output of white sugar in 2009-2010 to 18.7 Mt. Although the ISMA shied away from predicting total white sugar output for 2010-2011, it did say in June that Indian stocks by the end of the 2009-2010 season may be just 4.9 Mt. It also argued that higher planted areas ought to result in significantly higher output. To which the only response is – possibly, but the balancing act will remain precarious.

Indian sugar millers are calling for an import tax, to help lift domestic prices and notionally to enable millers to pay farmers the new minimum government-fixed cane price and still allow them to make a decent profit. As yet (22 June) the government has not announced any decision on this. It seems that the duty, if it sees the light of day, would be focused on white sugar rather than raws. The millers are also concerned that local prices have fallen so far – and so fast – that farmers may be discouraged from returning to higher planting of sugarcane. Currently, Delhi seems more to favour a cut in the allocation, to 16% rather than the current 20%, of sugar to public distribution schemes rather than re-imposing import duties. The difficulty facing the central government is that it needs to rebuild stocks and avoid further stoking food inflation.

Tightness in the Asian region does in any case look likely in the forthcoming season – we estimate an overall regional deficit of 8.67 MTRV, with possibly a severe crunch in Q3 2011, with a deficit of 13.92 MTRV. And we still have to get through lingering physical tightness in the region, as we approach the end of the 2009-2010 season. In testimony to this, Pakistan's state trading agency TCP issued on 22 June an international tender for 200,000t of white sugar; the tender is being held on 31 July. This follows a purchase by Pakistan of 100,000t in late May from China's Yunnan Coal Chemical Industry Group, at a price of $558/t (cif). The Philippines' Sugar Regulatory Administration said in June that, following a severe El Niño-related drought, the country would need to import 100,000t more sugar than planned this year. Back in January the Philippines said it would seek 150,000t tonnes of sugar, its first return to imports since 2006, as it sought enough stocks to meet local demand and continue preferential exports of the sweetener to the US. The Philippines consumes around 2 Mt/year of sugar, but its own raw value output for the current crop year may be around 1.97 Mt, below the start of the season estimate of 2.18 Mt. The Philippines also exports between 136,000t-137,000t of sugar to the US under an annual quota, which was increased this year after other countries failed to fill their quotas.

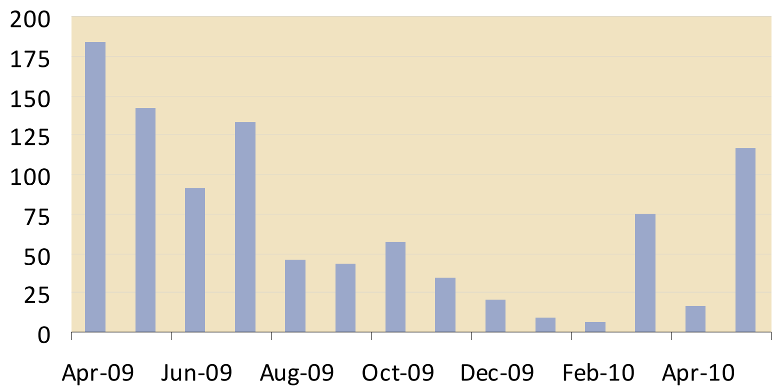
Thailand

Thailand's Office of Cane and Sugar Board said in June that the country plans to increase its sugar-processing capacity, to raise output to 10 Mt in the next five years, by constructing six new mills to add to the current 47. This is an ambitious target and there must be real doubts that it can be achieved – the likelihood is that if the new capacity is added then some mills will not be stretched, as the country will find it difficult to produce sufficient cane to work all the mills at full capacity. To keep all the mills working at full capacity would require cane throughput of ~100 Mt, 47% higher than currently produced. It's not impossible to reach ~80 Mt, but Thailand is reaching the limit of land suitable for cane cultivation, so yields would have to be boosted considerably. Thailand produced 6.9 Mt MTRV in its 2009-2010 season, and this is not expected to rise noticeably in the 2010-2011 season, as the country emerges from drought.

China

China is increasingly likely to play an important swing factor role in the 2010-2011 season. Back in March this year the country's Sugar Association said that the country's (white) sugar production in 2009-2010 was likely to fall by 11.5% compared with the previous season, to around 11 Mt – significantly below its annual consumption of ~14 Mt (white value). Its imports during the current 2009-2010 season have been erratic, on a monthly basis fluctuating between a low of 6,132t in February this year and a high of 116,525t in May – the low and the high coinciding neatly with the rise and fall in international prices. On a net basis, China has imported more than 266,000t so far this season and, given its own domestic production problems – all weather related – it's likely to be a major importer in the coming months. This will be especially true if prices stay at their recent levels and if China's preparedness to revalue the Yuan actually materialises, as the country's dollar-denominated imports, including sugar, would be relatively cheaper. Guangxi province, one of China's biggest sugar producing regions, had been suffering a severe and prolonged drought. However, while that drought has now ended, the province, along with several others, has been badly hit by exceptionally heavy rainfall, with up to 100cm in just a few days running up to 23 June. According to local reports the government (by the start of June) had already released 1.2 Mt of sugar from state reserves.

China, monthly sugar imports (000t)



Source: VM Group

The Americas

South America balance, MTRV

	Q4 10	Q1 2011	Q2 2011	Q3 2011	Total
South America	4.12	(3.19)	9.11	16.01	**26.06**
Argentina	(0.09)	(0.44)	(0.11)	1.13	**0.49**
Brazil	4.58	(1.85)	8.85	14.03	**25.60**
of which Brazil NE	2.10	0.18	(0.81)	(0.78)	**0.70**
Brazil CS	2.48	(2.04)	9.66	14.80	**24.90**
Colombia	0.24	0.19	0.26	0.25	**0.94**
Others	(0.60)	(1.08)	0.11	0.61	**(0.97)**

Source: Fortis Bank Nederland

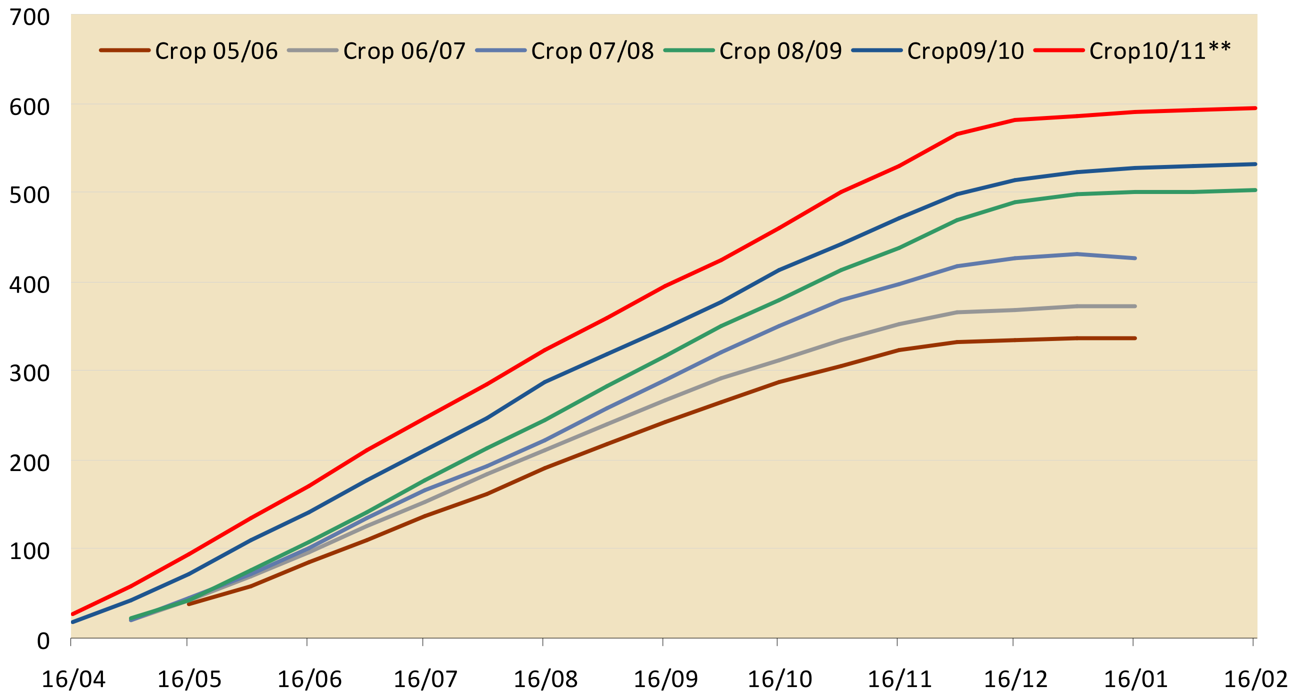
Brazil

The most recent update from Unica, Brazil's cane industry association, put the centre-south region's sugar output as of 1 June at 6.67 Mt, 31% higher than at the same date last year, based on an assessment of production since the start of the country's 2010-2011 season on 1 April. This cracking rate appears to have slowed a little however – in the second half of May sugar production was 2.23 Mt, 18% more than the comparable period of last season. The total centre-south crush so far this season by 1 June reached 134.3 Mt; forecasts for the total likely cane harvest this season vary, with the consensus being that it will exceed 600 Mt, with perhaps 67 Mt additionally coming from the north-east region.

Given that the forecast for the centre-south region is for an overall crush of 600 Mt during April 2010-March 2011, and that the April-May crush was 134 Mt, it will be necessary to crush 466 Mt from June-December this year to get to that final total. This implies an average two-weekly crush of 33 Mt, a figure that the industry has never before achieved – the previous maximum average two-weekly crush during June-December came in 2008, when it was 30 Mt. It might be feasible that the industry can reach a new height for the crush but to get there it will need dry weather. However, although the dry weather has helped the 2010 crush campaign off to a cracking start, it has also hampered cane development and this might possibly impact the tail end of the crop – and lower cane weight will result in lower sugar production.

So while Brazil appears to be producing ever-greater quantities of cane, the proportional increase in its sugar output may not be as much as imagined. Which ought to give pause for thought to those who believe that, in the case of a structural world sugar deficit emerging over time (on the strength of growing populations and rising consumer wealth), Brazil will inevitably be able to come to the rescue. It may not.

