

Sugar market review: What has changed?

- The international sugar market remains one of the most interesting in the agricultural commodity complex, with prices seemingly defying gravity. Prices in the past week have surged higher, with speculative investor buying being fuelled by continued bullish reports from the field.

Recent price action

- New York raw sugar futures (ICE, 1st contract basis) have rallied strongly over the past 4 ½ months. This week prices touched US\$24.36/lb, which is not far off the 30-year peak of US\$30.40/lb observed at the start of the year.
- Current prices are double the decade average of US\$10.50/lb, and easily exceed the 2005/06 peak of US\$19.73/lb.
- The strength in the raw sugar market is broad based, with fresh contract highs being posted this week for all raw sugar contracts that expire before mid-2012.
- Refined sugar prices have also rallied. But as Figure 3 reveals, the most recent strength in the global sugar complex has been led by surging raws, not by booming whites, as was the case in the middle of this year. The white premium (basis Oct 10 contracts) has now dipped under USD100/t for the first time since June after rallying up to USD160/t in July.

What is in store for the future?

- Markets are questioning whether the market has rallied too hard, or if indeed fresh 30 year highs could be observed. The sharp correction observed last night (both raws and whites down 2-4%) is perhaps a insight into the future...
- In this report we review the recent price movements, pass judgement on what fundamentally (if anything) has changed, plus assess what the future may bring.

Figure 1: Long Run Sugar Prices (ICE, 1st contract, US\$/lb, monthly average)

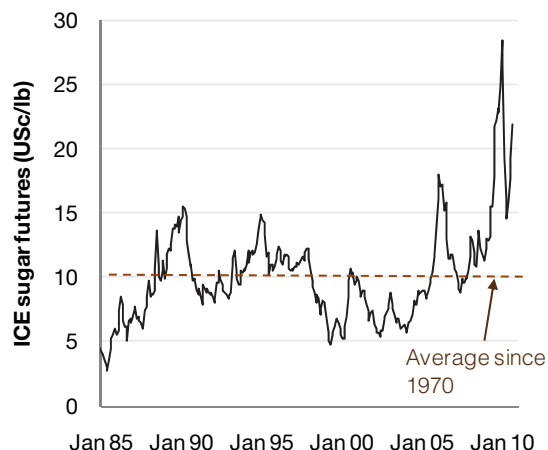


Figure 2: ICE Raw Sugar Curve Movements

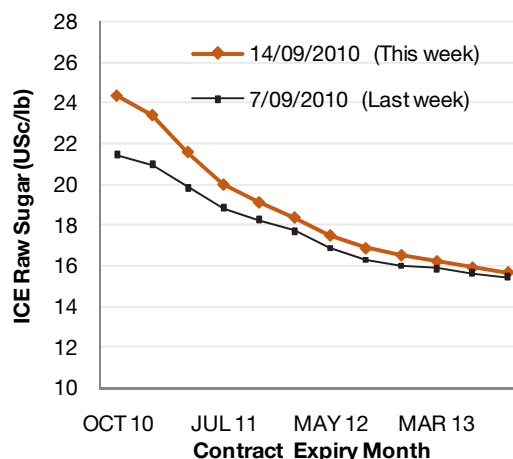
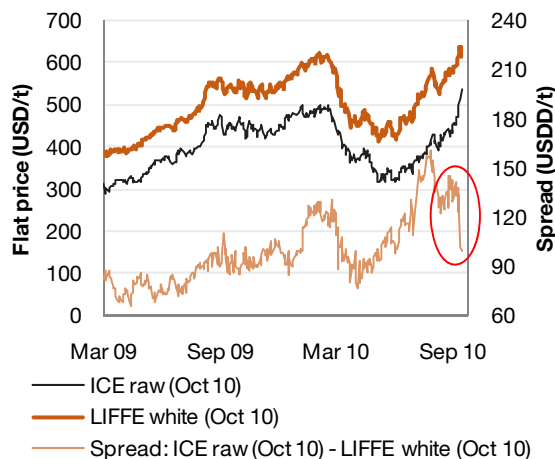


Figure 3: White vs. Raw Sugar Price Spread





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Why has the market rallied so sharply again?

