Global Markets Research

Commodities: Agri Updates

06 May 2010

Sugar. Continuing to sour.

- The international sugar market has continued to sour over the past few months.
- Fundamentally the market has changed drastically. This added to the increasingly cautious market sentiment.
- An additional 3 ½ million tonnes of sugar was 'found' in India this season. This represented 25pct of original forecasts.
- After a spike, prices only stop falling once they erase all the original gains. This suggests more downside to come.
- We have swung the axe through our 2010/11 price forecasts.

A fundamentally different market now…

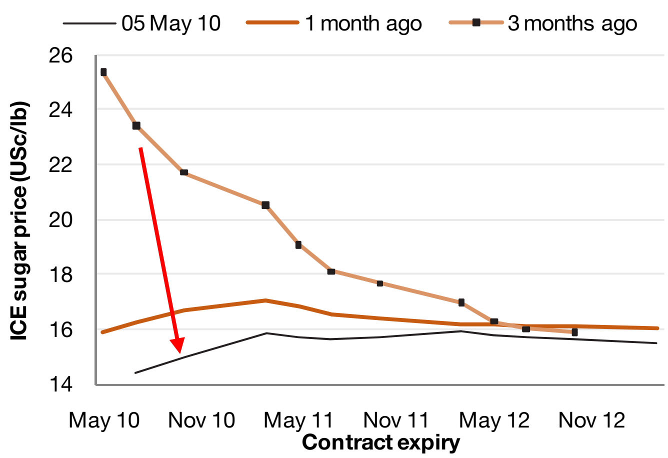
The one thing we have learnt from this turbulent sugar market is we can never say never! Whilst we were taking some time off to recharge the batteries in April, the sugar market was moving at full steam. Downwards. Raw sugar futures (nearby contract) at the end of April were below USc15/lb, less than half of where they were only a few months earlier. At the time of writing they had fallen further to USc14.41/lb.

Our judgment in early March that the market may bounce proved incorrect. But the market is now a fundamentally different beast. The supply and demand situation for the key nations did an about-face while we were away.

Figure 1: ICE raw sugar prices (first contract, USc/lb)

Source: Bloomberg, CBA

Figure 2: ICE raw sugar futures curve (USc/lb)



Source: Bloomberg, CBA

What's different?

1. The size of India's crop

We were once warned not to believe anything we heard from India. Perhaps we should have paid more attention. Back at the start of 2010, Indian sugar production for the current season was forecast well below 15mt against consumption requirements of 22-23mt. This was to follow the previous season's 14.7mt crop, which would have created a deficit of around 8mt. This deficit was to be met by imports and existing stocks. Because stocks were tight, India's reliance on imports was expected to be immense. This anticipated buying was the primary catalyst for prices shooting up toward 30cents.

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However, in March and April a series of upward revisions were made to India's production prospects. Miraculously, Indian production for the current crushing season (nearly complete) is now estimated at 18.5mt. We remain perplexed at how the Indians can discover an additional 3.5mt in such a short period of time. But they did, and the world is now different. 3.5mt of potential imports are no longer needed.

2. Brazil's immediate production and export response

Brazil continued to crush cane throughout their traditional 'off-season'. Aided by favourable weather conditions and a desire by the Brazilians to take advantage of the firm prices (while they lasted!) The Brazilian sector focused on supplying the export market, and according to some analysts an additional 1mt of raw sugar was available for the world market. The combined impact of Brazil and India is a 4-5mt swing in prompt net import requirements.

Unica's final numbers for the 2009/10 season (finished 31 Mar) show total cane crushed was 542mt, up 7.3pct on the previous year. This included a huge 23mt of cane crushed during the traditional inter-harvest period of Jan-Mar. Sugar yields (TRS) for the full season were disappointing, down 7.5pct (yoy). But a swing to sugar production (away from ethanol) resulted in total sugar production up by 7pct to 28.6mt.

3. Focus on 2010/11 and beyond

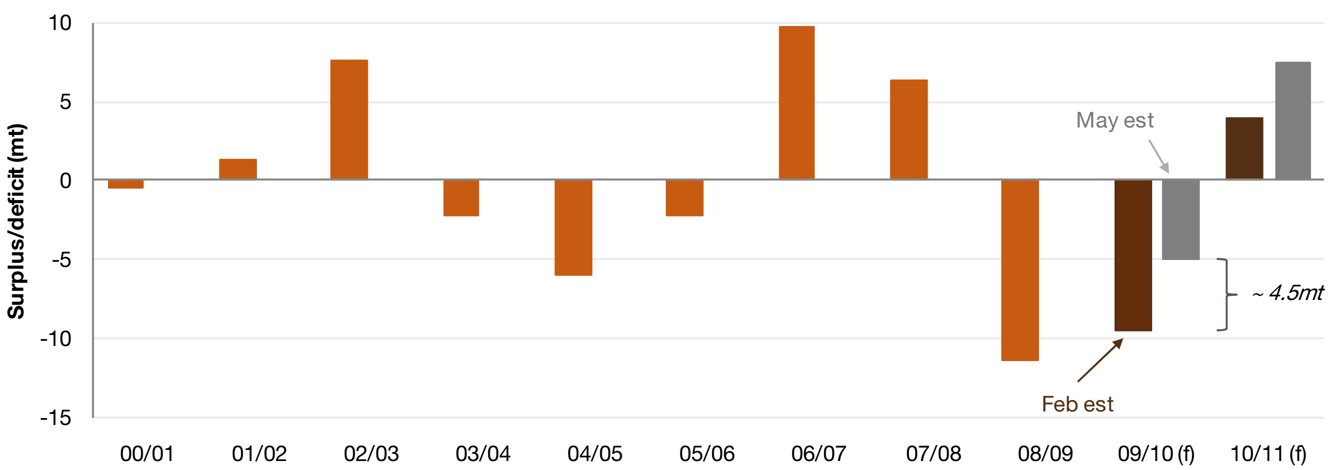
In the past 6 weeks the market has paid increasing attention to planned production increases for 2010/11 and beyond. Increased production in response to the rampantly high prices observed late last year and at the start of this year. This will be a global production response, but again India and Brazil will pay a central role.

