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PALM OIL: FUTURE RISK

VM GROUP

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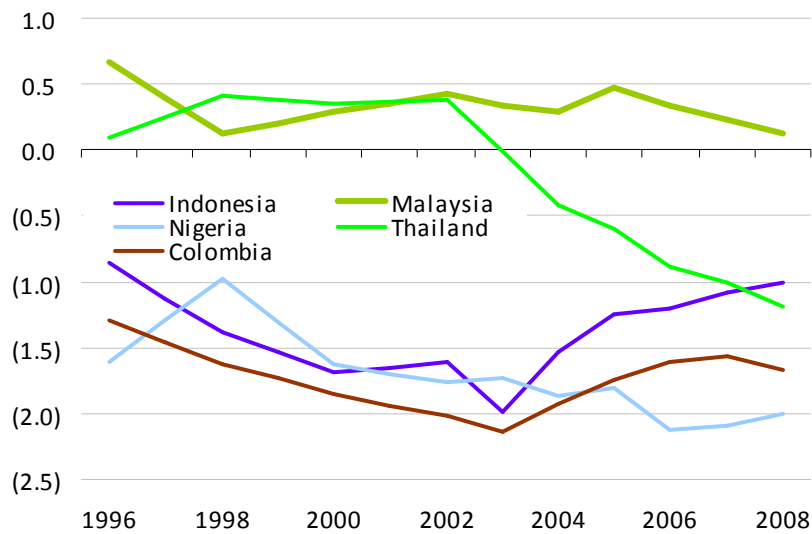
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Introduction

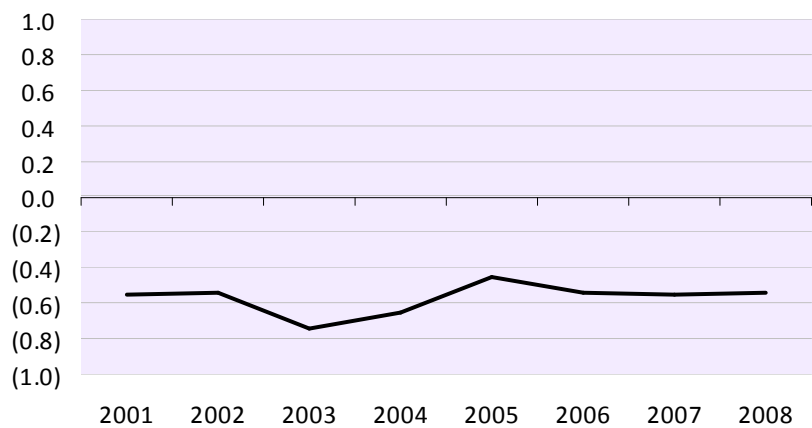
This report examines future risk in crude palm oil (CPO) production. It analyses political stability in the top producers and reviews the history of palm oil cultivation and trade, and examines its contemporary applications and price movements. It looks at risks on the demand and supply sides, including country risk in the main producers and exporters in the short to medium term. It also reviews the broader global picture in terms of economic risks, commodity performance and geopolitical threats, and how they might impact the market.

Future risk

Political stability in the top five palm oil producers



Political stability worldwide weighted by share of global palm oil production



Source: VM Group

In both the supply of and demand for CPO there are political and other risks that represent threats to the future expansion of this relatively well-established commodity industry. The charts above show the evolution of political stability for the leading CPO producing countries: Indonesia, Malaysia, Thailand, Nigeria and Colombia. We measure political stability based on the World Bank's worldwide governance indicators, where zero is the average political stability worldwide; below zero means a country is more unstable than average, above zero means it is more stable than average. Weighting the political stability by each producer country's share of output (and including all 27 producers, not just

the top five) shows that palm oil production is carried out, on average, in countries that are slightly unstable, and this has been relatively constant so far this century.

The past decade has seen an explosion of interest in biofuels.¹ There are three main reasons for this: the desire for energy independence; the rising cost of fossil fuels; and environmental concerns about the impact of burning hydrocarbons (and consequent release of carbon into the atmosphere). The paradigm shift towards much greater use of bioethanol has been driven by a raft of government mandates – in the US, the EU and Brazil especially – which has underpinned the growth of the biofuel industry. The UN environmental programme (UNEP) noted in 2009 that world ethanol production tripled from 17bn (billion) to 52bn litres between 2000-2007, and is estimated to have risen to 65bn during 2008.

But while fuel ethanol production and consumption has soared, world production of biodiesel has grown at a much slower pace, from 1bn litres in 2000 to around 12bn litres in 2008. Partly this is because biodiesel, unlike bioethanol, has had little or no government support in the form of mandates to blend biodiesel with conventional diesel. This has had a direct impact on CPO, which many had regarded as having a much bigger future in biofuel expansion than has so far proved the case.

CPO had been seen as providing a perfect feedstock for the biodiesel sector because of its large yields and its established cultivation base. But the difficulty for the CPO industry is that CPO prices have become closely tied to crude oil prices, rendering the substitutability of biodiesel less competitive than previously hoped. The higher prices of CPO, plus the failure of governments to provide incentives for production by imposing mandated blending of biodiesel, has left the sector in a state of considerable uncertainty about the longer-term viability of biodiesel and, consequently, that of CPO as a biodiesel feedstock. Currently, about 10% of CPO production is used as a feedstock for biodiesel.

The sad irony is that a booming palm oil sector could have been a gift to emerging economies, many of which have substantial tropical rainforest belts ideally suited to CPO production. An economically productive agricultural sector would have been a boon, providing foreign exchange and attracting investment, driving agricultural and economic development and boosting trade. But global environmental activism has systematically criticised and lobbied hard against using CPO for fuel purposes, on the basis that currently palm oil cultivation is harming ecosystems, hurting indigenous communities and reducing Earth's biodiversity. The public image of CPO production is also being damaged by allegations of associated problems of corruption and repression by producers and governments. As a consequence, palm oil is increasingly viewed as a 'toxic' crop. Even worse, the concept of sustainable palm oil – offered as a solution to this problem – has not yet been sufficiently taken up by buyers, many of who are deterred by the widespread market uncertainty.

The burden (as so often) is falling on farmers in emerging markets to try to second-guess the whims of manufacturers and consumers in more mature markets. This situation ultimately benefits neither the environment nor consumers. Government help in the form of supportive taxation, tariffs and blending mandates would enhance the prospects of CPO emerging as the main form of biodiesel feedstock, but presently, the lack of fiscal support to producers combined with sustainability concerns by consumers, and the myriad supply-side risks outlined in this report all suggest that the future for palm oil – certainly in terms of its demand as a biodiesel feedstock – is plagued with risk.

¹ Biofuels are renewable, combustible fuels derived from biomass. The two main types of biofuel are ethanol and biodiesel. Biodiesel can be made from either vegetable oil or animal fat feedstocks, which are chemically transformed into diesel fuel. Biodiesel can be used with petroleum-based diesel in existing (unmodified) diesel engines.

History, cultivation and trade of palm oil

The bulk of the world's palm oil is now grown and harvested in regions where the plant is not native – Asia and Latin America. *Elaeis Guineensis*, the African oil palm plant, originated in Guinea, West Africa, where it is still a staple crop. Although the oil palm has been used for some time in other parts of the world, (there are even indications that it was used in Pharaonic Egypt), its large scale cultivation and processing only really got started in the early 20th century.

The introduction of the oil palm to areas outside Africa occurred during the 19th century, when planting of it started in Malaysia (previously British Malaya), and in Indonesia. By 1911, significant oil palm plantations were established in both countries. The journey to Latin America came later, with a recorded introduction to Colombia in 1932. The United Fruit Company began industrial scale cultivation in 1945, and western hemisphere palm oil production grew after that.

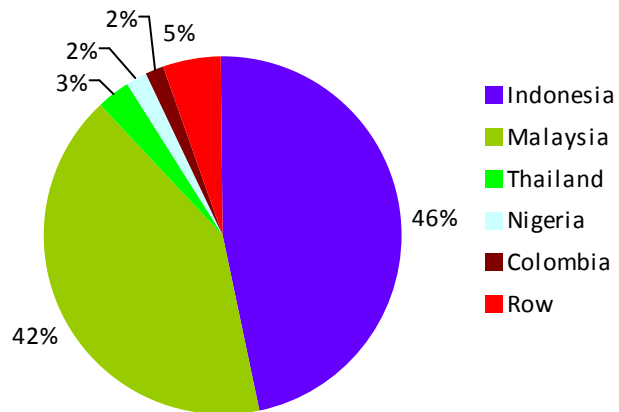
Like other palms, the oil palm grows in tropical rainforest areas, within a 10° band of the equator. It is a perennial and, if well managed, has an economically productive life of 25-30 years. It is prized for its fruit, which grows in bunches (referred to as Fresh Fruit Bunches – FFB) and contains both a soft pulp and a hard seed with a kernel. The fruit can be harvested throughout the year but must be processed within 24 hours of picking, so mills are usually sited close to the cultivation areas. When mashed the pulp produces crude palm oil (or CPO). The seed, when pressed, releases palm kernel oil. These are related but distinct products. Potential crude palm yields are high, with an average annual yield of 5 tonnes of oil (excluding palm kernel oil) per hectare – the highest efficiency ratio of yields per hectare of any comparable oilseed crop or vegetable oil.

Palm oil's key attributes are its abundant fruit and oil, and therefore its low price relative to other edible oils. It is highly versatile, and is used in a range of applications. CPO is refined and then used in two main forms: as liquids (palm olein) and solids (palm stearin). These are used as oleochemicals in the industrial and chemical sectors, and as edible fats and oils. The less refined palm kernel oil is higher in saturated fats, and can be made into a cake for animal feed, or used as cooking oil. Both CPO and palm kernel oil can also be processed for use as biodiesel. Estimates on usage vary, but it is particularly common in packaged foods, and is present as an ingredient in many supermarket products.