Nervousness within the global sugar market remains apparent. With existing global inventories still so low, any production scare, whether perceived or real, is going to have a significant influence on market sentiment. Volatility is always higher than normal in such times.

Production uncertainty has re-emerged in the global market, and this is the primary reason for the price rally. Earlier in the year the market was expecting a significant easing in the global stock tightness during the fourth quarter. However, recent issues in Brazil, Pakistan, Russia and even Australia have raised concern as to the rebound in global production.

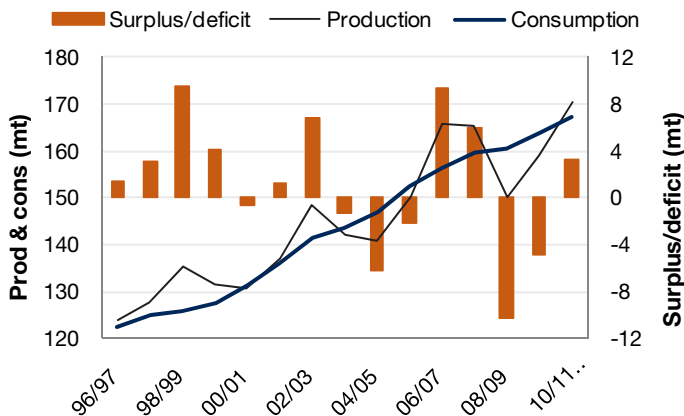
International Sugar Organisation World Sugar Balances

In their late August market update the ISO pencilled in only a moderate rebuild in global sugar stocks for the 2010/11 marketing year (commencing October). The forecast return to a 3.2mt global surplus, following the 2009/10 deficit of nearly 5mt, is the result of a solid but not exceptional recovery in production.

The ISO has forecast global production to expand 7% next season. However this is more subdued than the assumed 9 ½ % jump factored in by private analyst Czarnikow (25th Aug).

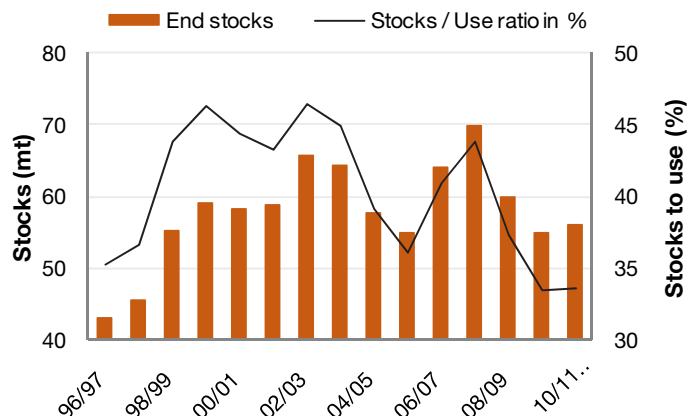
ISO expect global ending stocks to grow from 54.9mt to 56.2mt, but as Figure 5 indicates, stocks remain tight. Because of these continuing tight stocks, ISO note that a “major downward correction [from 19-20cents] would be a surprise. [But] on the other hand a surplus is a surplus, and further price rises are likely to be capped.”

Figure 4: ISO world sugar balances (August 2010)



Source: ISO and CBA (based on an Oct-Sep marketing year)

Figure 5: ISO world stock forecasts (August 2010)



Source: ISO and CBA (based on an Oct-Sep marketing year)