Brazil cumulative cane crush, Mt



*Source: Fortis Bank Nederland: ****NB: forecast from 1June 2010 onwards – up to that date, current data included***

Unica said sales of ethanol in May rose by 16% compared with April, to 2.15bn litres (0.57bn gallons), with almost 200m of those litres exported. The higher domestic ethanol sales reflect a reinstatement of the 25% ethanol blend (from the previous 20%, as mandated by the federal government) with regular gasoline as of 1 May. Despite the increase in ethanol sales, the percentage of cane earmarked for sugar production over the last half of May had risen to 44.4% compared with the average of 42.7% average over the whole season so far, according to Unica. Ethanol production will account for 56.71% of Brazil's total sugarcane production in 2010-2011, with 43.29% being used for sugar production, according to Unica. We expect that over the course of the 2010-2011 season Brazil will have total raw value output of 25.6 Mt, with the centre-south as usual accounting for almost all that.

In Brazil, the logistical supply chain is currently being stretched to its limits, with ports struggling to cope with the volume of exports now awaiting loading onto ships. Vessels are currently being kept waiting for two weeks to be able to obtain a berth. This infrastructure issue will impose its own restrictions on Brazilian exports going forward and will be as important a factor as production capacity in setting limits to the amount of Brazilian sugar entering the world market.

North and Central America

Poor weather in Mexico early in the 2009-2010 season has, as expected, pushed its output below the 5 Mt mark, to 4.81 Mt as of 19 June – about 3% less than at the same stage of the previous season. The country's agriculture ministry expects that the country's total sugar output in the 2009-2010 season will be 4.83 Mt. Mexico's sugar stocks as of May were put by the ministry at more than 2.5 Mt.

Cuba's 2009-2010 sugar production is likely to fall even further than the previous season's 1.34 MTRV and may struggle to tally much more than 1.1 MTRV, following the worst harvest in more than a century, according to the country's Communist party newspaper, Granma. It appears to many within the country that the unthinkable is now being contemplated – inviting foreign investment into the ailing sugar industry for the first time since the industry was nationalised in 1959. Cuba exported 740,400t (raw value) in 2009, slightly lower than 2008. There are clearly deep-seated structural problems; according to official data, cane yields per hectare have declined from 41.3t in 2008-2009 to 33.3t in 2009-2010. By comparison Brazil achieves more than twice that. At the beginning of June state-run television broadcast a commentary on the country's sugar industry, arguing that the industry was worth rescuing, given the recent spate of high prices and the growing usefulness of sugar in energy production as well as food, and floating the idea that foreign investment should be considered. The most obvious investors (no doubt already clocking up the air miles to Havana) would be from China – Cuba has a protocol agreement whereby it is committed annually to supplying China with 400,000t. Given that Cuba's annual domestic sugar consumption is at least 700,000t, a further serious decline in its output could see further local rationing.

North & Central America balance, MTRV

	Q4 10	Q1 2011	Q2 2011	Q3 2011	Total
North & Central America	(2.03)	2.42	(2.02)	(1.11)	**(2.74)**
USA	(0.99)	(1.02)	(2.70)	1.42	**(3.29)**
Cuba	0.05	0.37	0.15	(0.18)	**0.39**
Guatemala	0.12	1.32	0.01	(0.19)	**1.26**
Mexico	(0.65)	1.10	0.34	(1.34)	**(0.56)**
Others	(0.55)	0.65	0.17	(0.82)	**(0.54)**

Source: Fortis Bank Nederland

Europe

Eastern Europe & Former Soviet Union balance, MTRV

	Q4 10	Q1 2011	Q2 2011	Q3 2011	Total
Eastern Europe and FSU	**1.61**	**(1.51)**	**(2.62)**	**(0.69)**	**(3.22)**
Belarus	0.29	(0.01)	(0.01)	0.29	**0.58**
Kazakhstan	(0.12)	(0.12)	(0.12)	(0.12)	**(0.49)**
Russia	0.83	(0.47)	(1.56)	(0.73)	**(1.93)**
Ukraine	0.97	(0.53)	(0.54)	0.26	**0.16**
Others	(0.37)	(0.38)	(0.39)	(0.40)	(1.54)

Source: Fortis Bank Nederland

Western Europe balance, Mt

	Q4 10	Q1 2011	Q2 2011	Q3 2011	Season Total
Western Europe	**5.64**	**(4.59)**	**(5.65)**	**1.59**	**(3.02)**
EU	5.58	(4.45)	(5.44)	1.79	**(2.53)**
Others	0.06	(0.14)	(0.21)	(0.21)	(0.49)

Source: Fortis Bank Nederland

Russia's Union of Sugar Producers said in June that in the course of the 2010-2011 season the country may refine a record 4 Mt of sugar from this year's beet crop, following a 30% rise in the area to be sown with sugar beets. The previous beet sugar output record was set in 2008-2009, when the country refined 3.5 Mt of beet sugar. In 2009-2010 beet sugar output fell 3.2 Mt as a result of a decline in the sowing area to 822,700 hectares. Russia refined 1.3 Mt of white sugar from imported raws between the start of 2010 and 21 June, 25% more than the same period of 2009, according to the Union. The difficulty for Russia remains the relative poor utilisation rates of its sugar mills. Russian refineries switched to processing raw cane sugar after the domestic beet refining season finished in February. But by 20 April they had stopped, after refining 391,800t from the start of the year, 28% less than a year before. The problem for Russia is that it needs to invest more in its refiners, so that the daily crush rate of beet can be expanded to take advantage of when the sucrose yield from its harvested beet is at its highest. That would ultimately make Russia self-sufficient – something the government has set as an objective by 2015, but has yet to formally support by the kind of financial backing that could come from bank loan guarantees.

Comment

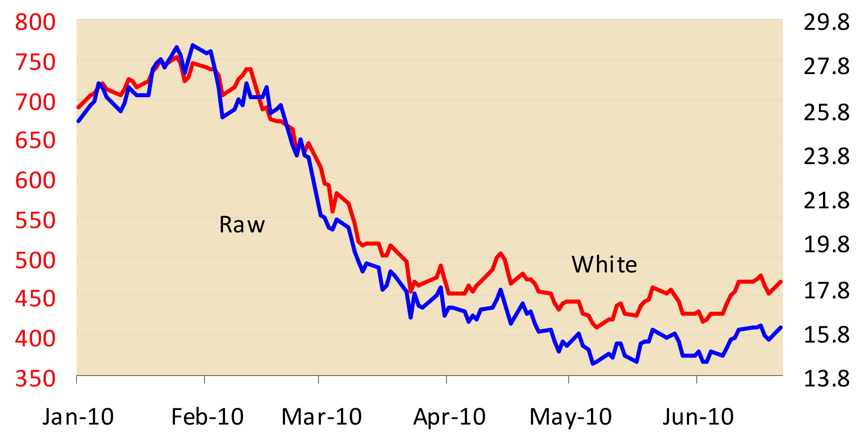
Sugar prices veered out of control and crashed in March and, by May, were in intensive care. They have since undergone a sort of convalescence, and the patient has perhaps stabilised. Having slumped by more than 50% since the start of this year, by the close of the week ending 18 June the New York contract was down just 5% from where it was a year ago, while the London contract had done somewhat better and was actually 5% higher than 12 months' previously (both second position contracts closing that week at 15 cents/pound and $454/t respectively).

This stabilisation has helped steady the nerves of speculative investors and some previously lost ground has been made up, although we are still far from the heady days of February, when the non-commercial net long on ICE Futures US stood at 136,487 lots (for the week ending 2 February). According to data published by the CFTC, the non-commercial net long in sugar futures on ICE

Futures US was 72,567 lots for the week ending 15 June, the latest reported date. This was a fairly significant rise of 14,763 lots on the previous week. The non-reportable net long position however went in the opposite direction, falling by 5,053 lots, to 8,152 lots, its lowest since the start of the year, apart from the week ending 30 March, when it was 7,972 lots. The other main speculative element on ICE Futures US, the index fund position, also rallied in the week to 15 June, up by 13,115 lots, to 176,656 lots. The index position has been steadily climbing since touching its low (for the year so far) of 133,333 lots in the week ending 9 February, and is approaching its peak for this year, of 180,491 lots, seen in the week ending 4 May.

What's perhaps notable about this rally in the speculative investment element is that it has happened although the futures' price has been fairly range-bound. Since the start of May the settlement price for the second-month contract has been in a fairly tight range, of 14.58-15.95 cents/pound, yet the non-commercial net long has put on 16,848 lots, having dipped to as low as 55,719 lots (in the week ending 18 May), when the price looked for a moment as though it might close in on 14 cents/pound.

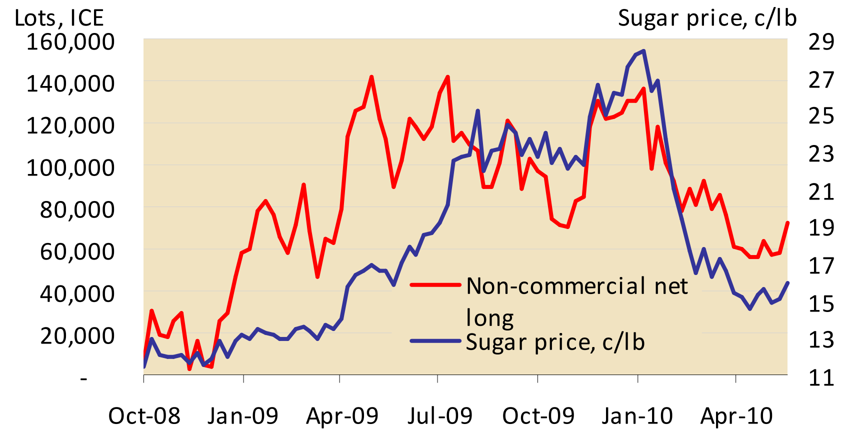
White and raw sugar prices, $/tonne and cents/pound



Source: VM Group

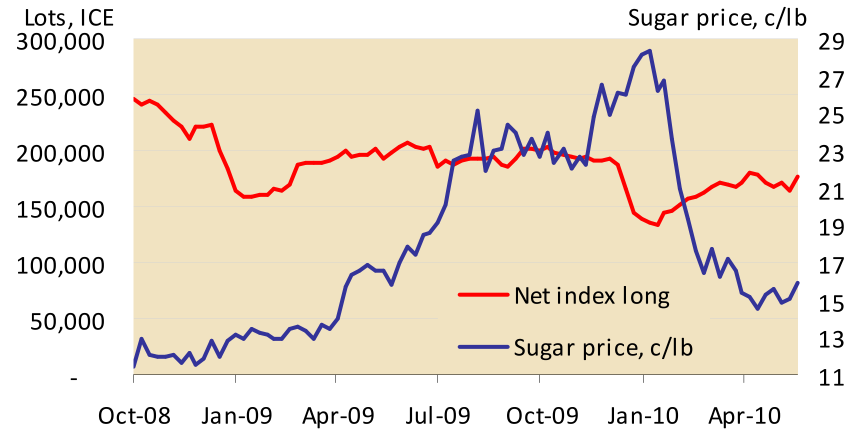
The price for the second position contract (October) for white sugar (No.5) on NYSE Liffe has had achieved a floor since we published our last *Sugar Outlook* in March. It too remains far below its peak, although the spot month price hit $767/t on 21 January; but the second position contract since the start of April has only once managed to settle above $500/t, on 14 April, when it closed at $503.40/t, then falling to a low of $410.80/t on 7 May. It rallied thereafter, to a recent high of $471.20/t, on 15 June, but as of 24 June had settled at $468.1/t. Spot month prices have however traded above $500/t for the past 10 trading days (as of 23 June). It's clear that the deferred demand from H1 has meant that some stocks have been so depleted that some have had no choice but to buy. This has driven the spread between the July-October No. 11 contract to a 60 point premium, from minus 53 at the start of June.