The palm oil trade has historically been directly linked to economic development. On the gradual abolition of slavery, vessels that had carried slaves from West Africa began to carry palm oil as cargo across the Atlantic. West African port cities such as Lagos became hubs of the international palm oil trade, and benefited from the increased demand – generated by the industrial revolution in Europe – for palm oil in the form of food oils and for household products such as soap. In the 1870s, exports of CPO from the Niger Delta averaged around 30,000 tonnes per year and, by 1910, exports from British West African territories – as they were then called – had reached 87,000 tonnes per year. The dominance of West Africa, Nigeria especially, in palm oil trade continued until the 1930s, when production from Malaysia and Indonesia began to outstrip total yields from the entire African continent. Indonesia and Malaysia emerged as palm oil producer powerhouses due to a combination of supportive agricultural policies, intense research and development into cultivation practices, and existing skills in large-scale plantations, thanks to rubber production. The demise of the West African palm oil trade was in turn directly linked to the economic and political turmoil that followed de-colonisation.

Today, total annual CPO global production is about 45 Mt – significantly higher than the 33 Mt produced five years ago – with Indonesia likely to produce 20.7 Mt and Malaysia 18.5 Mt in the 2009-2010 season.

Share of world palm oil production 2009/2010

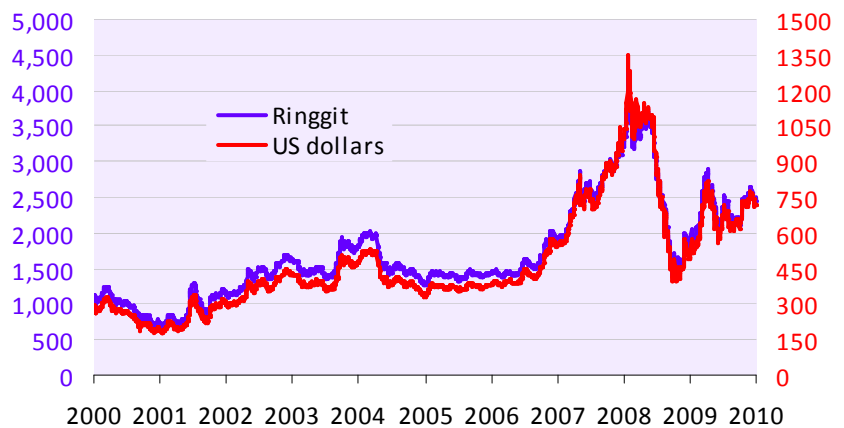


Source: VM Group

Palm oil prices

Palm oil has become the world’s favourite vegetable oil – ranked by production, trade and consumption. Palm oil accounts for more than one third of all the vegetable oil supplied worldwide, recently surpassing soyoil. It currently makes up about 25% of global oil and fat supplies.

Palm oil futures’ prices: MDEX, MYR/tonne & US dollars/tonne

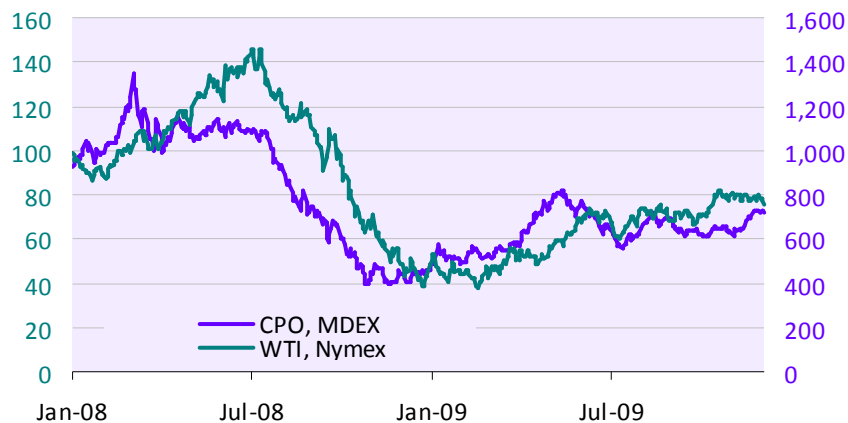


Source: VM Group, Bursa Malaysia

The main futures’ exchange for palm oil is the Bursa Malaysia, or Malaysia Derivatives Exchange, which has provided benchmark prices for the commodity since 1980. CME Group, the world’s biggest derivatives exchange, announced plans in 2009 to develop a dollar-based palm oil futures contract using the Bursa Malaysia settlement price for its Globex trading platform, which would effectively mean that Malaysian palm oil could be traded around the clock, giving US investors greater access to this market. However, although CME has acquired 25% of Bursa Malaysia’s derivatives unit, the two exchanges have not yet given a firm date for the launch of this contract. Bursa Malaysia prices are quoted in MYR/tonne; when converted into US dollars, CPO prices tend to track both crude oil and soybean oil prices. In the heady days of 2008, when most commodity prices reached new nominal peaks, CPO futures hit a peak of \$1,344/t in March before plunging to \$376/t in November, hit by the generalised

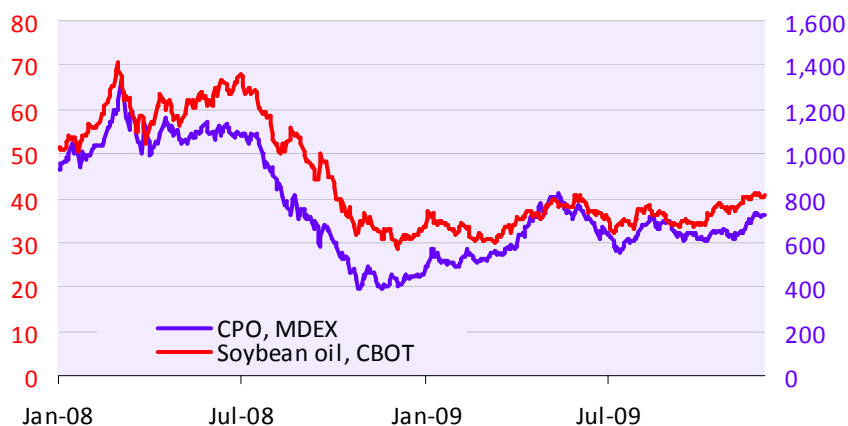
commodity price rout of late 2008. In 2009 they recovered, with a low for the year of \$488/t in January, and quickly reached their peak for that year of \$821/t, in May. At the time of going to press, CPO was trading at \$752/t.

Crude oil price (\$/barrel) v. CPO price (\$/tonne)



Source: VM Group

Soybean oil price (cents/pound) v. CPO price (\$/tonne)

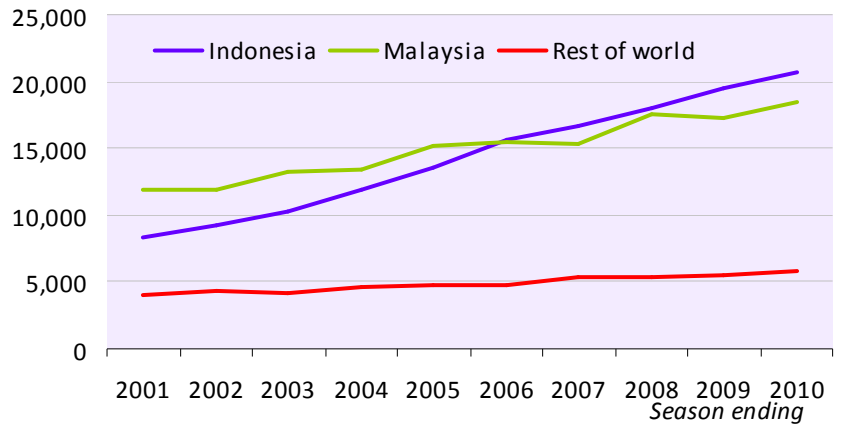


Source: VM Group

The use of CPO for both human consumption and as a key feedstock for biodiesel means that it occupies an unusual position when it comes to pricing – CPO prices can be and frequently are driven both by movements in crude oil prices and substitutable cooking oils.

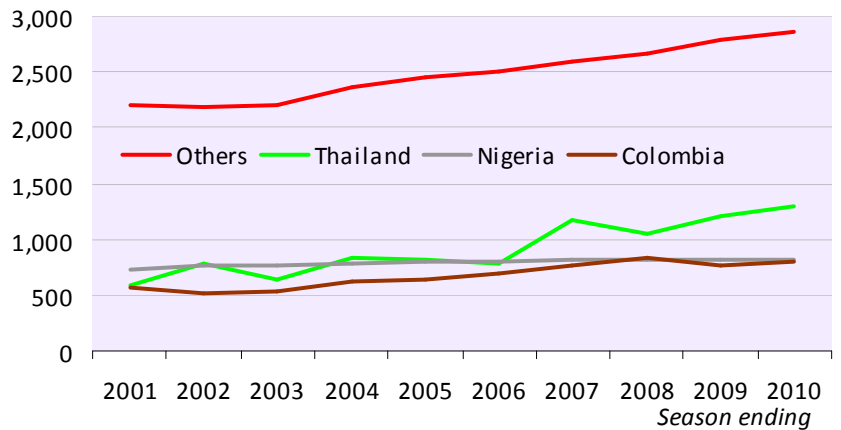
The average ratio of CPO prices to crude oil prices in 2009 was 10:1; that is, CPO prices per tonne traded at about ten times those of crude oil per barrel. We see this ratio as persisting in the medium term, although as ever in the current macro-economic environment, there is considerable scope for volatility. We anticipate crude oil prices rising to fresh nominal peaks by Q4 2010, driven largely by strongly growing demand from emerging markets (particularly in Asia) and slow demand recovery in OECD countries. This may not bring about a vigorous upward movement in CPO prices however, as the 2009-2010 season for global soybean production is likely to result in a substantial global supply-demand surplus and the replenishing of previously depleted world carryover stocks by the end of August this year. This in turn ought to mean that consumers of vegetable oils have access to plentiful supplies of soyoil, the closest substitute for CPO, thereby helping to restrain potential rises in CPO prices.