In India, talk is that the 2010/11 crop will cover domestic consumption requirements. Bloomberg reported (4th May) the Indian Farm Minister as saying production 'may exceed' annual demand of ~23mt. The Minister was also quoted as saying "forget about imports, we will be in a position to export next year". Media reports indicate that production may be as large as 24-25mt. Reports that India will consider the immediate reintroduction of the 60pct sugar import tax signifies that India need to import has greatly diminished.

In Brazil, centre-south cane production for 2010/11 is forecast to be at least 600mt, up 11pct from last year and nearly 20pct from 2008/09. Sugar production may reach 34mt, nearly 20pct higher than last year.

Incorporating the latest numbers for India and Brazil into our global sugar model reveals the extent to which the global situation has changed. Rather than a 2009/10 deficit of near 9mt, it now seems likely the deficit will be trimmed to around 5mt. This has implications for the size of the 2010/11 surplus which now looks likely to come in between 6-8mt. The result is import requirements are lower and ending stocks will be higher. Two factors that weigh on prices.

Figure 4: The global sugar balance has changed.



Source: CBA estimate.

When will prices stop falling?

History suggests that after a spike, sugar prices only stop falling once most (if not all) the hard earned gains have been erased. In other words the market needs to get back to where it started.

Panel 1 (to the right) plots the weekly movements of NY raw sugar futures during the 3 major spikes over the past 5 decades. These are the 1974, 1980 and 2005 spikes. We also present the trajectory of the most recent 2009/10 spike.

Two key features are evident:

- Prices return to where they started; and
- Each cycle is somewhat symmetrical.

This suggests (rather crudely) that the raw sugar market will not stop trending lower until they get near their late 2008 levels of less than 11 cents per pound.

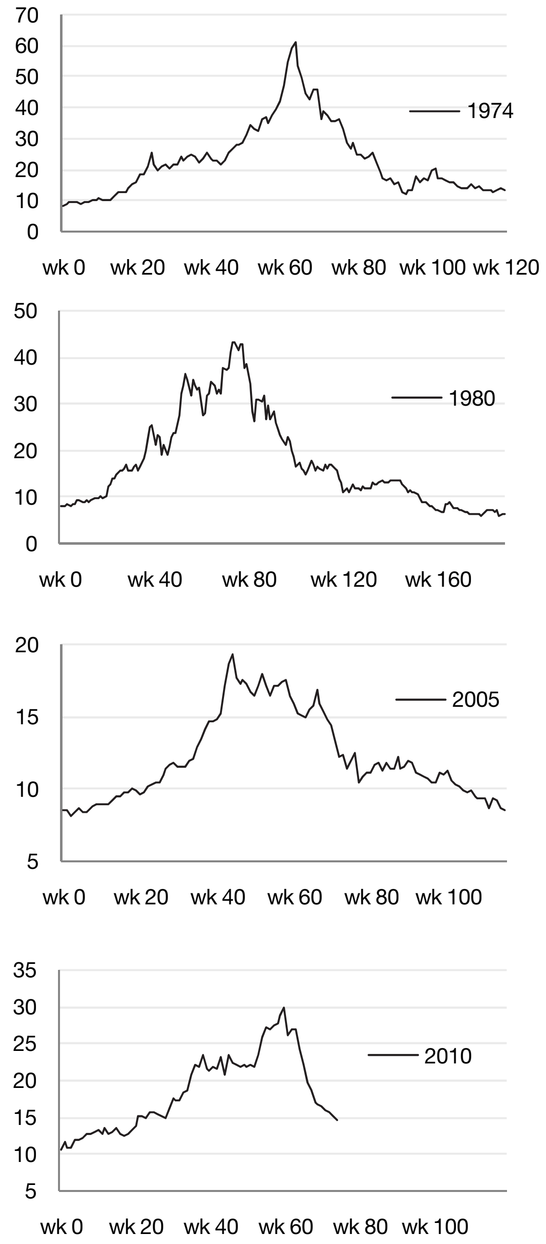
Furthermore if prior rules of symmetry are repeated, this would occur by March 2011.[1] However the recent trajectory of the decline suggests this could come sooner rather than later.