Non-commercial net long and sugar price, ICE Futures US



Source: VM Group, CFTC

Index fund net long and sugar price, ICE Futures US

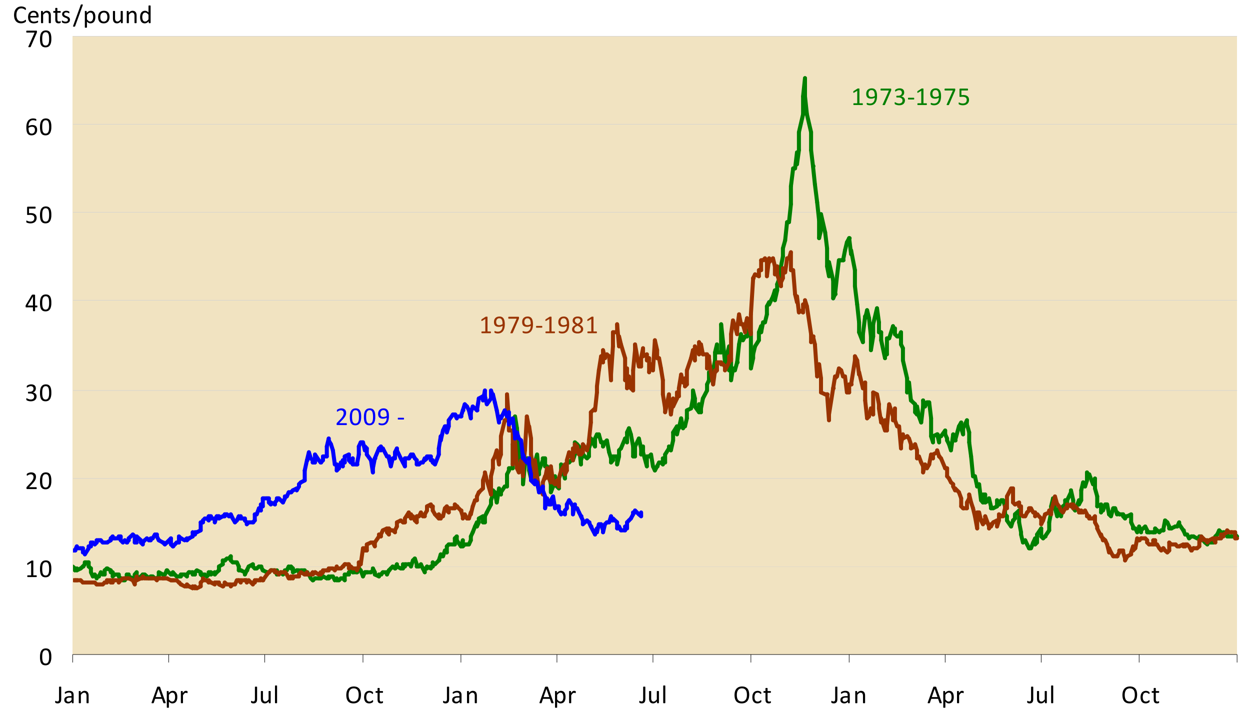


Source: VM Group, CFTC

If there is floor of sorts currently in place for both white and raw futures' prices, how long can we expect it to persist? Much depends on contingencies that certainly will be clearer by the time of our next *Sugar Outlook*, due for publication in September. By then the Indian monsoon will have come and gone; the relative weighting between sugar and ethanol from Brazil's crop will have crystallised; and the propensity (or not) for stock re-building will have firmed up. Perhaps the most that can be said right now is that both contracts appear to have found a solid floor above 14.50 cents/pound and $425/t respectively.

The chart below shows the pattern of the recent price-run compared to two previous strong bull sugar markets in raw values, and it suggests that the next few weeks will be critical in determining the mid-term price trajectory. In the very short-term – i.e. over the next few weeks – it's quite likely that a floor of around 15 cents/pound will be in place, but the chance is that a greater degree of physical buying could surprise to the upside. In the medium-term – out to the end of the 2010-2011 season – there is plenty of scope for more price volatility, albeit perhaps at a reduced level from that seen at the start of the year.

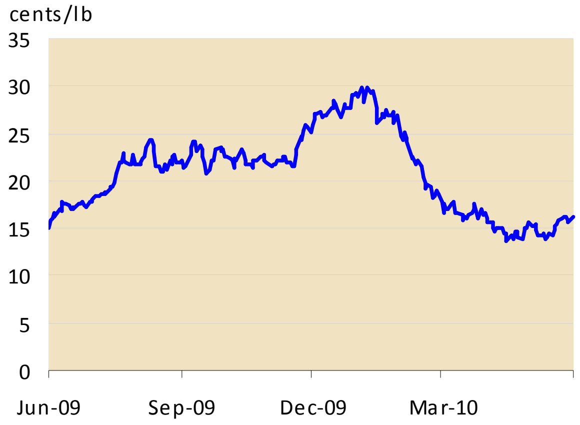
New York sugar futures: 1980 and 1974 peaks compared to 2009-2010, nominal cents/pound



Source: VM Group

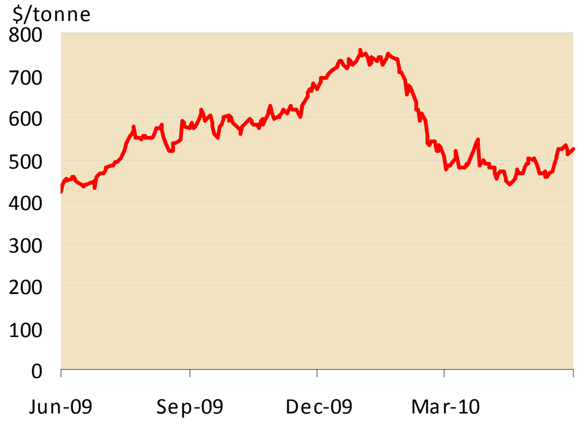
Sugar data

Sugar no.11 price, ICE Futures US, cents/pound



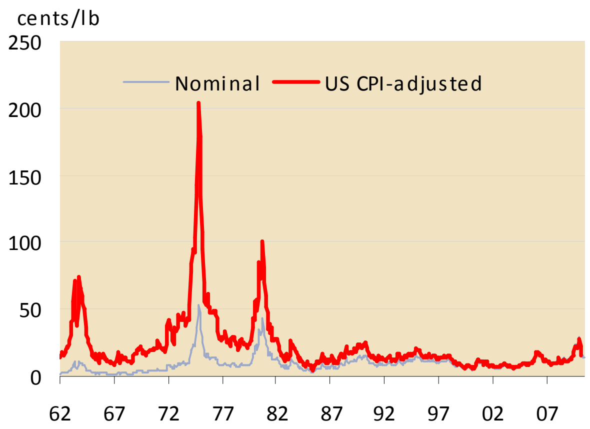
Source: VM Group, ICE Future US

Sugar no.5 price, NYSE LIFFE, $/tonne



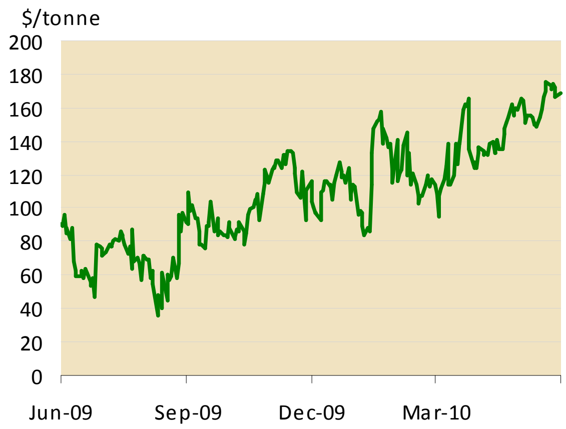
Source: VM Group, NYSE Liffe

Real and nominal price of No.11 contract since 1962 (cents/lb, monthly average)



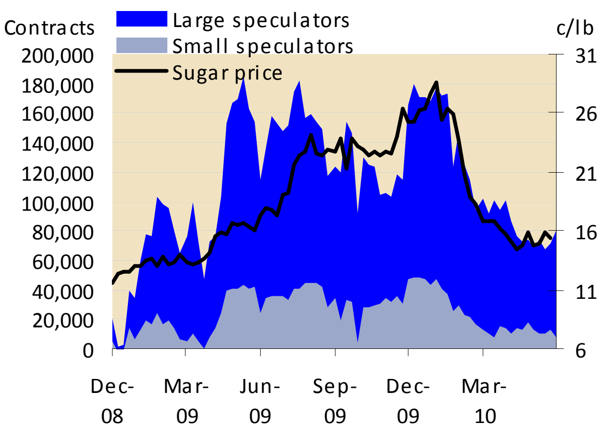
Source: VM Group, ICE Future US, US Dept of Commerce

No.5/No.11 arb ($/tonne), $/tonne



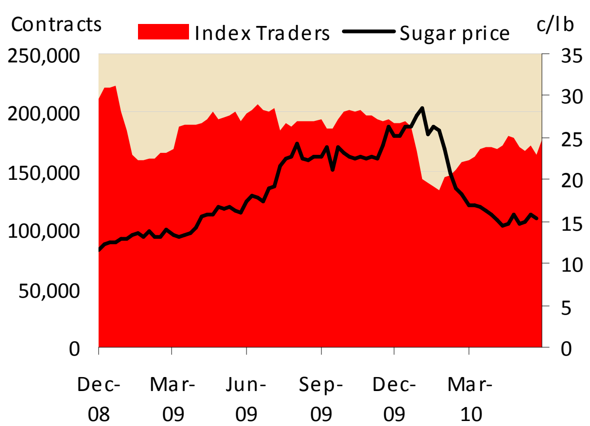
Source: VM Group, ICE, NYSE Liffe

Long positions on ICE Futures US by type of investor, since Jan 2006



Source: CFTC, VM Group

Index traders on ICE Futures US, since Jan 2006



Source: CFTC, VM Group

Weather watch

- **North America:** Apart from some fairly minor localised flooding, the US Corn Belt has been experiencing ideal weather for the development of the current soybean and corn crops. The current outlook is for this weather pattern to persist in the short-term with mostly dry conditions interspersed with sporadic showers.