World CPO production since 2000, (000 Mt)



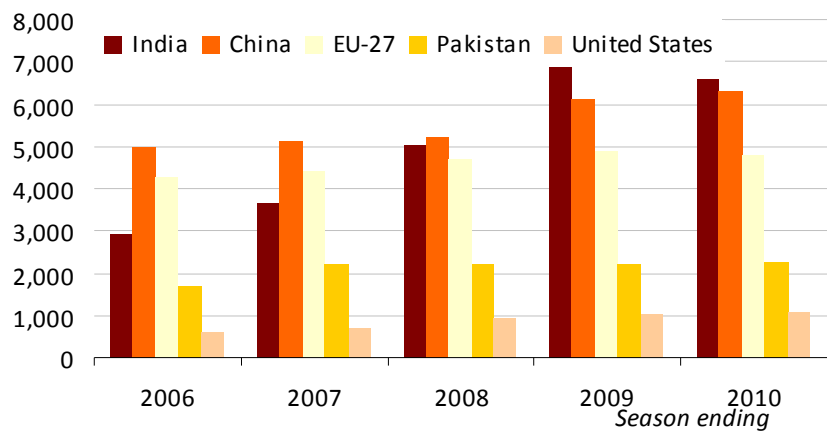
Source: VM Group

CPO production from second-tier producers since 2000, (000 Mt)



Demand risks

World palm oil imports (000t)



Source: VM Group

Demand for CPO has been rising strongly in recent years, largely because of the new and still developing use as a feedstock for biodiesel. Population growth in Asia is also pushing up demand for human consumption purposes. India, China, the EU, Pakistan and the US are the biggest importers; all the producing countries are also consumers. Global demand has already doubled since 2000 levels of 21 Mt – the USDA estimates 2010 demand will be 44 Mt. This has already vastly exceeded previous expectations, which were that demand would double (on 2000 figures) by 2030 to 42 Mt, and triple by 2050 to 62 Mt.

In the medium term, demand growth, especially in more mature economies, will be increasingly tied to the use of CPO as a fuel feedstock. Yet there is a growing consumerist backlash against CPO, especially for biodiesel, based on concerns that its production is doing serious environmental harm. This debate is raging and, without clear resolution, will continue to cloud prospects for CPO demand growth. And if the sustainability issue is finally judged negatively, then CPO biodiesel may well disappear as fast as it appeared – which would be extremely negative for the economies of the two biggest producers and all those currently betting heavily on greater uptake of CPO biodiesel.

Sustainability

The swelling campaign against the alleged negative environmental and human impacts of palm oil plantations has the potential to become a major issue concerning palm oil demand. In part this is because of the nature of the information that has been revealed, but it is also a result of a surge in advocacy around CPO production, in the last year especially.

In December 2009, Martin Hickman was awarded the Foreign Press Association's "Journalist of the Year" Award for an article in the British newspaper *The Independent*. Written in May 2009, and entitled "The Guilty Secrets of Palm Oil", the article persuasively outlined the damage being wrought in Indonesia and Malaysia's rainforests, both to indigenous tribes such as the Penan, and to endangered species such as orangutans and sumatran rhinos and tigers. Hickman's article – while not directly citing palm oil production as the cause – gave some correlated data in this regard, asserting that between 2004-2008, coinciding with the surge in CPO production, the orangutan population fell by 10% in Borneo and 14% in Sumatra. Logging has claimed 90% of Borneo's national parks, and UNEP estimates that 98% of Indonesia's forest could be destroyed by 2022 at current depletion rates.

Perhaps more striking than even these statistics was the quote from a Penan headman about the impact of palm oil plantations on the tribe's livelihoods: "When the logging started in the nineties, we thought we had a big problem. But when palm oil arrived [in 2005], logging was relegated to problem number 2. Our land and our forests have been taken by force. Our fruit trees are gone, our hunting grounds are very limited, and the rivers are polluted, so the fish are dying...all of our land has been given to the company."

Less emotive reports than this focus on another side-effect of growing oil palms – the impact on the environment through greenhouse gas or carbon emissions released in the planting and growing cycle. In a report called "Assessing biofuels",² commissioned by UNEP, the International Panel for Sustainable Resource Management used a life-cycle assessment method to evaluate the impact on the environment of growing various biofuel feedstocks. It found that the carbon emissions' savings of ethanol from sugarcane were between 70%-100% compared to fossil fuels. Emissions savings from corn ethanol were less impressive, ranging from providing between 60% emissions savings to generating 5% more emissions than fossil fuels. But in the case of growing palm oil for biodiesel the report argued that it could result in significant net carbon emission *additions*. This research is of course not the final word on this issue but the UNEP-backed report is most problematic for palm oil production precisely because of the land used for its cultivation.

Palm oil is planted in tropical rainforest regions. When these forests are cleared for planting, a naturally occurring carbon "sink" (or entity that can absorb and sequester carbon from the atmosphere) is destroyed. When that rainforest timber is burnt for clearance, it releases carbon emissions. Often the forests are in peatland – another natural and extremely efficient carbon sink – which, when drained, again releases emissions. Finally, when the oil palms are planted, fertiliser is required, a further source of carbon emissions through nitrogen and phosphorous losses, depending on the fertiliser used. At worst, the whole process can be "dirty" in terms of emissions – and appears worse for palm oil than for comparable biofuel feedstocks such as maize or sugarcane. However, UNEP also says that the situation can be mitigated as long as oil palms are not grown on deforested land or drained peatlands but instead on "abandoned or degraded land."

These findings matter because government mandates are starting to include criteria for biofuels that refer to their overall carbon savings. The European Union (EU) Directive on renewable energy of December 2008, for example, includes specific sustainability criteria for biofuel feedstocks. It stipulates that: "The overall GHG savings from biofuels production must be at least 35% for cultivation to be considered sustainable – the values increase in 2017 to 50% for existing installations and to 60% for new installations." It also notes that areas that contain "high carbon stock – wetlands, continuously forested areas and peatlands – or land with high biodiversity – primary forest, highly biodiverse grassland and nature protected areas – should not be used for biofuels production." While the EU denies that this is effectively a trade barrier, it means that palm oil produced without meeting these criteria cannot receive EU subsidies and will not be counted towards the EU renewable energy targets, although it can still be sold in the EU.³

Best practice

Activism by local and international organisations to promulgate this research – that palm oil is not a panacea for carbon emitting fossil fuels and could even be making things worse – has had a demonstrable impact on demand. It has also

² <http://www.unep.fr/energy/bioenergy/documents/pdf/Assessing%20Biofuels-Summary-Web-.pdf>

³ "EU Directive on renewable energy: Implications for the palm oil industry", speech by EC Commission to Malaysia, 15 August 2009.

shifted the debate from a simplistic and largely unquestioned assumption that CPO could be an easy and relatively cheap substitute for crude oil-based diesel fuel, and could ultimately ensure that, if CPO does move higher up the alternative fuel agenda, then it will do so on a much more solidly-supported basis. The debate has led to the founding of the Roundtable on Sustainable Palm Oil (RSPO)⁴ – a body established in 2004 and now with nearly 400 stakeholders, including producers, consumers and financiers as well as environmental activists and community representatives. In response to concerns about current palm cultivation practices and impacts, the RSPO has drawn up the standards, policies and the certification process for producing an alternative – certified sustainable palm oil (CSPO).⁵ If palm oil is to have a long-term future as a biodiesel feedstock then it is starkly evident that it will only be via this mechanism – otherwise the public backlash will be overwhelmingly negative and halt this fuel revolution in its tracks.

The RSPO has already garnered support from leading multinational consumers of CPO. A founding member of the Roundtable is Unilever, one of the world's largest purchasers of palm oil at 1 Mt-1.5 Mt a year, around 3%-4% of annual global supply. Unilever has pledged to make all its European purchases from CSPO by 2012, and to ensure that by 2015 all its global CPO purchases will also be sustainable. It's evident that Unilever means business in this respect; in December 2009 Unilever took action against one of its five palm oil suppliers – PT Smart, an Indonesian palm oil producer – in response to findings presented by Greenpeace about the supplier's environmental practices. Unilever said its decision to suspend procurement from PT Smart was because "they [Greenpeace] showed us evidence we can't ignore."⁶ Although Unilever will not reveal how much CPO it bought from PT Smart in the past, it has stated that it will now buy that share from its other five suppliers, all in Indonesia and Malaysia. The message is clear; Unilever does not want to risk alienating its customers because of palm oil's bad environmental and ecological reputation.

Nor is Unilever the only manufacturer to act against unsustainable CPO supply. Cadbury, Sainsbury's and other major food and cosmetic companies are also members of the Roundtable. Almost all members have committed themselves to switching to CSPO in the future. In June 2009, Nestlé announced it would shift to CSPO as its sole product feedstock by 2015 "when sufficient quantities are expected to be available." Nestlé however does not use crude palm oil, nor does it have links to palm oil plantations and is still working on a "system of full traceability" for the palm oil it does currently use (processed palm oil and processed mixed oils). Right now, the company uses 320,000t of palm oil per year – around 0.7% of global supply. Also in June 2009, Mars said it aimed to shift to 100% CSPO by 2015. Sainsbury's, one of the UK's biggest supermarkets, has also embraced the idea. It already buys and labels products containing CSPO, and plans to switch to 100% CSPO in its own-label products by 2014.

Despite the plethora of pledges from the big buyers, there are problems with CSPO. The first is that it is difficult to certify and prove sustainability. Inevitably the process of certifying initially drives up the cost of production and reduces margins and makes palm oil less competitive. Certificated sustainable palm oil also has to be grown, stored and shipped separately from palm oil that is not certificated. These could be regarded as inevitable and even justifiable start-up costs, but there is a further problem, that of tepid demand. According to the World Wildlife Fund, also a Roundtable founding member, by October 2009 only 195,000t of sustainable palm oil – about 19% of the approximate 1 Mt produced – had been traded. Palm oil end-users are simply not buying

⁴ <http://www.rspo.org/>

⁵ CSPO is defined by the Roundtable as "production comprised of legal, economically viable, environmentally appropriate and socially beneficial management and operations".