Can we realistically see this scenario becoming reality in the current market?

Definitely. Market sentiment and technical trading alone can take the market there quickly. Developments in the fundamental space also suggest this could become reality. In Q1 next year India will have nearly completed the 2010/11 cane crush. Early estimates suggest this could be large enough to produce an exportable surplus. And Brazil will be about to ramp up their 2011 centre-south cane harvest. This is likely to be another record breaking crush by the ever expanding Brazilian sector.

It seems likely that a production concern in either India or Brazil over the coming 12 months will be required to reverse the decline in price. This is possible, but shouldn't be banked on.

Panel 1: Previous Sugar Price Spikes - NY Raw Sugar Futures (1st contract, USc/lb)



Source: CBA Research.

Revision to our price forecasts

The changing fundamentals in the sugar market and continued collapse in prices warrant a change to our near term price expectations. Indeed we have taken an axe to our existing numbers, and we have front loaded our existing declines into a few short months. But thanks to movements over the past 2 months, a large proportion of these declines are now assumed to be behind us.

[1] Based on the fact the rally commenced in the Dec 08 peaked in late Jan 09, a total of 60 weeks.

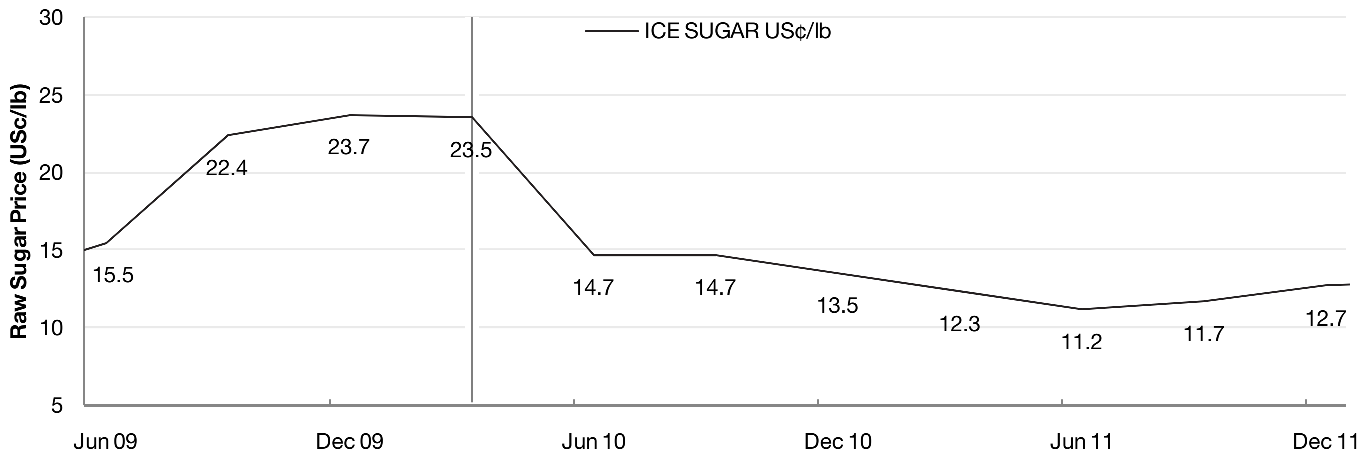
Indeed, we don't expect the extraordinary rate of decline to be repeated for the remainder of the year. Our primary thesis is that the market is still historically tight, and therefore vulnerable to any negative production scares. Upside and downside risks are clearly evident in the current environment.

We feel that the market is likely see the year out in a broad band from US13-16c/lb. Further declines are now expected in the first half of 2011 as the second instalment of the global production response commences. Our expectations of a strong Australian dollar this year will add additional weight to local prices (see Figure 6).

We remain optimistic about longer term sugar prices. Our view is primarily based incomes in Asia, our assumption of growing medium term Chinese import requirements, and increasing competition for cane by the renewable fuel sector.

But don't expect a smooth ride. The historic boom-bust cycles seem set to continue…

Figure 5: ICE raw sugar price forecast (nearby contract, USc/lb, quarterly average)



Source: CBA Research

Figure 6: Forecasts

		Current at 5/05/10	Actual (Quarter Average) Jun 09	Sep 09	Dec 09	Mar 10	Forecast (Quarter Average) Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12
Raw Sugar (ICE)	USc/lb	14.4	15.5	22.4	23.7	23.5	14.7	14.7	13.5	12.3	11.2	11.7	12.7	13.0
	US$/t	318	341	493	523	519	324	323	298	272	246	257	279	287
	A$/t	350	438	578	580	578	346	348	328	307	282	300	329	337
Currencies (period end)														
	AUD/USD	0.91	0.81	0.88	0.90	0.92	0.95	0.92	0.90	0.88	0.87	0.85	0.85	0.85

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Unless otherwise noted, all data is sourced from Australian Bureau of Statistics material (www.abs.gov.au).