- **South America:** Brazil's sugarcane areas are experiencing generally dry conditions with a few light showers. Temperatures are at the seasonal (i.e. winter) average and there are no indications of any serious cold fronts, bring the threat of possible frost damage, to the country's coffee growing areas. In central America and across Mexico the outlook is for largely dry conditions with scattered showers; conditions for coffee trees, currently flowering and budding across the region, are drier than ideal.

- **Asia:** The major issue for India is the erratic pattern so far this season of the monsoon, which according to the country's Meteorological Department is now 11.3% below average. State officials correctly point out that it is too early to become worried at this – after all, the monsoon period usually lasts for another two months. In other parts of Asia conditions have been fairly close to the seasonal norm, although rainfall across some parts of Vietnam's main coffee regions have been less than ideal and farmers have been forced to irrigate more than usual.

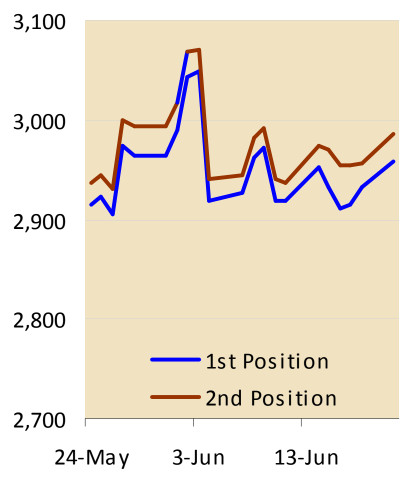
- **Europe:** Much of West Europe has experienced its driest June for some time and this pattern looks set for the short-term. Conditions across much of the continent and far into Russia and East Europe have been ideal for harvesting of summer cereal crops.

- **Africa:** Weather conditions across West Africa have been normal for the time of year with good sunshine, high temperatures, and scattered showers, with good moisture levels for the early development of the 2010-2011 main crop for cocoa.

- **La Niña:** The Australian Bureau of Meteorology said in late June that there is an enhanced prospect of a La Niña weather event developing in 2010. This could benefit winter crops such as wheat, which is now germinating in Australia, provided that rain arrives before harvesting starts in October. In Australia, summer crops such as cotton and sugar, grown in the northeast could also benefit. On the other side of the Pacific, a La Niña event can bring hot, dry weather into the US Midwest grain belt. The developing La Niña event follows a dissipating El Niño pattern; historically, about 35%-40% of El Niño events are followed by a La Niña, within the same year.

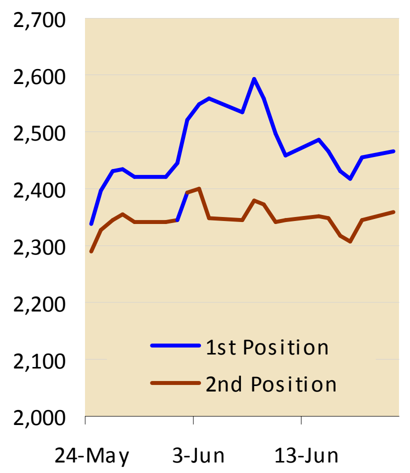
Cocoa

Cocoa price, ICE Futures US, $/tonne



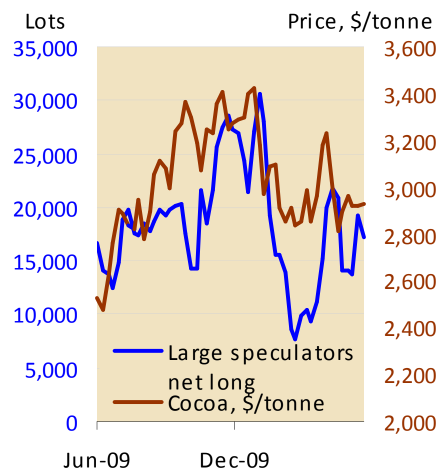
Source: VM Group

Cocoa price, NYSE LIFFE, £/tonne



Source: VM Group

Cocoa speculation, ICE Futures US, lots and price



Source: VM Group

News

- **June 21:** China's cocoa bean imports rose between October 2009-May 2010 by 39% compared to the same period of the previous season, a total of 15,422t of cocoa beans; in May alone its imports rose by more than 50% to 1,723t.
- **June 21:** Brazilian grindings for May 2010 rose 15% compared to the same month last year.
- **June 14:** Cocoa arrivals at Ivory Coast ports since the start of the 2009-2010 season, in October, totalled more than 1.02 Mt by this date according to our estimates, in line with our previous forecasts. This compares with arrivals totalling 1.046 Mt by the same date for the previous season (2008-2009). Our estimate for cumulative purchases for Ghana for the same date are that they exceeded 580,000t, again slightly lower than this time last year.

Short term outlook

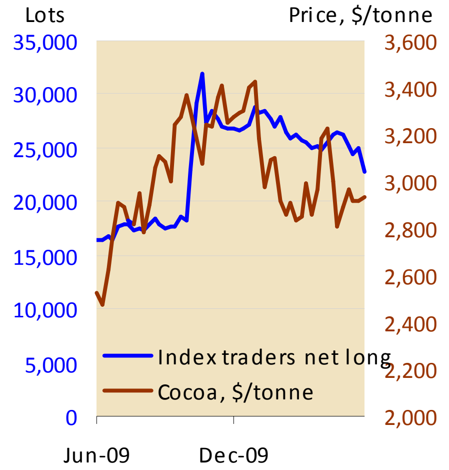
With prices remaining at historically high levels there remains a degree of nervous anticipation in the cocoa market. We have adjusted our estimate for the global balance in the 2010-2011 season, largely on the basis that weather conditions for the early development of the West African main crop have been better than normal. However, it's still early for any certainty and much hinges on weather conditions across West Africa remaining good over the next couple of months. The high price clearly has encouraged a degree of profit-taking among the speculative investment element of the market – according to the most recent data from the CFTC, the non-commercial net long on ICE Futures US for the week ending 15 June fell by 2,074 lots on the previous week, to 17,242 lots, although the non-reportable net long rose by 213 lots, to 1,068 lots. The index traders net long also rose modestly, by 376 lots, to 23,098 lots, against the previous week. Open interest fell by 7,108 lots in the week ending 15 June compared to the previous week. We consider that in terms of futures' prices the market remains poised on a knife edge.

Analysis

Apart from the fact that the London front month contract traded for much of June (so far) around its highest in more than three decades, there were a couple of other notable events – not least being the unprecedented wide arbitrage of the July futures' contract in New York against the same month contract in London, ballooning to $807 on 4 June. The New York market is now essentially Indonesian-based while that in London is African-based, and this wide arbitrage reflects a perceived deficit of African cocoa against a surplus of Indonesian.

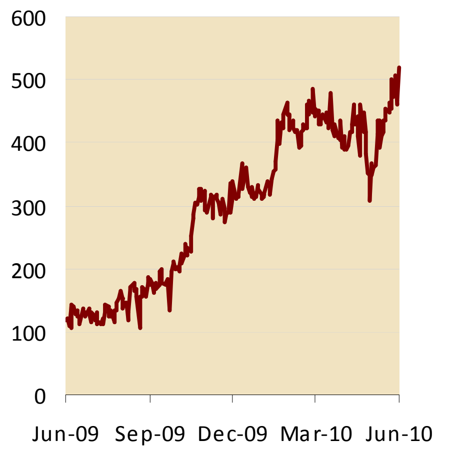
As if these were not enough to keep cocoa traders busy, there was also the very high premium of the July contract in London to that of September to contend with. By 2 June the July-Sept spread closed the day at £127/t, widening to £150 by close of the next day's trading and to £214 by the settlement of 8 June. By close of business on 22 June things had calmed down – a little – and the spread had narrowed to £111. What's behind these very wide spreads at the front months? It seems plausible that three issues have been at play. One is the (now widespread) acceptance that the 2009-2010 season will see a substantial deficit, with the stock/grind ratio one of the lowest in 20 years. Another is the amount of stock available to the London market, which remains at a very low level, emphasising the deficit of African cocoa. The third reflects the large amount of

Index fund position, ICE Futures US, lots



Source: VM Group

Arbitrage between 2nd position contracts on NYSE Liffe and ICE Future US, $/tonne



Source: VM Group

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cocoa butter stocks hedged in the July position. Processors have been forced to roll these hedges.

On top of all this, we have also witnessed another unprecedented development – the switch in the London market to the open interest in options being significantly higher than that of futures. As of 22 June the open interest in futures was 153,447 contracts, while that in options was more than 194,000 contracts. This inversion of the more usual relationship is entirely a reflection of the degree of perceived uncertainty/risk in the cocoa market right now. Key to the fate of the July position and subsequent months is the quantity of uncommitted cocoa currently available – and that unknown figure is keeping everything on tenterhooks.

We have adjusted our supply-demand estimates for both the 2009-2010 and 2010-2011 seasons from our report last month, reducing by 48,000t the estimated deficit for the former to 88,000t, and converting our previous estimate of a 3,000t deficit for the latter to a 72,000t surplus. These higher estimates largely reflect a stronger than previously anticipated response to higher prices, particularly in Indonesia, and a more considered assessment of rainfall in West Africa in the build-up to the 2009-2010 season's main crop – particularly over the key producing areas in Ivory Coast. Rainfall between the start of April and the end of May in 2009 in Ivory Coast was slightly lower than average, but during July-August that year was close to normal. However, there was significantly lower rainfall during the whole of October, and this stressed trees and impacted overall output in the main crop. The increase in the estimated surplus for the 2010-2011 season is again largely attributable to output in West Africa, where, according to our assessment, rainfall from the start of April and throughout May has been very good for the time of year.