⁶ "Unilever cuts palm oil ties over environmental fears", *Financial Times*, 11 December 2009.

sustainable palm oil. This may be no more than a consequence of the global recession, with subdued demand in the main markets for certificated palm oil, in the EU. It is too early to judge how strongly implemented the move to certificated sustainable palm oil might be, but the vigilance of environmental activist members of the RSPO will be intense and they will undoubtedly be hot on the case of large companies to ensure they adhere to their own undertakings to use CSPO. Compliance will remain an issue; the old adage “trust but verify” will remain key to the future of the sustainable palm oil market.

And indeed, as of February 2010, things appear to be picking up somewhat for CSPO, which now makes up about 4% of CPO totals. If the switch to sustainable CPO grows we could see in the not too distant future an entrenched price differential emerge between sustainable and non-sustainable CPO. As only sustainable CPO is likely to be acceptable as a biodiesel feedstock in the main biodiesel markets (within the EU), then its future growth generally within the biofuel market will inevitably be slower than might have been the case.

Finally, many have noted the lopsidedness of this sustainability drive. All the costs of compliance and certification of sustainability are borne by the producer, at the emerging market/developing country end of the process, and not at the consuming end. Some have argued that the ability to pay should play a greater role in dividing up the costs of building the sustainable palm oil market.

New technology threats

Even if the sustainability argument is resolved, and sustainably sourced CPO prices do not rise far beyond the point at which its fuel use becomes uncommercial, there are other threats to CPO as a biodiesel feedstock, including the development of second generation biofuels, which are not based on crops that can be used for human food purposes, and the development of road vehicles powered by electricity. One leading contender for future commercialisation as a biofuel feedstock is algae, for example, which has potential yields of 2-15 times that of palm oil, at between 150-2,000 gallons/acre. These second generation biofuels have the weight of big oil investment (including Shell and Chevron) behind them, and even though developing them to a functioning and efficient level might be a decade away, the probable rise of crude oil to fresh nominal peaks in the coming decade will give research and development of such fuels a vigorous boost. Even if estimates on the potential yields for second generation biofuels are currently very broad – as they are for any new technology – they are not necessarily incorrect. As for the electric car, this too is at a very early stage of development but major vehicle manufacturers are investing heavily in this technology and many see it as the future solution to high fossil fuel prices and shrinking fossil fuel reserves.

To sum up. In the medium term, sustainability concerns will keep CPO prices higher and possibly reduce biodiesel feedstock demand. In the long term, demand for palm oil for fuel purposes may well drop as other, more attractive and efficient biofuel technologies are developed – implying that CPO prices will tend to decline as the biodiesel revolution falters and finally gives way to more advanced technologies.

Supply risks

CPO production by country (000 Mt)

Season ending	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Indonesia	8,300	9,200	10,300	11,970	13,560	15,560	16,600	18,000	19,500	20,750
Malaysia	11,937	11,858	13,180	13,420	15,194	15,485	15,290	17,567	17,259	18,500
Thailand	580	780	640	840	820	784	1,170	1,050	1,200	1,300
Nigeria	730	760	770	780	790	800	810	820	820	820
Colombia	560	518	540	614	647	690	770	830	760	800
Papua New Guinea	336	329	316	326	345	350	361	384	400	440
Ecuador	245	228	241	244	295	310	340	340	340	340
Cote d'Ivoire	248	260	234	308	340	360	320	320	320	320
Honduras	148	161	165	165	165	180	195	220	250	252
Costa Rica	137	128	155	180	173	181	189	202	210	225
Guatemala	124	100	90	96	99	92	125	130	185	197
Congo (DRC)	155	167	170	175	175	175	175	175	175	175
Cameroon	136	138	144	147	150	150	165	165	165	165
Ghana	108	108	120	120	120	120	120	120	120	120
Brazil	110	108	110	110	110	110	110	110	110	110
Philippines	54	55	56	59	60	61	60	65	70	70
Venezuela	70	80	85	90	63	63	65	70	70	70
Angola	56	56	58	58	58	58	58	58	58	58
Guinea	50	50	50	50	50	50	50	50	50	50
India	40	35	35	40	40	40	50	50	50	50
Liberia	42	42	42	42	42	42	42	42	42	42
Peru	39	43	41	41	41	41	41	41	41	41
Sierra Leone	36	36	36	36	36	36	36	36	36	36
Benin	36	33	31	35	35	35	35	35	35	35
Mexico	10	11	10	18	26	26	27	27	27	27
Dominican Republic	6	8	14	20	21	22	22	22	22	22
Togo	8	8	7	7	7	7	7	7	7	7

Source: VM Group, USDA

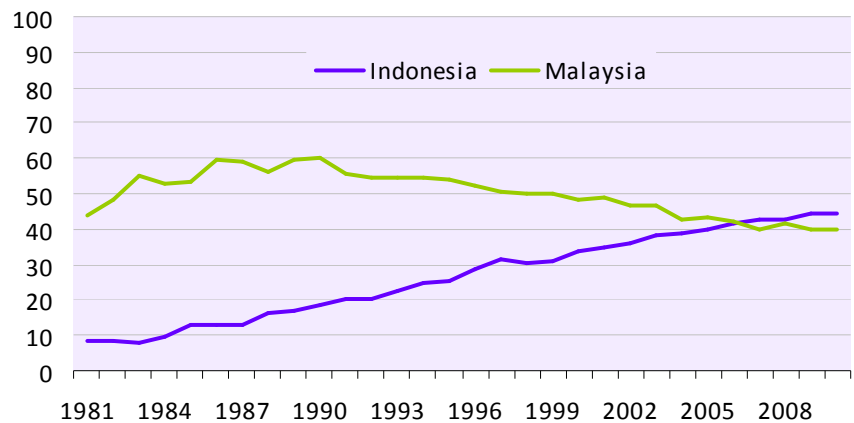
Cultivation

As with any agricommodity, CPO production is subject to the vagaries of soil fertility, weather, pests and disease. Oil palms need specific growing conditions to produce fruit at full capacity. They are grown in monoculture plantations, requiring total clearing of the land. For ideal productivity they need 2,000mm of rain annually, distributed evenly during the year, and at least five hours of sunlight every day each month. Minimum temperatures should be between 22-24°C and maximum temperatures between 29-33°C. Oil palms fruit after three years and reach their output peak between 5-10 years. Since yields are so critical to palm oil's competitive advantage, sound agricultural practice is a vital component of productivity. Regular fertiliser applications are required, bi-annually.

Concentration

Despite the oil palm's origins in West Africa, today most palm oil produced in the world – almost 90% of supply and exports – is concentrated in just two countries – Indonesia and Malaysia. Such a concentration of production elevates risk to supply at the cultivation stage: Indonesia and Malaysia share similar climatic challenges and weather patterns, as well as similar threats from pests and diseases.

Share of global palm oil processing, %



Source: VM Group, USDA

As Indonesia and Malaysia process most of their own palm oil, they are also exposed to parallel risks that could affect export, such as transport crunches or exposure to choke points because of security issues, such as, for example, increased levels of piracy in the Malacca Straits. This is the 3.7km-wide sea channel that links the Indian Ocean to the South China Sea and the Pacific, and is bordered by Indonesia, Malaysia and Singapore. It is one of the world's most critical shipping lanes and, until recently, was one of the most dangerous in terms of piracy. Conflict, especially as it relates to the emerging China, is also a major concern in the region. On the other hand, some would argue that, since the onslaught of the 2008 financial crisis and the subsequent recession, economic and financial risks have in any case become globalised.

Sovereign, political and security risks are high in each of the major palm oil producers: Indonesia, Malaysia, Thailand, Nigeria and Colombia. Each is battling one or more of the following: violent separatism, leadership and constitutional challenges, militant insurgencies, extreme poverty, gross inequalities of income and finally, large, diverse and rapidly increasing populations. Religious conflict and extremism, and terrorism, is prevalent in at least four of the top producer countries. The regionalisation of existing local conflicts is a major threat in at least two of the countries.

A further supply-side threat, given such a concentration of production exists, is that of producer collusion. There is obviously considerable scope for the two dominant producer countries to reach informal agreements to cut production and shore up prices. Strategies for doing this can be highly sophisticated – for example, by introducing replanting programmes that reduce crops for the years that it takes for seedlings to mature to the productive, fruit bearing stages. Such collusion is not apparent currently, but history is littered with examples where producers have attempted to control supply in all kinds of commodities, such as rubber or tin.

However, there are also some benefits to concentrated production. Indonesia and Malaysia have established comparative advantages in growing and trading CPO and developed a cadre of skilled and experienced smallholders, with a labour supply that is knowledgeable about this sort of plantation agriculture. Even weak governments tend to be supportive of the sector – not least because it remains a key source of revenues, foreign exchange and trade.

Land availability

The global supply of arable land is dwindling and, in some regions, quite rapidly so. In order to cope with the food demands of growing populations, especially in

water-stressed regions, a form of agri-colonialism is developing. Countries that are resource-rich but arable land-poor – including China and several Persian Gulf states – are buying or renting tracts of arable land from other countries. Estimates vary, but 20-30m hectares of arable land were sold for these purposes during 2007-2009. This is a rising trend – food imports will become more expensive and populations in these countries will grow sharply before peaking by 2050.

This is proving contentious for several reasons. Much of this cash-for-land trade is happening in Africa, where the UN's Food and Agriculture Organization (FAO) believes 10% of farmed land on the continent is today either rented or has been sold to grow food for other countries. Regimes that are often less than transparent stand accused of selling off one of the key assets of their citizens, arable land, in a short-term bargain that may ultimately work to the detriment of their own populations.

One of the most aggressive players in terms of land acquisition has been the Kingdom of Saudi Arabia. For many years it attempted to offset its own arid conditions and food insecurity by investing vast amounts in 'greening the desert', through large irrigation projects to promote and develop its domestic agriculture and farming. This has proved both too costly and a drain on Saudi Arabia's limited water supplies. Saudi Arabia has now shifted its stated policy towards long-term agricultural investment abroad. Broadly termed the "food security programme", the policy promotes joint agricultural ventures between Saudi companies and foreign host governments, and provides financing – in April 2009, the facility stood at riyals 3bn (\$800mn) – for investments focusing on wheat, rice, sugar and soybeans.