Brazilian production and eye on the future

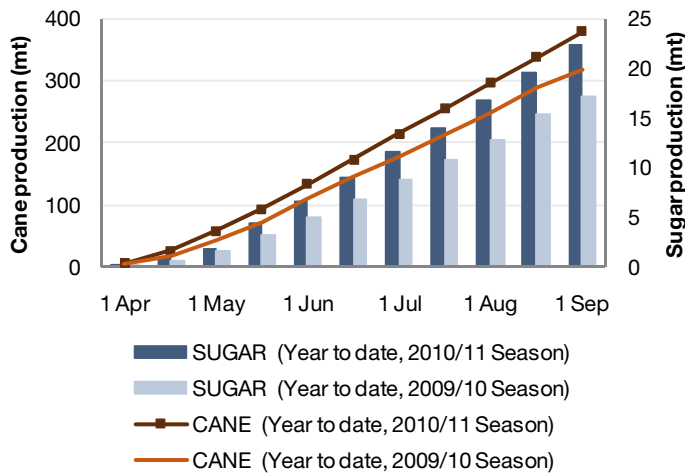
Strong early season production

Brazil's centre south sugarcane crush has progressed at breakneck speed this year, with dry conditions aiding crushing progress and sucrose yields. Total cane production in the year to September is 380mt, up 19% from the same time last year. Sucrose yields are running at around 138kg (ATR¹), 5% higher year-on-year, and mills continue to allocate more cane to sugar (rather than ethanol) this year because of favourable price differentials. As a result, centre south sugar production this year has already reached 22.5mt, up 30% from the same time last year.

¹ ATR refers to the amount of product extracted per tonne of crushed cane.

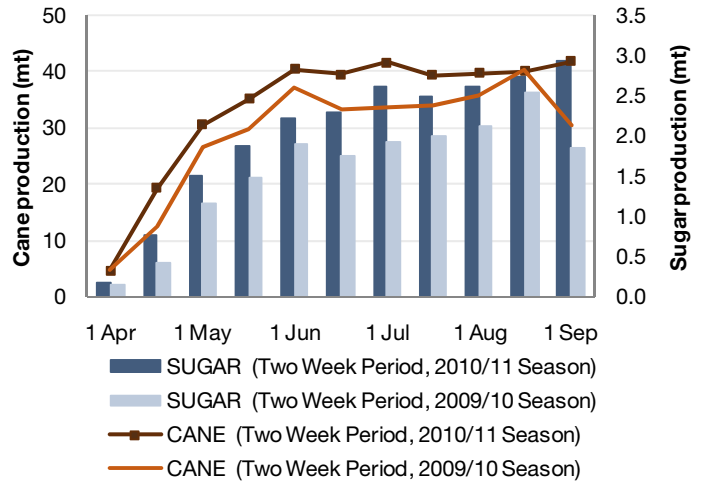


Figure 6: Brazilian centre south sugarcane crush (cumulative results)



Source: Unica and CBA

Figure 7: Brazilian centre south sugarcane crush (fortnightly results)



Source: Unica and CBA

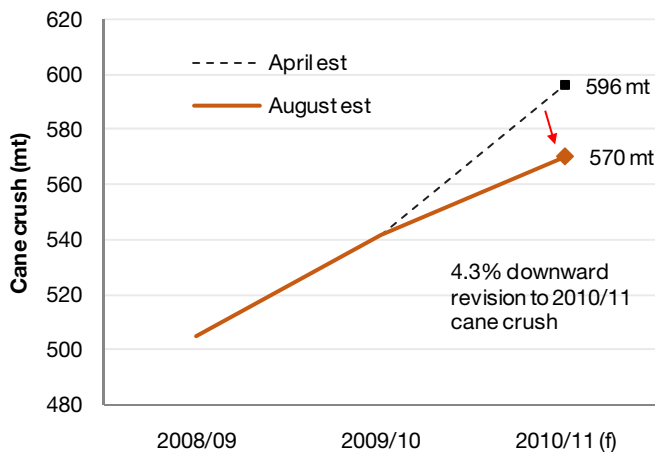
End of season production prospects

But while dry conditions benefited early season crushing, dryness also impairs cane growth. As a result agricultural productivity in the final stages of the current harvest is likely to wane, and there may also be negative repercussions for next year's harvest. These dryness concerns have supported international sugar prices in the past month.