Cocoa supply & demand balance, 000 tonnes

	2007/08	2008/09	2009/10	2010/11
Africa	2,607	2,457	*2,406*	*2,592*
Americas	430	464	*498*	*535*
Asia	599	615	*650*	*681*
Total production	3,636	3,536	*3,554*	*3,808*
Net production*	**3,600**	**3,501**	***3,518***	***3,770***
Europe	1,652	1,540	1,589	1,588
Africa	560	592	*597*	636
Americas	800	752	790	807
Asia	693	599	*630*	667
Total grindings	**3,705**	**3,483**	***3,606***	**3,698**
Balance	**(105)**	**18**	***(88)***	***72***
End stocks	1,475	1,492	*1,405*	*1,477*
Stocks/grindings ratio**	40%	43%	*39%*	*40%*

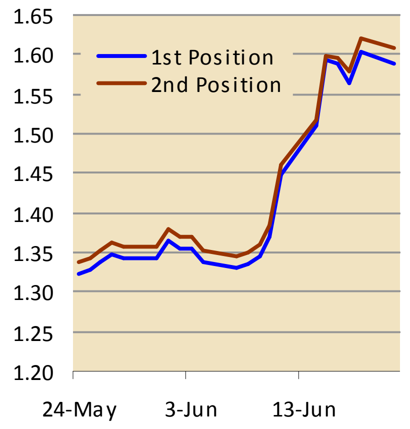
**1% less than total production to account for a loss in weight due to reduced moisture during transport ** Stocks as a % of total grindings. Italics denote revisions from previous report.*
Source: Fortis Bank Nederland

Coffee

News

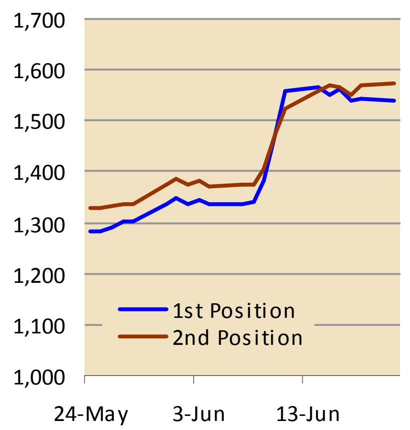
- **June 22:** The Guatemalan coffee growers' association, Anacafe, said that coffee exports from Colombia, the Dominican Republic, Mexico, Peru and five central American producers were almost 2.4m 60 kg bags in May, around 1% lower than the same month last year. Cumulative exports by the group since the start of the 2009-2010 season, in October, were almost 16m bags, almost 11% lower than for the same period of the 2008-2009 season.
- **June 16:** Coffee producers in Colombia called for ICE Futures US to abandon plans to adjust the terms and conditions of the arabica futures contract to permit Brazilian arabica to satisfy delivery requirements. Currently Brazil is not on the list of 19 arabica producing countries allowed to deliver coffee to the exchange's warehouses.

Arabica coffee, ICE Futures US, $/pound



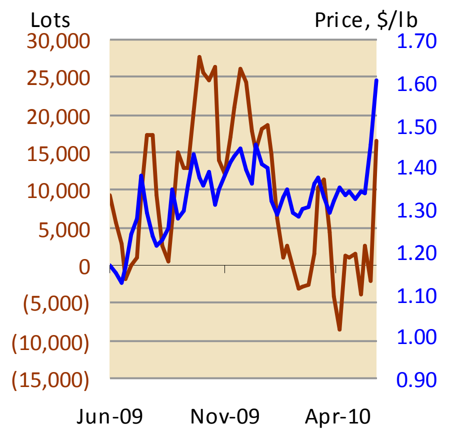
Source: VM Group

Robusta coffee, NYSE LIFFE, $/tonne



Source: VM Group

Arabica speculation, lots and price



Source: VM Group

Short term outlook

With hindsight, the shift into backwardation in the arabica market was perhaps a strong indication that the dramatic price rally in mid-June– which saw the second position contract on ICE Futures US gain 25 cents to $1.62/pound in short shrift and then a further 14 cents, having previously spent all this year in a dull drift between $1.30-$1.45/pound – owed much to a bout of intensive (and increasingly desperate) short-covering, rather than any serious and immediate concern that the fundamental supply-demand structure of the market has abruptly changed. But a rally is a rally, even if it is essentially based on technical matters.

Unsurprisingly, this shift to a higher level has gone hand-in-hand with an equally dramatic upsurge in speculative investment levels. In the week ending 15 June (the latest data available) according to the CFTC the non-commercial net long position in arabica futures on ICE Futures US shot up by 16,459 lots, with a rise of 11,683 longs and a fall of 6,729 shorts from the previous week, and reversing the previous week's overall net non-commercial short position of 1,953 lots. This is almost the highest net long seen so far this year, only some 2,000 lots below the net long non-commercial position seen in the week ending 19 January, when it was 18,493 lots. The non-commercial gross short remains large however, as it is still thought to be housing substantial arbitrage short positions. The net index traders' position also rose quite sharply, by 3,501 lots, to 55,612 lots.

The big worry about such an abrupt reversal in the non-commercial position is, of course obvious – what goes up fast may well come down equally rapidly. Arabica futures have now risen by 35% from where they were 12 months ago (as of the week ending 18 June). Robusta futures in London have followed suit and, by the close of business on Thursday 24 June were $1,649/t, up by 26% from 12 months' previously – 24% of that coming in the past month and 6% in the past week alone. By the same date, arabica futures closed at $1.69/pound, 40% higher than this time last year, 26% of that in the past month. The current non-commercial net long position may look chunky (and indeed is the biggest so far this year) but put into context it's not overly burdensome.

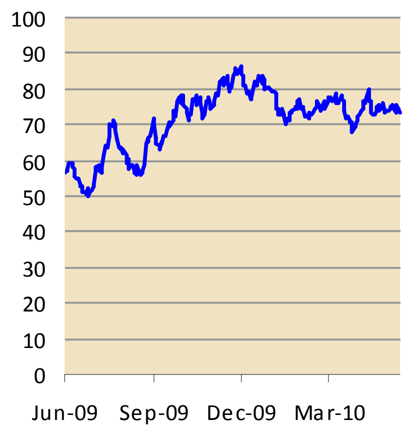
Analysis

The surge in coffee futures' prices has been a largely technically driven rally – as prices moved higher, shorts have been gradually forced to cover gradually higher and higher levels of exposed positions – but there are some sound fundamental reasons that have sparked the shift higher. While there have been

Arabica index fund investment, lots

Source: VM Group

Arbitrage between ICE Futures US and Liffe 1st month contract, cents/pound



Source: VM Group

no serious weather threats and no abrupt events that threaten to remove the probability of global arabica and robusta surpluses in the current 2009-2010 season, there has been a relentless drip-drip pull on certified stocks in both New York and London for months. It's also true that output and shipments of higher-quality arabica from Colombia remain very much lower than in seasons past; flows from Vietnam ground to a standstill when prices dropped to around $1,200/t; and there is a justification for the view that prices for both coffees had previously declined to levels that signally failed to attractive enough to the sellers. This being said the rally in London has re-invigorated Vietnam's physical market with differentials moving to $100 under from $20 over. It's almost as if speculative investors had been in a Rip van Winkle stupor and finally awoke to the possibility that, if stocks continue to be drawn down in London and New York at the current rate then, no matter if there are big harvests coming from Brazil (arabica) and Vietnam (robusta), they may not be enough to prevent stress-points in physical markets later this year. On that note, as of 18 June certified arabica stocks in New York were slightly over 2.253m 60-kg bags, the relentless drawdown continuing, with stocks down by more than 40% from where they were this time last year. In London as of 14 June certified stocks on NYSE Liffe were 20,868 lots, a decline of more than 45% since late 2009, with the fortnightly average drawdown now 922 lots – at this rate by the end of November this year London stocks will be under 10,000 lots.

This time of year the arabica market typically becomes hypersensitive to the possibility of frost damage to Brazil's developing arabica buds – and this year is no exception, even though there is no sign of unusually cold weather passing across the country's main coffee growing regions. Robusta may, however, be slightly different in that there could conceivably be concern about Vietnam's recent rainfall – there are reliable indications that rainfall levels in the key provinces of Daklak and Gialai have been 30% lower than usual for the time of year, quite some way into what is usually the rainy season. Vietnamese farmers have been forced to revert to artificial irrigation much more than usual; this costs them money, and money spent there might be taken from other important inputs, not least fertilisers. And paradoxically the big rise in robusta prices has encouraged a surge of commercialisation of coffee in Vietnam – meaning that carryover stocks for 2010-2011 will be that much lower. (One side effect of the price surge is that it is likely to kill off all hopes for the country's planned 200,000t state-sponsored 'buffer' stock). In the other major robusta producer, Indonesia, there has been too much rainfall in some coffee regions, meaning difficulties in gathering the harvest and a higher-than-usual incidence of mouldy beans.

Coffee supply & demand balance, million 60 kg bags

	2008/2009		2009/2010		2010/2011	
	Arabica	**Robusta**	**Arabica**	**Robusta**	**Arabica**	**Robusta**
South America	52.15	12.82	48.79	13.48	54.93	14.00
Central America	17.73	0.23	17.98	0.23	17.38	0.03
Africa	8.85	7.65	8.55	7.75	8.67	7.85
Asia	3.85	33.65	4.36	31.95	4.56	31.45
Rest of world	0.45	0.36	0.45	0.36	0.45	0.36
Total Production	**83.03**	**54.71**	**80.13**	**53.77**	**85.99**	**53.69**
Demand	**78.55**	**49.15**	**79.02**	**49.68**	**79.32**	**50.71**
Balance	**4.78**	**5.56**	**1.11**	**4.09**	**6.67**	**2.98**

Source: Fortis Bank Nederland

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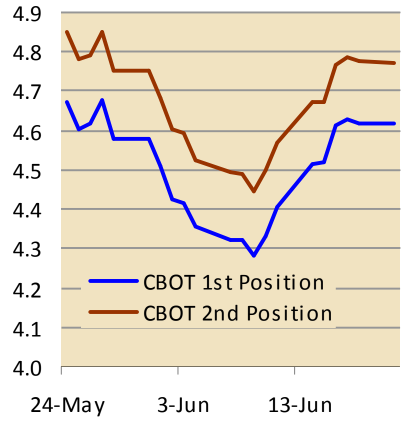
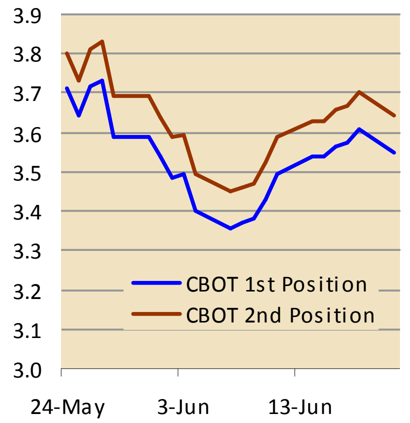
Wheat, CBOT, $/bushel