Saudi Arabia is not alone. The Gulf States import 60% of their food and this will certainly rise, as increased recurrence of drought and greater desertification combine with growing populations, pressuring food and water supplies even further.

If managed badly, this sort of land grab can ignore the rights and costs due to those people in the host countries who traditionally farmed the land – squeezing smallholders and pushing families away from the source of their subsistence agricultural practice and livelihoods. It is a classic case of profits being privatised while losses are socialised, which inevitably results in the further diminishing of food security in these countries.

A particularly interesting example of what this can look like in practice was the attempted lease in 2008 by South Korea's Daewoo of 1.3m hectares of land in Madagascar for 99 years. This was around half of the country's total arable land. Daewoo planned to lease the land to grow animal feed and biodiesel feedstock, mostly from corn but about 25% from palm oil plantations. The decision by Madagascar's government to accept the deal was nothing short of perverse. About 70% of its 20m population lives below the poverty line, and most are highly food insecure and dependent on foreign aid. In March 2009 Madagascar's government fell as a consequence of public reaction to the deal, which was promptly cancelled.

The consequences for palm oil are not yet clear, but in a world with already scarce resources and food security issues for more than 2bn people, the arable land grab is likely to continue and will only serve to highlight the ethical compromises involved in the processes of farming (and consuming) palm oil. It will also strengthen consumer reluctance to accept palm oil as a viable biodiesel feedstock.

In the future, these types of arable land deals will depend on how investments are made and whether they offer greater long-term benefits rather than short-term profits. Of course, some countries already successfully restrict information on these land-for-cash deals, and will continue to do so. Such secrecy protects

the buyer and seller governments, while ordinary people are left out of the negotiating process. Anecdotal evidence suggests that China has secured 6m acres of farmland in the Democratic Republic of Congo (DRC) for palm oil plantations – but this cannot be verified as yet. Meanwhile, the DRC continues to experience serious food shortages. Sudan is also believed to have sold a great deal of land; this in a country that has experienced massive ethnic cleansing, rooted in land disputes, and where the World Food Programme provides emergency food assistance to more than 4m people.

Macroeconomic and financial

Commodities of all varieties are vulnerable to all the macro-economic threats that exist in early recovery phases. These threats include those that can result from policy failures, such as insufficient stimulus leading to no recovery in real demand, or premature unwinding of emergency measures, as well as too rapid a tightening of monetary policy. There are also threats from the kind of heightened speculative investment swings that have characterised early 2010. Sound financial management might be the latest mantra of governments and banks – but the need to provide good returns in a zero-rate interest environment can put pressures on at precisely the moment they are least useful. On top of which, the impact of over-zealous financial regulation could limit opportunities for growth. And the risk of spiralling protectionist policies remain. The independent monitoring group, Global Trade Alert, records 300 separate protectionist measures introduced by governments in the 12 months of November 2008 to November 2009. All the main palm oil producer countries are subject to these risks.

Emerging markets

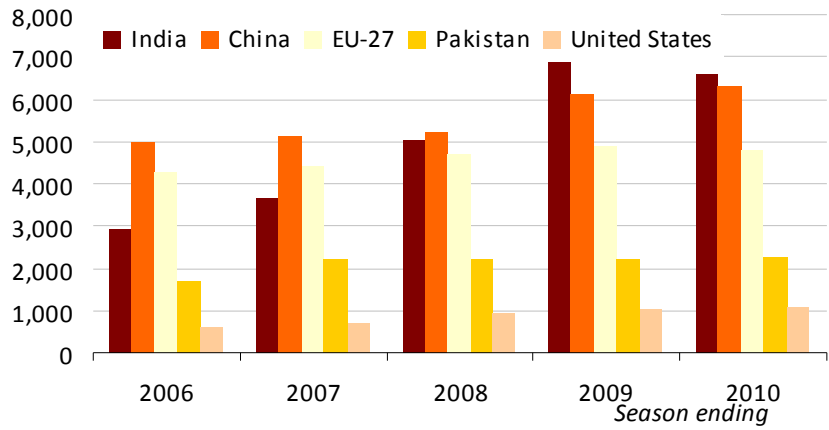
Despite the resilience shown by emerging economies during the current recession, their exports have suffered from reduced demand in mature economies, and general price falls in commodities have hurt. Jobs have been lost in emerging economies too, where the worst effects of income reduction may serve to widen existing inequalities especially in economically integrated, commodity dependent countries – which again encompass all the major CPO producers.

All the top CPO producing countries also have their own specific risks, in part due to the problems that come with their evolving national economic and political development. Several are only recently emerged from lengthy periods of harsh military rule and extra-judicial violence. The status of women and minorities continue to be politically and economically inferior generally, and exclusion of these groups remains an obstacle to full economic development in most of the top CPO producers.

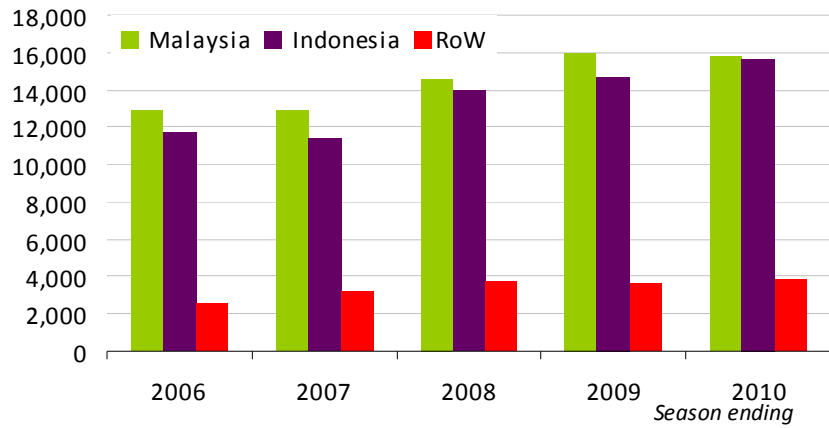
But the biggest political risk for the two biggest CPO producers remains their demographic trajectories. The ranks of their poor, urbanised and unemployed youth will swell. If managed well, this could prove a boon to the generally ageing world economy, but if not, it presents a clear and present threat to stability – not just in the emerging economies themselves, but in terms of transnational security as well.

On the plus side, almost all the countries appearing in the top five palm oil producers list have vibrant and vocal civil society sectors. They possess a relatively free and independent media, and there are strong – if sometimes harassed – opposition movements in Indonesia, Malaysia, Thailand, Nigeria and Colombia.

World palm oil imports (000t)



World palm oil exports (000t)

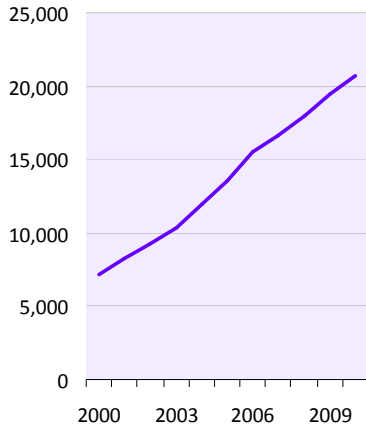


Source: VM Group, USDA

Country risks

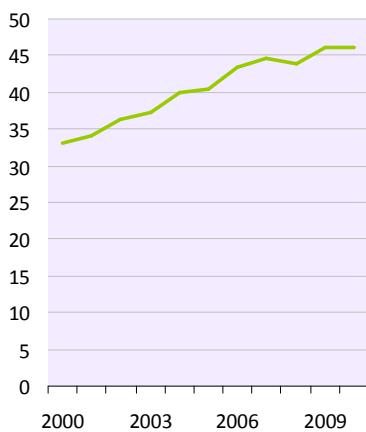
Indonesia

Indonesia CPO production, 000 Mt



Source: VM Group

Indonesia CPO production, % share of world



Source: VM Group

The undisputed heavyweight of palm oil supply, Indonesia is expected to produce 20.75 Mt in the 2009-2010 season, about 46% of total global supply. This commodity is a substantial earner of export revenues for Indonesia – an estimated \$6.5bn in 2008. Palm oil cultivation in Indonesia began in North Sumatra and Aceh in 1911. It became a key agricultural crop during the Suharto era (1967-1998) and remains an important part of the economy. There are a host of risks that affect Indonesia, whose 17,500 islands are scattered over 2m square kilometres. This vast area is subject to significant weather risks – not least from El Niño, which has the potential to reduce yields in the 2010-2011 season as a result of possible drought. Seismic activity, including powerful earthquakes and tsunamis, is an extra risk throughout the region.

Indonesia has plentiful natural resources and is also home to a diverse range of people. The population of 230m are in the majority Muslim, while Christians, Hindus and Buddhists form large minorities. Over 300 ethnic groups speak more than 700 languages, in this, the world's fourth most populous country. Until recently, Indonesia's political history was turbulent, with violent government regimes and internal terrorist threats common in the years since independence was achieved in 1945. This national insecurity has hindered democratic progress and development, especially in some outlying regions.

Another entrenched risk comes from corruption. Some of this is historic, with former leaders and their cronies, particularly in the army, responsible for siphoning off resources for decades. More than 60m people live below the poverty line, on less than \$2 a day. But even in today's more modern and transparent Indonesia, red tape and corruption are rife, seriously hampering competition and growth. The World Bank's "doing business" survey – a composite index measuring business regulation and enforcement throughout the world – puts Indonesia at 122 out of 183 countries – placing it slightly worse than Russia, and only a bit better than Nigeria. Starting and closing businesses are particularly difficult, as are enforcing contracts.

Right now Indonesia is embroiled in a high-level political scandal, awaiting the verdict of an inquiry into financial impropriety relating to a rupiah 6.7 trillion (\$716m) bank bailout. This follows hard on the heels of a separate corruption scandal last year, and is threatening the second term agenda of President Susilo Bambang Yudhoyono, who was re-elected in July 2009 on a platform of fighting corruption and drawing foreign investment into the country. His inability to deal with these governance issues are problematic but he has made a successful break with the repression of the Suharto years, and in general has handled the country's significant political and economic challenges well.