Reflecting the La Nina related dryness, Unica has revised lower its initial estimates for the 2010/2011 sugarcane harvest (26th August). They now expect total cane production to reach 570mt, 4.3% less than the initial April estimate of 596mt. Yet the revised forecast is still 5.2% higher than the 542mt crushed in 2009/2010.

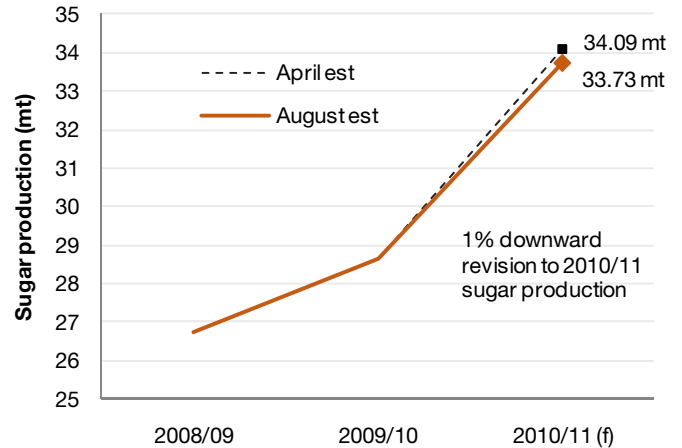
But it is not entirely all one way traffic. Unica has increased its estimate of sucrose yields to an ATR of 141.80 kg per ton of cane, compared to 138.59 kg estimated in April and 130.23 kg for the 2009/2010 harvest. And they also increased their sugar vs. ethanol production ratio. Critically, as a result sugar production is now projected to reach 33.7 million tons, down only 1% from the original estimate. But the latest forecast is still 18% over the 28.6mt produced in the 2009/2010 harvest.

Figure 8: Brazilian centre-south cane crush forecasts (Unica)



Source: Unica and CBA

Figure 9: Brazilian centre-south sugar production forecasts (Unica)



Source: Unica and CBA



Since this August update, further downside risks to cane output have arisen because of continued dryness. On the 13th September, Unica stated that “the drop [in cane yields] is likely to intensify as the end of the harvest approaches, because there is no expectation of significant rainfall.” And they went on to say “if current climate conditions persist, we might have a reduction of the crushing expectation presented in the revised projections we released in August”.

It is certainly possible that further downgrades could occur, however as with the previous reduction, it is likely that cane output, rather than sugar output will be hardest hit. Nonetheless, these concerns are likely to be a supportive factor in the global sugar market, but arguably, a raw sugar price above US\$23/lb already reflects expectations of further downgrades.

Brazilian sugar exports

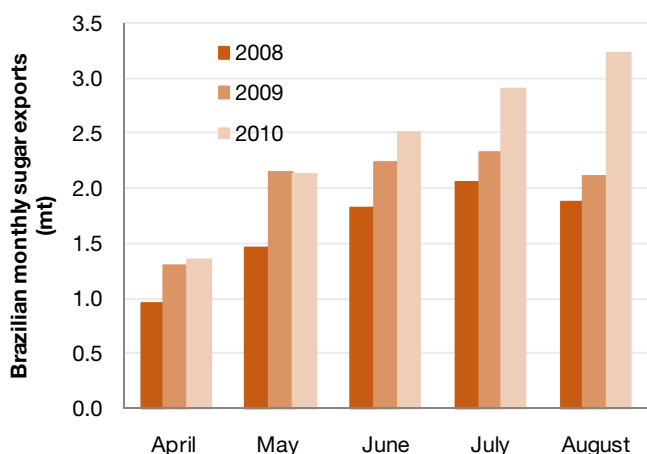
Significant talk of Brazilian port logistic constraints has continued in recent months, with many participants suggesting that the vast queue was an indicator of inadequate port facilities and slow exports.

But the export data completely refutes these claims.

In each of the past three months Brazilian sugar exports easily exceeded the levels of a year earlier. In the month of August, exports hit an all time record of 3.2mt, up from the record of 2.9mt set a month earlier and the prior record of 2.5mt set in September 2009. Cumulative exports from April to August are now in excess of 12.1mt, up 20% from the corresponding period last year and 50% higher than the corresponding period in 2008.