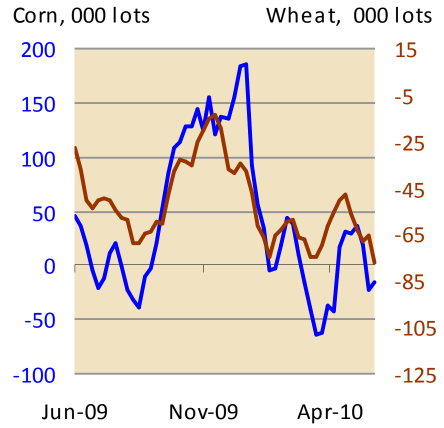
Source: VM Group

Corn, CBOT, $/bushel



Source: VM Group

Corn and wheat speculation, 000 lots



Source: VM Group

Wheat & Corn

News

- **June 23:** China's ministry of agriculture said the country had harvested 84% of its winter wheat, which accounts for around 90% of the country's wheat output. The country's National Grain and Oil Trade Centre, a state-managed agency, said earlier in June that 2010 output of wheat was expected to be flat year-on-year at 115.1 Mt. However, independent estimates cast some doubts about achieving that level, given adverse weather conditions during the early stages of the crop development.
- **June 23:** A representative of the USDA's international crop projection's department asserted that the combination of factors that created the conditions for CBOT wheat futures to spike to a record $12.80/bushel in February 2008 would be unlikely to be repeated in the next three decades.
- **June 21:** The USDA in its regular weekly crop ratings report slightly downgraded its view of the US corn crop, saying some 75% of the developing crop was in good/excellent condition, compared with 77% the previous week, and downgraded the good/excellent condition of the soybean crop from73% to 69%. Recent heavy rainfall in the US Midwest has slightly impaired crop development.

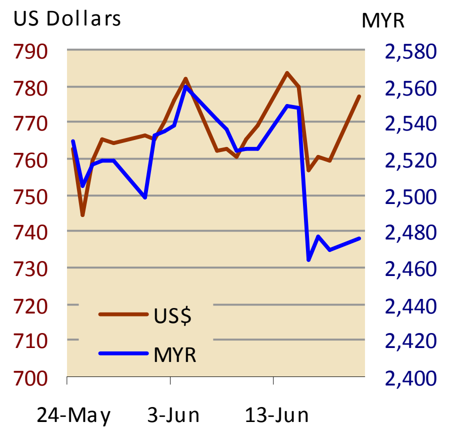
Short term outlook

Crop development in the US remains excellent with what many are describing as 'greenhouse-like' conditions – a good mixture of heavy rainfall and warm temperatures. Some parts of Iowa and north Illinois have had, if anything, a little too much rain. Since our report last month there have been no significant changes to estimates regarding the outlook for the corn or wheat global supply-demand balances; the prospect remains one of substantial crops in the US and other major producers, and for large surpluses as far as the eye can see. Perhaps the only surprise is that futures' prices remain relatively robust – on the CBOT wheat prices have slipped by 17% from where they were 12 months ago but staged a mini-rally in the week ending Friday 18 June, gaining 5% largely on fears aroused by the heavy rainfall in the US Midwest.

Analysis

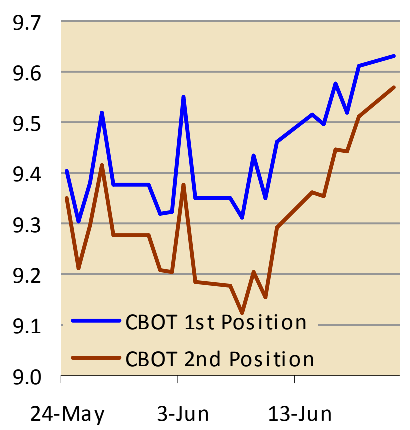
What to do with the looming grains' glut? Just a couple of years back the world was in a panic about insufficient supplies of corn and wheat – today the anxiety is about finding sufficient storage capacity to house the looming surpluses. Partly this problem is a consequence of a very rapid expansion of the global area sown to grains and oilseeds, rising by 82m acres in the past four years, according to the USDA. Partly it's the fault of the multiple price spikes in 2008, which encouraged farmers everywhere into imagining that the long-term food supply crisis was actually a short-term matter, so they went into output overdrive, with the result that (according to the UN's Food and Agriculture Organization), global cereal reserves will this year be 24% bigger than two years ago. And partly it's down to the simple matter of almost universally excellent weather conditions for all the main cereals' producers, with an end to droughts in South America, Australia, and ideal growing conditions in the US for two successive seasons. Just about the only bullish factor at play in the wheat world right now is the exceptionally heavy rainfall across Canada's prairies, which will certainly cut its wheat output later this year – but probably not by enough to make much difference to the vast global wheat stocks that are likely to be with us by the end of the 2010-2011 season, which the International Grains Council sees as being 201 Mt, their highest in nine years.

Palm oil, BMDM, price/tonne



Source: VM Group

Soybeans, CBOT, $/bushel



Source: VM Group

Palm oil & soybeans

News

- **June 23:** Indonesia's trade ministry said it would keep its export tax rate for crude palm oil at 4.5% in July but lower the base price – used to calculate the tax rate – from $754/t (as in June) to $732/t.
- **June 10:** India's imports of soyoil by the end of the current marketing year (the end of October) could be as much as 50% higher than the previous year, according to the Bombay-based oilseeds' importer Palmtrade Services. The company suggested that as the premium of soyoil over palm oil has shrunk to about $40/t from as much as $150/t, India's soyoil imports could be as high as 1.6 Mt this year, compared with just under1 Mt last year.
- **June 10:** Chinese imports of soybeans in May totalled 4.37 Mt, 24% higher than the same month last year and 4.3% more than in April. Expectations are for a similar or possibly higher volume of imports for June.
- **June 10:** Argentina's soybean harvest was almost complete, with the final tally likely to be a record 55 Mt, according to the Buenos Aires Grain Exchange.

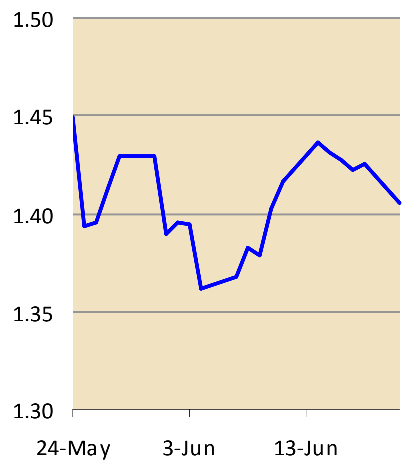
Short term outlook

What is keeping soybean futures' prices up as high as they are? The July contract on CBOT closed 22 June at $9.65/bushel, 2.25 cents higher, while the most actively traded contract, November, that same day slipped just 3 cents, to $9.36/bushel. It can hardly be because the world has failed to grasp the fact that supply in the 2009-2010 season is rebounding from the prior season's drought-hit output from South America. Global soybean stocks by the end of August this year may well be as much as 70 Mt, a vast carryover into the next season. The only real explanation is that Brazilian and Argentine shipments have slowed in recent weeks, as exporters there withhold crops to strike better deals, in the knowledge that US soybean stocks currently remain rather tight. This will change later in the year, so long as the US soybean areas continue to have good weather conditions. If the world wants soybeans between now and August, when the US crop starts to make itself felt, it has no alternative but to get them from South America.

Analysis

US planting and growing conditions for soybeans have been good to excellent for most of this year, except for some excessive rainfall in the past couple of weeks. There remains however a degree of uncertainty about the probable size of the final US soybean crop – which may exceed 90 Mt this year, only slightly lower than last year – and that, plus the nearby tightness of physical supply within the US, is keeping prices higher than might otherwise be expected. The very large stocks of soybeans currently being held back by South American producers, all of whom have turned in substantial crops in 2009-2010, will have to come to market sooner or later – and probably sooner, to avoid the risk of having to compete (at what will probably be a significantly lower price than today) with US exporters come September. For the time being China also remains a soybean price supporter, its vast imports of soybeans partly going into soyoil production as its shunning of Argentine soyoil continues.

FCOJ, ICE Futures US, $/pound



Source: VM Group

Frozen concentrated orange juice

- **June 22:** The independent weather forecasters Weather Services International said it expected the current Atlantic hurricane season to result in 20 named storms and 11 hurricanes, five of which would be category three or stronger. This is significantly above the long-term average of 1950-2009 of 10 named storms and six hurricanes, two of which were severe. The 2010 Atlantic hurricane season is expected to be as active as 2005, when a record four major hurricanes hit the US.
- **June 10:** The USDA raised its estimate for the 2009-2010 Florida crop by 2m 90-pound boxes to 133.6m boxes. It left the estimated yield per box at 1.55 gallons. This moderate revision was widely anticipated.
- **June 1:** Brazil exported 154,500t of FCOJ in May, 5,700t more than the corresponding month in 2009, according to figures from the country's foreign trade ministry.

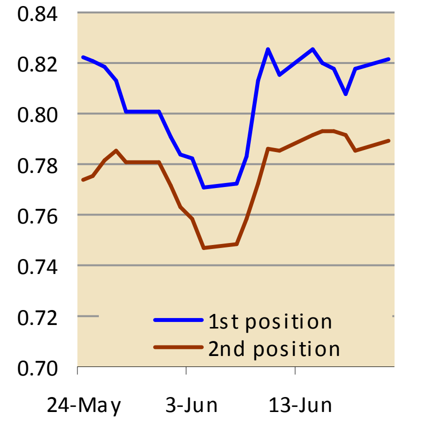
Short term outlook

FCOJ futures on ICE Futures US led the pack of commodity price risers at the start of this year but have since been slightly eclipsed by others, although as of the close of the week ending 18 June they remained a remarkable 90% higher than 12 months previously. Prices have been pretty much range-bound since last month's report, the nearby (July) contract closing on 23 June at $1.3995/pound, barely changed on the previous day, with the whole forward curve fairly flat, the furthest dated contract (May 2012) settling that same day at $1.5035/pound. But with the consensus being that this year's hurricane season is going to be a humdinger, there's every chance of the recent dullness livening up if storms approach the Florida coast.