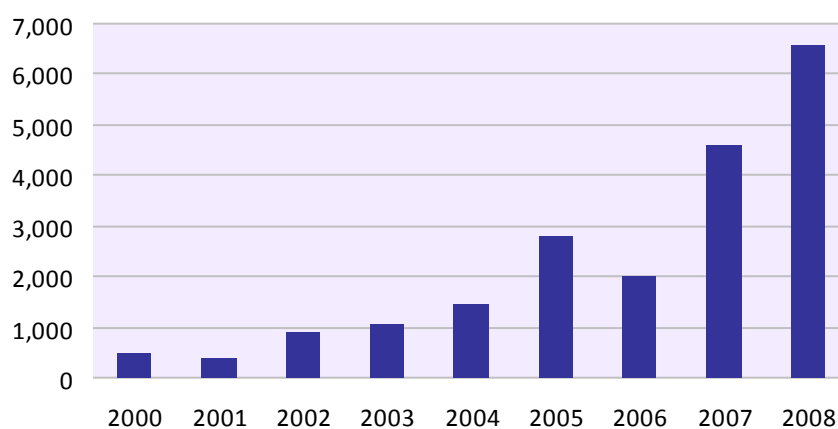
Since Yudhoyono was first elected in 2004, support for extremist Islamic parties has dropped by 10%, and inter-religious tensions have eased. While there have been some terrorist incidents they have not been as extreme as those of 2002 or 2005, and justice was seen to be done as the perpetrators of the Bali bombings were brought to trial. Yet extremism is established in Indonesia; even though major terrorist leader Noordin Top was killed in September 2009, his network, and many of the grievances that inspired it remain, as does the threat of terrorism.

Despite the policy of equal representation for all religions and groups, the Muslim majority dominates. Dissent is labelled "subversion" in some places, such as Papua, and is frequently punished. There are strong separatist movements and the government and army are concerned by this threat to Indonesia's integrity as a single political entity, which they see as exacerbated by its geographical spread and population diversity. The centre is fearful of losing control; this fear can lead to harsh censorship and the curtailing of other

liberties and rights, especially with regard to the rule of law. However, the media is vibrant and free and the Internet is providing a growing number of people (currently 30m users) with more access to information.

Economically, Indonesia has survived the global recession well, in part because of long term policy improvements including the reduction of public sector debt and the build-up of international reserves, both of which acted as a buffer to the external shock of the financial crisis. But unlike other countries in the region, or even most other emerging markets, Indonesia is particularly buoyant because of the strength of its domestic consumption over exports. The stimulus and election-related spending in 2009 also benefited the economy and encouraged greater private consumption. The International Monetary Fund (IMF) puts GDP growth for Indonesia at 6% in 2008, and at 4% in 2009 and forecasts it will be 4.9% in 2010. Inflation – which has averaged about 9% over the past five years – remains a concern.

Indonesian palm oil exports, value, \$m



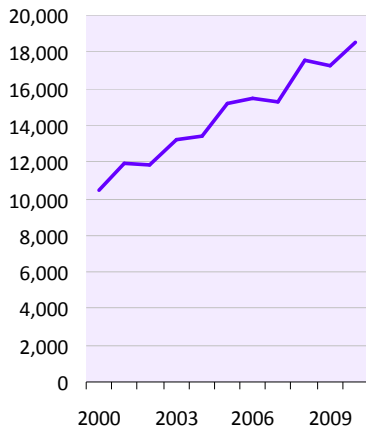
Source: VM Group

Internationally, Indonesia remains strategically important to the West. Its value comes from the role it plays as a counterweight to China, and as the largest Muslim state that operates a democratically elected form of government in the world. Both attributes make Indonesia a vital partner in achieving some global priorities such as counter-terrorism, energy and food security and environmental progress. In 2010 President Barack Obama intends to visit Indonesia, where he spent his childhood. In the context of worsening US-China relations, and ongoing tensions with the Arab and Muslim worlds, Indonesia will continue to be an important ally for the US.

Yudhoyono has managed the country's ongoing transition to democracy well, but he has not curtailed the power of those elites that continue to dominate the Indonesian economy. Term limits mean he cannot run again in the next elections in 2014. Members of the Suharto-era old guard and the military are waiting in the wings for the opportunity to run with no incumbent competition. The lead up to the election and the outcome will decide whether Indonesia's fate lies as a modern, plural democracy or a country veiled in corruption and cronyism with deep roots in a repressive past.

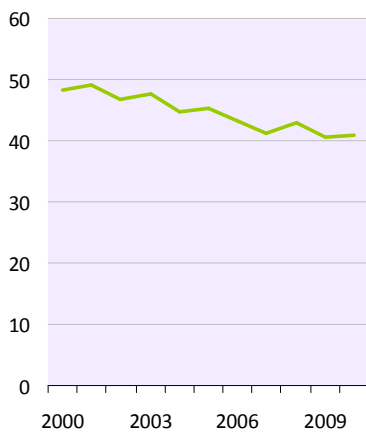
Malaysia

Malaysia CPO production, 000 Mt



Source: VM Group

Malaysia CPO production, % share of world



Source: VM Group

Expected to produce 18.5 Mt – 42% of world supply – in 2009-2010, Malaysia is the world's second largest palm oil producer. Historically, Malaysia dominated production, but was displaced in 2005-2006 by Indonesia. The production difference between the two countries may prove short-lived though, and much depends on the weather. Floods in 2008 led to Malaysian shortages in production, and El Niño weather patterns this year are likely to create drier conditions in Indonesia that could see Malaysia's output in the 2010-2011 season being very close to that of Indonesia.

Malaysia is at a political crossroads. For the most part a diverse and tolerant country of 26m people, some political leaders have been exploiting its ethnic and religious differences in order to win votes and secure constituencies. This has pitted ethnic Malays, most of who happen to be Muslims, and who form about 60% of the population, against Chinese and Indian minorities, and has created rifts between Christians and Muslims. This has spawned outbreaks of politically motivated violence, with serious attacks on religious buildings. However, it would be wrong to read too simplistic a message into this sad state of affairs. What is happening is a manifestation of party politics, rather than a spiral down into age-old religious conflicts. Yet it does still speak to the problem of ensuring religious freedom and minority protections. These are rights that democracies must protect through law – but the Malaysian judicial and security system right now does not appear able or willing to extend these protections to all of its citizens.

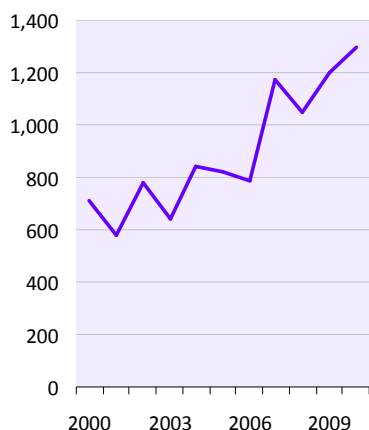
Also worrying is the pattern of using the courts to slander, defame and imprison opposition leaders. The impact of these political and legal problems on Malaysia is to promote a sense of insecurity and risk. With violence in the streets and questions of good governance hovering in the background, as the courts decide whether to uphold the law or bend to political pressure, foreign investment in particular is being discouraged.

Economically, the country's performance has been mixed. In the World Bank's "doing business" index, Malaysia does extremely well, coming 22 out of 183 countries – better than Germany, which is ranked 25. It scores highly on ease of access to credit and the protection of investors. More broadly, although Malaysia has steered a steady economic course in the past decade, building up large foreign reserves, diversifying trade and ensuring that its financial sector is well capitalised, the economy has been badly buffeted by the global recession. GDP growth contracted in 2009 by 3.6% – the first fall in a decade – although it is expected to recover in 2010 and grow by 2.5%. Trade is still comparatively weak and the markets are volatile, with no obvious return of capital and investment flows.

Malaysia's economy would have been in more serious trouble had it not been for the protection provided by the government's active stance on monetary and other policies. Domestic consumption is still fairly strong, and is compensating somewhat for the absence of export trade. In many respects, Malaysia has a bright economic future and could be an engine of growth in its region. But its leaders face a simple choice – to promote reform and tolerance or exploit ethnic differences in the hunt for political power. If they choose the latter, then political risk will surely increase with serious consequences for Malaysia's palm oil sector and export market.

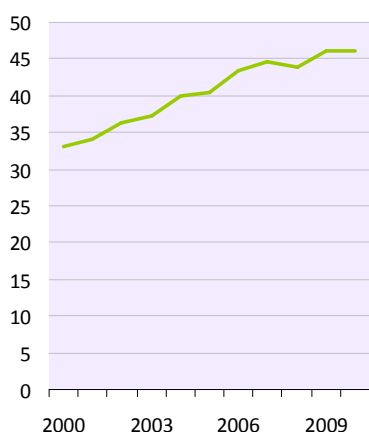
Thailand

Thailand CPO production, 000 Mt



Source: VM Group

Thailand CPO production, % share of world



Source: VM Group

Thailand produces 1.3 Mt of world palm oil supply – about 3% of the total. Long known as an attractive tourist destination, the country has proved hospitable and open to visitors and to business. In the World Bank’s “doing business” index, Thailand comes an impressive 12 out of 183 – better than Japan or Sweden. Exports have driven growth over the past decade, reaching average growth rates of 10% in 2006-2007. But the economic crisis has hurt; domestic demand is weak, private sector growth has stumbled and its GDP contracted by 3.5% in 2009 – the first fall since the Asian financial crisis of 1997-1998. The IMF however forecasts GDP growth rates to return to 3.7% in 2010.

On top of the global and domestic economic risks, Thailand is also facing extremely low levels of consumer and investor confidence because of nearly five years of ongoing political instability. Partly, this is a historical legacy: there have been 10 political coups in the country since 1932, and the last occurred in 2006, when Prime Minister Thaksin Shinawatra was removed by the army. The ensuing political stalemate should have been resolved by elections held in December 2007, but despite a convincing and certifiably fair win by the People Power Party (PPP), political unrest continued and two more governments fell in 2008.