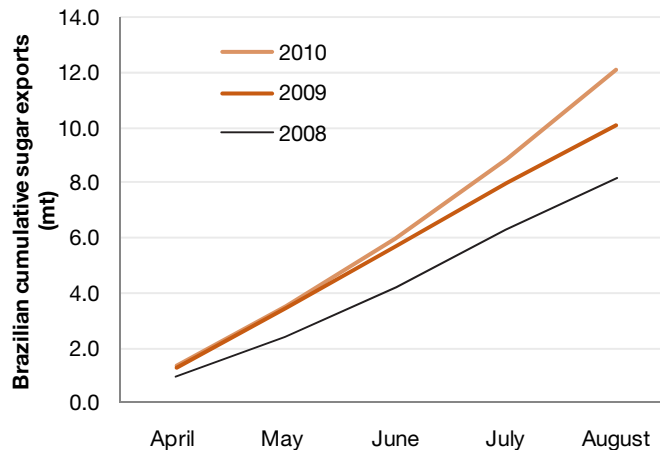
In our opinion, the extremely high number of ships off Brazilian ports is a reflection of firm import demand and limited supplies in other origins. Interestingly, the length of the shipping queue has started to trend lower in recent weeks. This may be the result of waning global demand and/or improving supply prospects in other regions.

Figure 10: Monthly Brazilian sugar exports (mt)



Source: Unica & SECEX

Figure 11: Cumulative Brazilian sugar exports (mt)



Source: Unica & SECEX

Russian and Pakistan production issues

Excessive dryness across Russia has hurt beet production this year, capping the production response. Early season production forecasts put the Russian beet crop at around 3.9mt, up sharply from the 2009/10 result of 3.3mt. However the widespread drought this year has resulted in very low test weights, and production will now struggle to reach 3mt according to ISO reports.

In Pakistan, horrific floods wiped out huge areas of cane. The Pakistan Agriculture Ministry reported that some 60,000 hectares of cane was significantly affected in the north of the country. At the start of the year the government was reportedly targeting cane production of 55mt against 49mt last year, and raw sugar production of 4mt against 3.4mt last year. But the floods have likely



eroded the entire expected production increase, and Pakistan will be forced to remain a significant sugar importer in 2011.

Indian production response

Despite questionable conditions in many parts of the world, conditions in India, arguably the most important nation in the sugar complex, remain fantastic. Forecasts of Indian sugar production remain on track, with the Indian Sugar Mills Association expecting white production to hit 25.5mt, up from 18.9mt last year and above domestic consumption requirements of 22-23mt. Furthermore, some forecasts suggest production could reach 27mt. As long as sugar output exceeds 25mt, we expect India to become a significant sugar exporter following a few seasons as the world's most influential importer. The Indian cane crush will get under way over the next few months.

Trading patterns of market participants

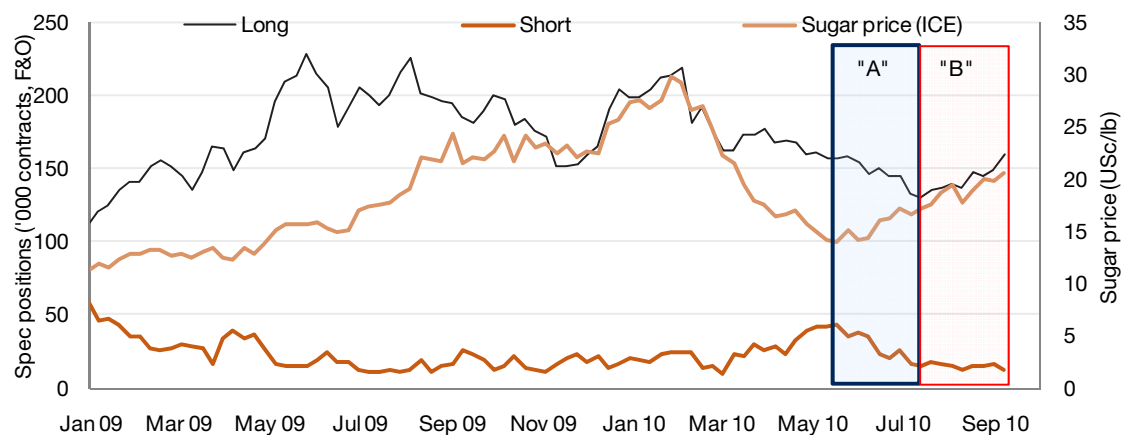
Across the commodity markets, the activities and positions of various participants warrant monitoring. Speculative investors are an important group to watch, as the trading patterns of these investors are often associated with price movements.