Analysis

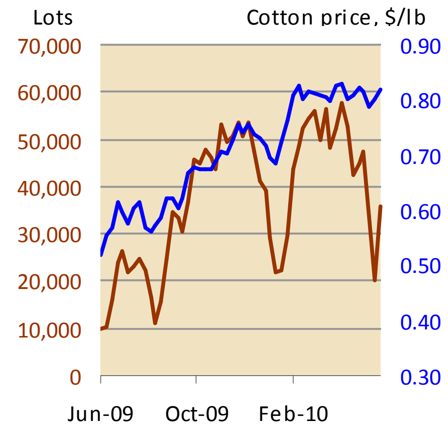
Now that the 2009-2010 Florida crop is more than 90% harvested the fate of FCOJ futures' prices is (mostly) in the hands of Mother Nature. By now FCOJ futures have fully priced-in the expectations of a very busy Atlantic storm season up to the end of November, and it's only to be expected that the driving force behind prices will be weather-related. Demand remains subdued and hesitant and the latest evidence of a truly sluggish US economic recovery – sales of single-family homes in the US collapsed by 33% in May to a record low, one month after the expiry of tax incentives – will act as a depressant to consumers across the country. US unemployment is stubbornly stuck at 9.7% and those with jobs are feeling deeply insecure. Belt-tightening remains the order of the day; among the items many households feel able to cut back on is orange juice. One day, no doubt, demand will surge back – but that day looks a little longer in arriving.

Cotton, ICE Futures US, $/pound



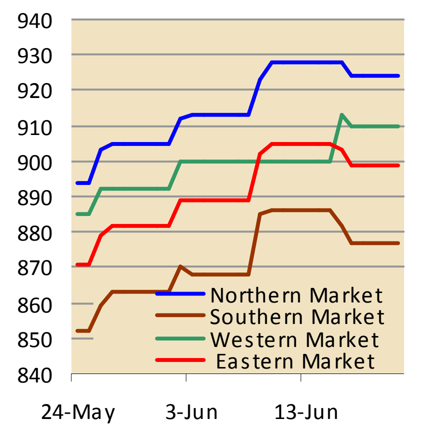
Source: VM Group

Cotton speculation, lots and price, $/pound



Source: VM Group

Wool prices, Australian market, Aus c/kg



Source: VM Group

Cotton and wool

News

- **June 23:** Namoi Cotton Co-operative, Australia's biggest cotton processor, forecast that cotton production in Australia could rise 50% in the 2010-2011 season, as farmers are tempted to switch to cotton from other crops. Namoi anticipates that the area planted to cotton in the upcoming season could rise to 300,000 hectares, compared with 210,000 hectares last season. Australia's 2009-2010 harvest totalled 1.6m bales (364,000t); with good rainfall and expanded crop planting this could rise to 2.5m bales (590,000t) in 2010-2011.
- **June 23:** Reports from India suggest that the government may scrap its export tax on cotton by the end of September. The tax was first imposed in April following intensive lobbying by local textile producers, who argued that high international prices were encouraging large export volumes and that their own industry was threatened by rocketing domestic prices. Earlier in the month Indian official estimates put the country's 2010-2011 cotton crop at 29.5m bales (6.7 Mt).
- **June 21:** China imported 197,938t of cotton in May according to customs data. This was 31% higher than the same month last year and brought the country's total cotton imports for the January-May period to 1.37 Mt, more than twice as much as the same period in 2009.

Short term outlook

Cotton futures on ICE Futures US have been stellar investments in the past 12 months and (as of the week ending 18 June) were 47% up on where they were a year ago, but the 1% rise in the past month has been less awe-inspiring. As of close of business on 22 June the key contract on ICE closed at 79.21 cents/pound while the front-month (July) contract ended at 82.46 cents/pound. While the price rise has eased off the pedal recently there are still some bullish supportive factors at work although not necessarily in the short term. Estimates from the USDA project global supply in the 2010-2011 season could fall short of demand by as much as 14.5%, but this is obviously contingent on the global economic recovery not stalling. A stronger Chinese currency – the certainty and extent of which remains in doubt – would naturally be supportive of prices.

Analysis

Higher commodity prices generally have only one response, all things being equal – higher production. This is certainly likely to be the case with cotton in the coming 2010-2011 season. The consistently strong prices for cotton this year are evoking a strong response from US farmers, who are expected to plant a much bigger area to cotton this year. From planting just 9.15m acres to cotton in the (depressed and dispiriting) year of 2009, US farmers this year are likely to plant more than 10.5m acres according to the USDA – even more, according to some independent crop forecasting agencies. Their output is consequently likely in the 2010-2011 season to rise to 16.7m bales compared with 12.19m bales in 2009-2010. For cotton futures to rise much higher – or perhaps even cling onto the gains they have made over the past 12 months – the global economic recovery needs to pick up a lot more speed.

Fund activity

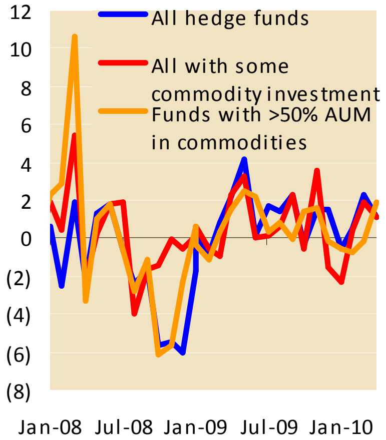
News

- **Jun 16:** Hedge fund assets under management could grow to $3 trillion by 2013, according to Connecticut-based investment manager consultant Casey Quirk. The growth is expected to continue despite a raft of regulatory changes which will make the operating environment of the alternative investment managers more challenging, because funds will – so runs the theory – benefit from increased inflows from institutional investors. Hedge funds are fast gaining favour among some of the biggest pension funds in the world, their active management strategies being a fair counterbalance to the traditionally more staid stuff of retirement scheme portfolios. Commodity plays are also attracting interest from pension funds.
- **Jun 7:** The US House and Senate passed new legislation to regulate the OTC derivatives market, with an estimated value of $615 trillion. The two separate Bills will now need to be amalgamated into one for President Obama to sign into law by 4 July. The combined bill will include provisions for central clearing of "standardised" swaps but allow for certain exemptions primarily for commercial end users – a distinction which is likely to exclude hedge funds. Clearing houses will be subject to regulation and will not be eligible for government bailout funds. Major swap dealers and market participants will be required to register with regulators who will enforce minimum capital and margin requirements. Both Bills include provisions for the enforcement of position limits. The provisions in the Senate Bill are intended to protect the "price discovery function" of the underlying commodity, something considered to be compromised by "excessive" speculation.

April: poor returns

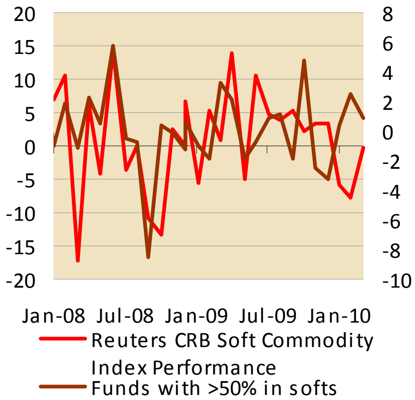
April returns were poor compared to February and March, and preliminary data point towards a similar result in May. Preliminary estimates suggest an average return of 1.07% in May. Average returns for all hedge funds in our database fell from 2.33% in March to 1.10% in April. Funds with commodity-weighted strategies returned 1.27%, those with over 50% of their assets exposed to commodities showed slightly better returns of 1.89%. Softs funds struggled to make headway during April, returning 0.92%. Funds with investments in the energy sector returned 0.98%, below the aggregate sample, but outperforming the Reuters CRB Energy Index, which fell 3% in April. Metals funds fared marginally better than the broader sample, returning 1.12%. As usual, performance was diverse with some strong recoveries amid the general malaise. Despite the stalled recovery in returns, assets under management continue to increase, reaching $1.07 trillion for our sample. Commodity funds are gaining in their share of the total asset sample, at $293.09bn. Returns in May are expected to show the strain of broader market volatility. The VIX Index, tracking volatility on the S&P 500, hit a 10-month high of 45% on 21 May, after dipping to 15.5% on 12 April.