Effectively the political divide within Thailand is between those seen as pro-Thaksin – the “reds” such as the PPP – and the “yellows”, including the Peoples Alliance for Democracy, who oppose Thaksin. These labels fail to explain what is, at its heart, a fight between the rural poor (the “reds”) and the rest. The “reds” benefited from the reforms that Thaksin introduced, particularly in terms of health and education, but also from efforts to distribute more fairly among Thailand’s 68m people what had until recently been an elite-controlled pie.

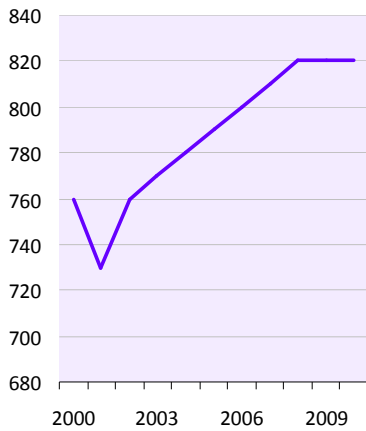
The “yellows” are made up of royalists, middle class urbanites, and the military, as well as some intellectuals and pro-democracy activists. They accuse Thaksin of corruption and are intent on keeping power where it has always been situated. Tactics used by the factions have ranged from assassination attempts to strikes and the seizure of airports – which have hurt tourism, a critical sector of Thailand’s economy. The “yellows” have also worked to keep the democratically elected PPP out by strong-arming the country’s institutions – especially the courts and the military. This is not sustainable, nor democratic, and the lingering threat of another military coup is hindering Thailand’s economic progress.

A separate conflict in the southern region of the country, which has intensified since 2004, poses a further risk. Here, the predominantly Buddhist Thai leadership in Bangkok is pitted against an insurgency by Muslim Malays. In part this is a secessionist bid by the Malays to reclaim what was once an independent sultanate, but it is also a response to the historic oppression of this ethnic and religious minority by Bangkok. Young Malays are targeted for radicalisation by the terrorist insurgency and the army operates here unchecked. As a result weapons and paramilitaries flourish – all at the cost of local civilian life.

These conflicts are hurting Thailand, once considered a leader in its region and generally a solid bet. The one positive is that, for now, Thailand’s internal problems do not involve foreign actors. The southern insurgency is localised and Thailand is not yet the kind of weak or failing state that could easily be exploited by foreign militants. However, if the elites/majority standoff cannot be resolved, disaffection and insecurity will grow. This will continue to generate risks in terms of macroeconomic stability and investor confidence – which will in turn impact growth, exports and supply chains in the palm oil sector.

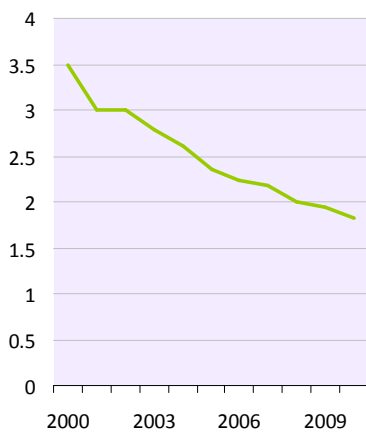
Nigeria

Nigeria CPO production, 000 Mt



Source: VM Group

Nigeria CPO production, % share of world



Source: VM Group

Producing 820,000t – about 1.8% of the world total in the 2009-2010 season, Nigeria today is a CPO minnow where once it was a world leader. Production has grown a little over 10% in the past decade. Despite the growth in domestic consumption, Nigeria has not capitalised on its historical and comparative advantages in palm oil. The economic crisis has not helped; after a period of crude oil-led GDP growth that averaged about 7% from 2004-2008, GDP growth fell to 2.9% in 2009. The IMF forecasts GDP growth of 5% in 2010.

Nigeria is a major producer of crude oil, which brings in 80% of its export revenues. But these have fallen too, in part due to the militant activity in the Niger Delta that reduced oil production from a potential 3.6m bpd (barrels per day) to 2.2m bpd in 2009. However, an offensive by the Nigerian army against the militants, known as the Movement for the Emancipation of the Niger Delta (MEND), and an offer of amnesty and reintegration by the government, meant that a ceasefire was signed in October 2009.

Many credited President Umaru Yar'Adua for his personal involvement in bringing the deal off. But between late November 2009 and late February he had not been seen in public in Nigeria; his absence was explained by his undergoing medical treatment in Saudi Arabia. MEND is pondering whether to suspend the ceasefire and Nigeria is currently in the midst of a presidential and constitutional vacuum. Yar'Adua did not hand over executive power to his deputy before departing – and it is not clear when or even if he will return to the country. For now, his Vice President Goodluck Jonathan has been given the role of acting President. But this unprecedented situation has added to the existing problems of entrenched corruption, power shortages, electoral malpractice, and a potential terrorist infiltration, all of which have made conflict and instability heightened risks in this, Africa's most populous country.

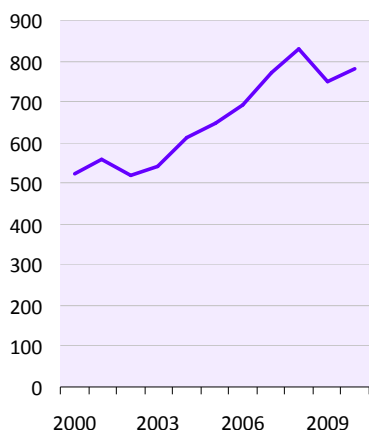
Nigeria's population is growing rapidly: the UN projects it to almost double – from today's 150m, to 289m – by 2050. The population is divided almost equally between the Muslim north and the Christian south, with more than 200 other regional and ethnic identities in between. This tends to generate significant and often violent conflict between groups, usually relating to the access to and distribution of scarce resources. In the north, water and land conflicts are on the rise as a result of drought and desertification, and in the south, large numbers of unemployed young people have turned to crime and vandalism – including destroying vital infrastructure. There are real environmental, economic and employment problems in the Delta – many of them related to the extraction of oil. Poverty affects more than 70% of the population of this oil-rich country.

Most recently, the attempt by a Nigerian to blow up a plane over the US has shunted Nigeria, long a US ally, into the same category as Yemen or Somalia – weak states that have become breeding grounds for terrorism. The comparison is simplistic, but it highlights the deep structural, political and governance reforms required if Nigeria is to remain a functional state and retain influence as a regional power. In its favour is its position as a strategic US ally – over half of its oil exports go to the US; and it has been a vital mediator and major contributor to regional and continental peacekeeping efforts, and acted as a counter to other, less friendly blocs in Africa.

Risk is intrinsically tied to leadership in Nigeria, and that issue remains in the balance right now. Even though President Yar'Adua has now returned to Nigeria, he has not returned to office and the long-term issue of succession is fraught. Yar'Adua is a Muslim from the north, Jonathan is a Christian from the south. What happens in the lead up to the election next year has the potential to shift the fragile power balances that hold Nigeria together – with a deeply uncertain outcome.

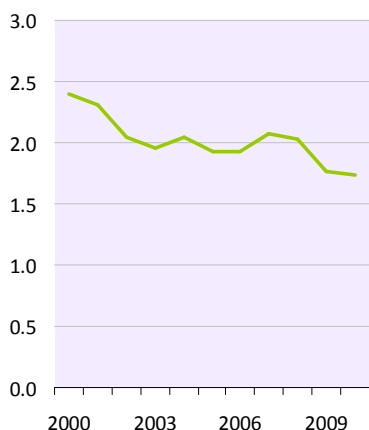
Colombia

Colombia CPO production, 000 Mt



Source: VM Group

Colombia CPO production, % share of world



Source: VM Group

Colombia is likely to have produced 780,000t of palm oil – 1.7% of the global total – in the 2009-2010 season. The country seems to have weathered the global financial crisis, in part because of sound fiscal and monetary fundamentals. Colombia is also a favoured ally of the US, and the IMF was quick to provide a flexible credit line arrangement of \$11bn in May 2009 to help the government deal with the impact of the crisis. These strengthened reserves immediately increased confidence. By June 2009, the peso started to appreciate and the stock market returned to pre-crisis (September 2008) levels. As a result, GDP contraction was minimal, at 0.2% in 2009, and in 2010 the GDP rate is expected to grow by 2.5%. Inflation has fallen, and commodity prices have picked up, all helping to secure these economic gains.

President Álvaro Uribe has been in power since 2002, and was elected on a “democratic security” pledge, to end more than five decades of struggle between the government and its paramilitaries, and the Revolutionary Armed Forces of Colombia (FARC) – formerly a Marxist militant movement but more recently a narco-guerilla entity. While the FARC still poses a threat, its force has been reduced by two thirds and its leadership weakened by a successful military offensive, aided by significant US military assistance.

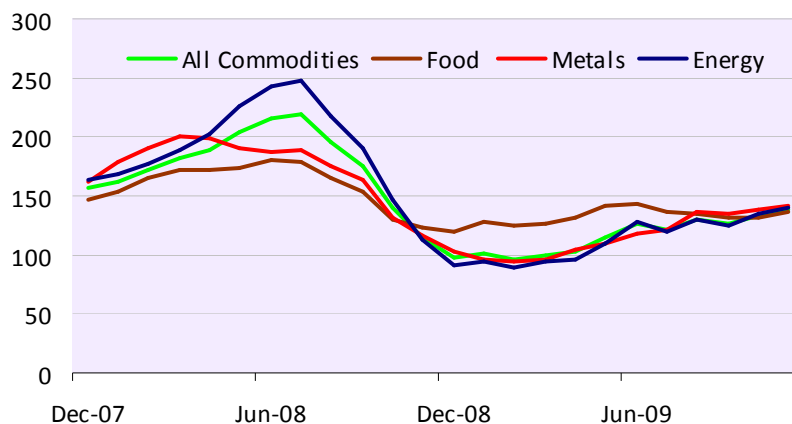
Uribe and his government can take credit for transforming the security situation. Yet the decision to allow the US to use seven Colombian military bases to assist in fighting the FARC and pursue counter-narcotic aims has come at a cost. It triggered old resentments and concerns in the region that the US once again has broader territorial intentions in Latin America, and led to several tense disputes with Ecuador and Venezuela. Venezuela’s President Hugo Chávez in particular believes that the Colombians are assisting the Americans in their aim of “regime change” in Venezuela, and Venezuela has imposed sanctions on trade with Colombia. With bilateral trade at \$6bn last year, this will hurt. It is not just the leftists that are angered by the decision though; Brazil – arguably the most powerful country in Latin America – is also unhappy with the US military presence in its backyard. Even though Uribe has prevented these disputes from escalating, Colombia remains regionally somewhat isolated.