Two distinct phases have occurred in the ICE sugar market in the past 5 months.

- A. From May through July, speculative short covering was a key driver of increasing prices. These investors were keen to square up short positions as it became evident that the February to May sell-off was overdone.
- B. From July, building long positions has been a key focus of the speculative investor, and this has been associated with a further push higher in prices.

Which way the speculative investor will move in the future is always up for debate. However Figure 12 indicates that further short covering is likely to be limited, and this removes a potential source upward price pressure. And while long positions are still some way off the peaks of the past 12 months, they remain well above long run averages². We believe that the speculative investor will want further bullish news before they are willing to extend these positions further. And with most of the adverse production news now presumably known, the question must be asked, where will this bullish news come from?

Figure 12: Speculative trading positions vs. ICE sugar prices.



Future price expectations

Unless there are unexpected issues with the upcoming Indian cane crush, we struggle to pinpoint

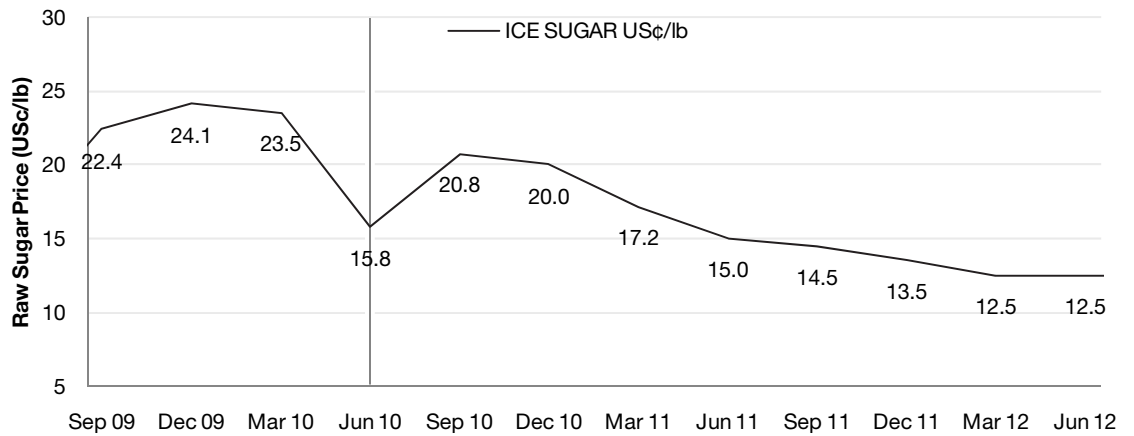
² Speculators currently have over 160,000 long contracts (futures and options). The average since is 98,000 lots.



where fresh bullish news for the sugar market will come from. Indeed it seems that current pricing should already reflect all bullish fundamentals. For this reason we think it is likely that the market will wane over the coming 3-6 months, with the catalyst being the start of the Indian cane harvest in October.

However, the extent of the price movements will be tempered by the production downgrades discussed in this paper, and the resultant slower than expected rebuild in global sugar stocks. Consequently we have lifted our 12 month price forecasts. Medium term prices are expected to come under more serious downward pressure because of the additional planting response induced by the current strong prices.

Figure 13: Raw sugar price forecasts (Commonwealth Research)





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