Hedge fund returns by commodity weighting



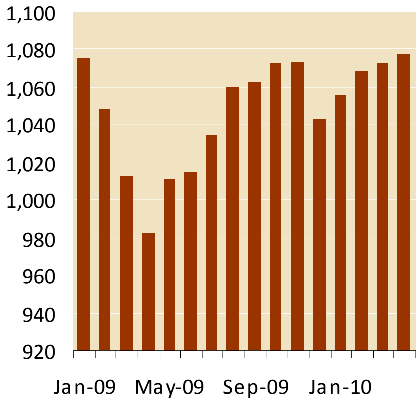
Source: VM Group

Hedge fund returns in softs, % monthly



Source: VM Group

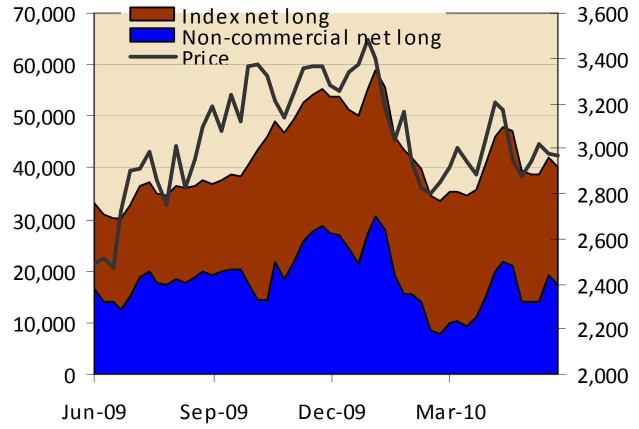
Hedge funds AUM $bn



Source: VM Group

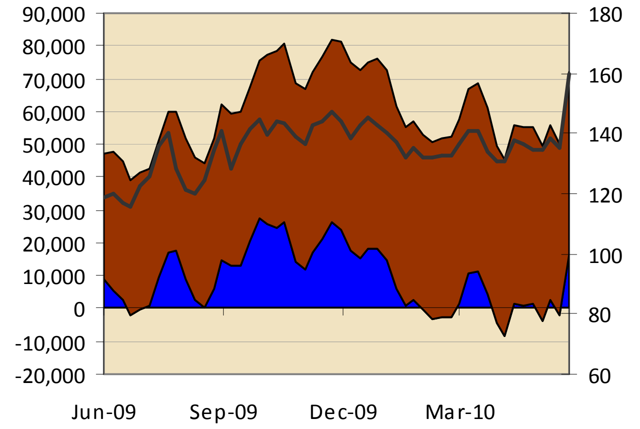
CFTC positions

Cocoa, ICE Futures US, lots & $/tonne



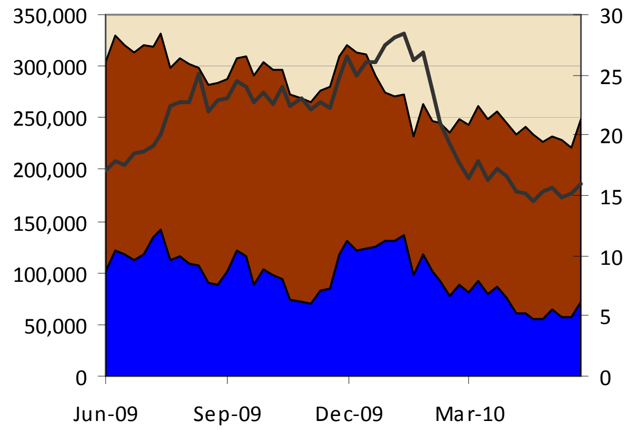
Source: VM Group, CFTC

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



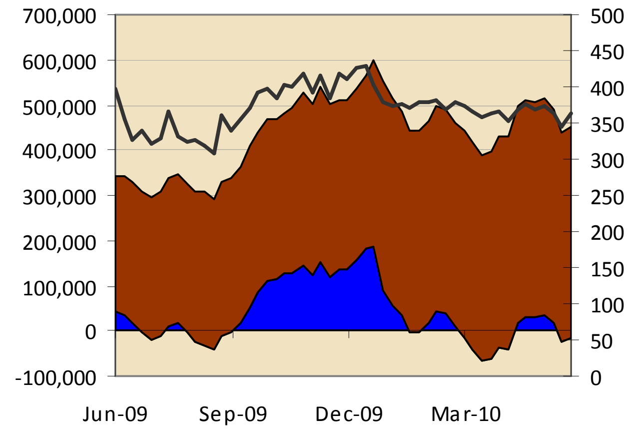
Source: VM Group, CFTC

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



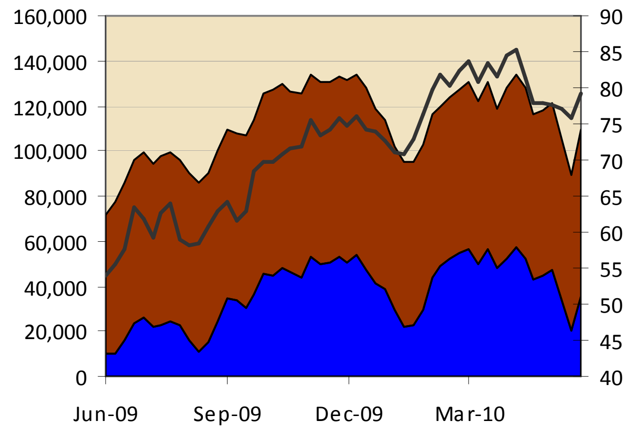
Source: VM Group, CFTC

Corn, CBOT, lots & cents/bushel



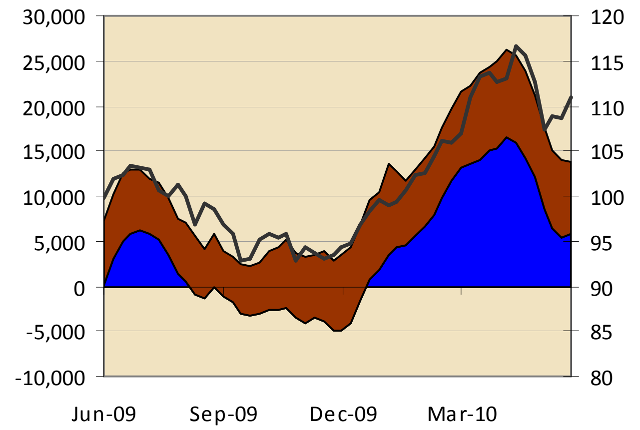
Source: VM Group, CFTC

Cotton no.2, ICE Futures US, lots & cents/pound



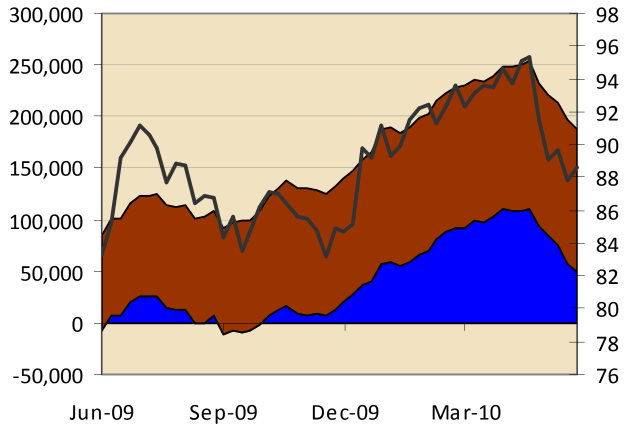
Source: VM Group, CFTC

Feeder cattle, CME, lots & cents/pound



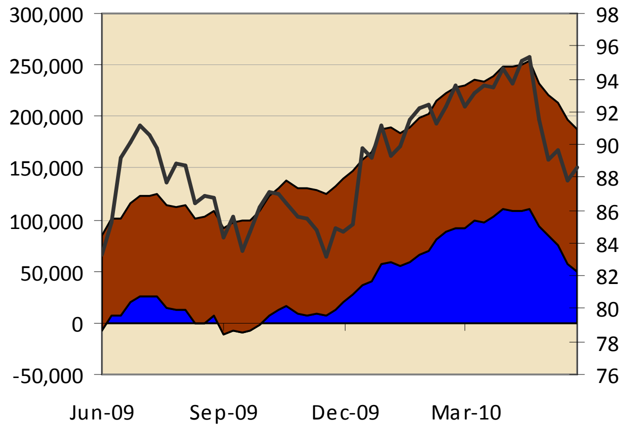
Source: VM Group, CFTC

Lean hogs, CME, lots & cents/pound



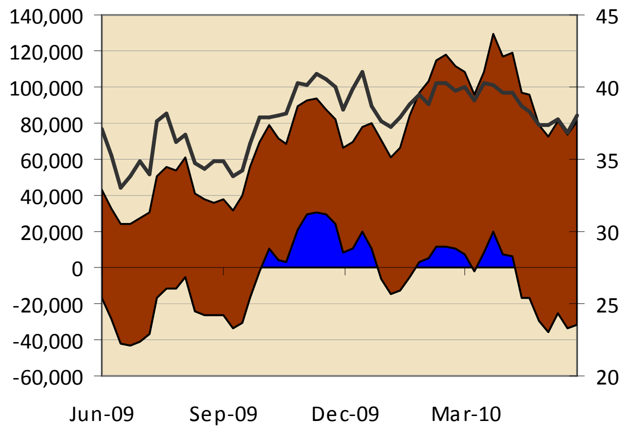
Source: VM Group, CFTC

Live cattle, CME, lots & cents/pound



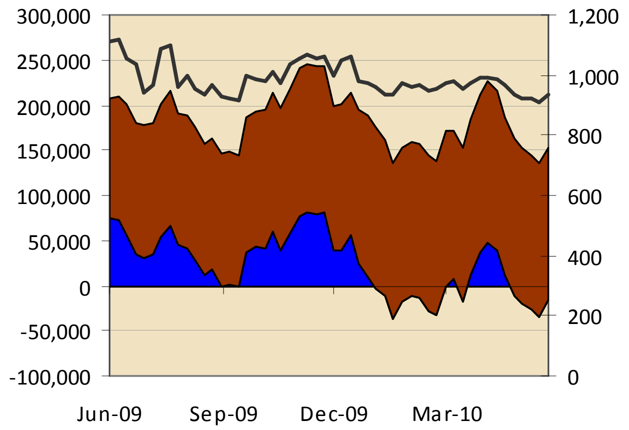
Source: VM Group, CFTC

Soybean oil, CBOT, lots & cents/pound



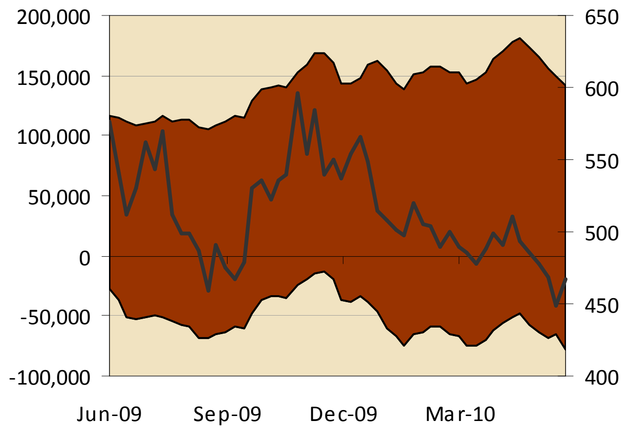
Source: VM Group, CFTC

Soybeans, CBOT, lots & cents/bushel



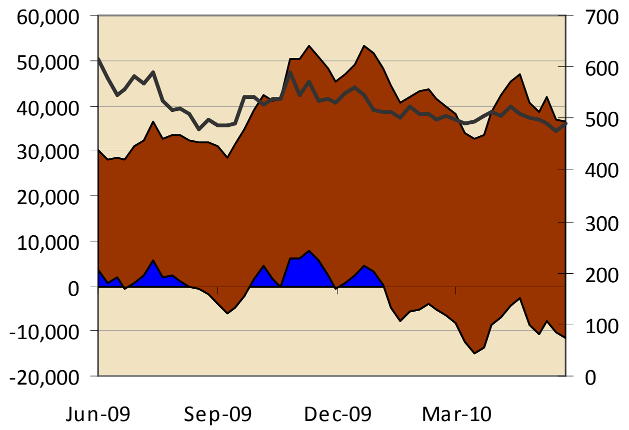
Source: VM Group, CFTC

Wheat, CBOT, lots & cents/bushel



Source: Source: VM Group, CFTC

Wheat, KCBT, lots & cents/bushel



Source: VM Group, CFTC

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

About VM Group

VM Group is a commodities research consultancy that covers not just agricommodities but also conventional and renewable energy, carbon trading, base and precious metals. 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.

VM Group work excels in macro-economic analysis, the generation of supply and demand scenarios, costs analysis, derivative research and price forecasting. Confidentiality, experience and independence are key elements in this advisory capacity. We deliver excellence to those in need of external expertise, as well as those who wish to supplement their own in-house resources. Our extensive international contacts mean we are able to span the globe.

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

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