Economically, Colombia is still a very inequitable society; unemployment is at least 12%, poverty is common and corruption and the illegal drug trade are prevalent. The palm oil sector has also suffered from the conflict. In the 1990s land was seized by paramilitaries, and the original farmers pushed out. Some restitution has taken place. In 2008 a judicial investigation found that more than 20 companies in the sector had links to paramilitaries, and half of these companies have been ordered to return the land they took from the farmers. The investigations, including into the murders of farmers, continue. But Fedelpalma, the national CPO producer body, is trying to deal with the challenges of the future as well as the past. In particular, responding to the current sustainability challenge, Fedelpalma has told its members to stop clearing rainforest and only to plant on former agricultural land. Colombian participation in the sustainable palm oil sector will be key to increasing its global share of the market.

2010 will be a decisive year for Colombia. Local and presidential elections are due in March and May and Uribe – who earned respect for his economic and security policies – wants to alter the constitution to allow himself a run for a third successive term, although the constitutional court has ruled against this possibility. Political risk in Colombia remains high, investor confidence is precarious and the economic and security gains made over the last decade are under threat.

Economic risk & commodity performance

Commodity prices 2007-2009



Source: VM Group, IMF commodity price index

Set against the broader picture of financial and systemic collapse over the period 2008-2009, the story for commodities has been markedly different from that of other asset classes. Where currency and equities markets have soared and dipped, most commodities have generally strengthened, at least until early February 2010. Commodities have been volatile, but they have also benefited from their relationships with the dollar, risk and sentiment generally.

From a trough of February 2009, the IMF commodity index rose by 40% over the following eight months. In previous economic downturns, the commodity index rose by an average of only 5% over the same period. That this happened, despite weak demand and high inventories, is clearly unusual. The IMF forecasts that commodity prices will continue rising in 2010, although moderately at first. However, the extent to which prices will rise will depend on the degree to which demand for raw materials, improving industrial production, and the gradual erosion of spare capacity and inventories picks up.

On the downside, however, because strong performances by commodities are highly correlated with inflation, rising commodity prices indicate not only the threat of inflation, but also the potential for a corresponding tightening of monetary policy. Higher interest rates too early in the recovery will threaten nascent growth everywhere, and could shut down economic gains generally, as well as commodity returns specifically. Too slow an unwinding, though, and federal deficits will soar to truly insupportable levels and evoke a rapid punishment of currencies perceived to be in danger of collapse.

We believe a strong bull run is possible by 2H 2010 in a range of sectors, especially energy and agricommodities. If the year 2005 was an inflection point for commodities – in that China's demand became the dominant factor for metals first, and soon after for the majority of commodities – 2010 may well be a similarly critical and game-changing year.

Global political risks

As the global economy heads more firmly into recovery, we will likely see a return of the impact of political risk to commodity markets. Geopolitical challenges that abound in many parts of the world, but which have been subsumed by the welter of macro-economic factors related to the recession and its cure, will start once more to matter to the price of individual parts of the commodities complex, and particularly to energy and agricommodities. As palm oil is a dual use commodity – consumed as both food and fuel – political risk will almost certainly contribute to its price movements in 2010 and beyond.

The relationship between crude oil and palm oil, although faint right now, may reassert itself later this year, especially once carbon emissions' regulations become codified, and the switch to greater use of renewable fuels becomes law in many more countries and a market moving fact. As the two fuels become more intertwined, what happens to affect the risk of supply to crude – both politically and in terms of transportation logistics – will increasingly matter more to palm oil.

Political upheaval and security concerns will impact commodity prices in different ways. Some of them will have direct impacts on specific commodities (for example Iran, Sudan, Nigeria in relation to crude oil), while others, such as the ongoing wars in Iraq and Afghanistan, also act as serious drains on financial and political resources. The continued nuclear threat from North Korea and the deteriorating situation in Israel and Palestine will take scarce human, political and financial capital to resolve – all of which have opportunity costs. They also require bargains to be made with allies, which can tie countries to each other in allegiances that can both help and hurt trade. China's own development and its drive to secure resource channels all over the world, especially in Africa, will continue to be a critical factor.

In China, fears of economic collapse in the wake of the world recession are receding. There is however a rift within the Communist Party top levels about how to proceed on the question of political liberty versus government control, particularly as the urban and richer coastal areas pull even further away from the less wealthy rural heartlands. Beijing's 2012 leadership handover is approaching, and how the authorities manage this will be just as critical as who they bring in to replace President Hu Jintao.

The world needs China's cooperation on a range of issues. Its relations with the junta in Myanmar, and its ability to influence North Korea on denuclearisation will be critical, but are unlikely to force either regime in from the cold. China's veto remains a block to UN sanctions on Iran, which has not been helped by the recent US arms sale to Taiwan. The improvement in Sino-Taiwanese relations appears on hold as a result. War between the West and China is a fear for some, especially within the military establishment in the US, but it remains unlikely, not least because while China's military is massive in terms of manpower it remains technologically inferior. A greater threat comes from the continued and deliberate weakness of the yuan and China's controlling hand on US reserves, as well as the ever-present threat of protectionism.

In 2010, pressure will also come from deteriorating global social indicators. The FAO estimates that a further 100m people were pushed into chronic hunger as a result of the high food and fuel prices of 2007-2008, and then the financial crisis of 2008-2009. A total of 2bn people are estimated already to exist in a state of chronic hunger. If, as we expect, the price of crude rises this year to new nominal peaks, then the impact on those already vulnerable or marginal in societies around the world will be serious. Hunger, disease and chronic unemployment – some of the consequences of severe poverty – are global problems. They are also highly correlated with transnational security and social threats, such as terrorism, the trafficking of humans and illegal drugs and the spread of infectious diseases.

The danger these conditions pose for weak and failing states is especially serious. Countries like Somalia and Yemen are unable to protect the lives of or provide basic services to their citizens and are proving safe havens for terrorist groups. In formerly buoyant emerging economies like South Africa and Mexico, problems of weak governance – corporate and social – and the weak rule of law are proving politically destabilising, and are disrupting economic progress.

In the coming months, elections in Iraq, the continued standoff with North Korea, sanctions against Iran, renewed confrontation in the Middle East and the likely deterioration of the security situation in Afghanistan as a result of the surge and revitalised NATO efforts there will all be major concerns. These are not just political or security concerns though – the elections in Iraq will impact how much crude oil Iraq will pump in the next 10 years, North Korea's collapse will lead to the swamping of South Korea and affect demand and production in this critical part of Asia, and a cornered and irate Iran will seek to threaten one of the world's most important energy choke points – the Straits of Hormuz.

Conclusion

As of today the road ahead looks bullish for most commodities – supported in the long-term by rising demand from the rapid economic catch-up of Asia. The current foreseeable threats come from either overstocking or from reduced liquidity due to tighter monetary policy in China and other potentially overheating economies. Nor are the mature economies out of the woods. Recovery brings its own risks, not least the return of political risk, resource aggression and resource conflicts. Input disruptions – whether for energy, transport or labour – will become features that affect supply again, and inflation may become a more serious threat, as heavily indebted mature economies decide how they can best pay down these debts – either through painful cuts in the public sector or through inflating them away.

In the medium-term, emerging market economic development combined with continuing population growth – the UN forecasts the global population, already in 2009 at 6.8bn, and likely to grow to 9.15bn by 2050 – will drive the demand for all commodities, not least CPO and its substitutes, much higher than today. While the December 2009 Copenhagen climate change accord was a failure in one sense, it nevertheless started a process that will eventually lead to international legislation on carbon emissions. An agreement of sorts to replace the Kyoto Protocol will be cobbled together in Mexico in 2010. This will – along with rising energy prices – probably stimulate a shift in mature economies to a low carbon regime, albeit at a slower rate than expected. This in turn will serve to affect the demand for commodities that can be used as biofuel and biodiesel feedstocks, or alternatives to hydrocarbons.

In the short-term, palm oil faces a reasonably strong demand growth scenario. It will remain a favoured edible oil and – depending on the relative prices of crude oil, soyoil and alternative biodiesel feedstocks, such as rapeseed – will also remain a relatively attractive biodiesel feedstock. In the medium term however, the consumer and environmentalist backlash against palm oil plantations has gained a strong foothold and is unlikely to be reversed. This will have three main effects. The first will be to push producers increasingly towards developing the nascent sustainable palm oil market, even though the cost of production will rise and some of this cost will certainly be passed onto consumers. The second will be to give an extra nudge to the development of more advanced biofuel feedstocks, which are more effective at reducing total carbon emissions. The third will be to marginally dent the growth of the diesel car market, as drivers will increasingly opt for petrol-engine vehicles and/or flex-fuel vehicles that use ethanol.

But while CPO may have a much less certain future as a biodiesel feedstock than a couple of years ago, it is going to remain a highly sought-after food item and in the long term demand from the biggest current consumers – India and China – will inexorably grow, and their governments may have less compunction about the sustainability or otherwise of the source of their palm oil. Their populations are increasing, India's at a faster rate than China's, and the economic prospects for both countries, even at current recession-hit rates of growth, are good. On the other hand, global land use restrictions will grow – either by law or in practice as the availability of arable land lessens – and input costs (fertiliser, power, labour) will go up. All of these will push prices higher. This will necessarily affect demand, and then supply.

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.

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.

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