

5 May 2011

## COFFEE MARKET REPORT

### **BULL IN A CHINA SHOP**

Usually, when sitting down to write a market summary I have an ordered structure to my story arriving at a clear conclusion, representing my view to the future. My extended silence over the past months stems from writers block, brought about by information overload rather than a lack of inspiration. This is no longer a complex market to be navigated as you would a maze or labyrinth, applying logic and experience and historic data to map your course. Logic and reason only get you so far and are certainly no basis to trade on, as roasters, growers, traders and speculators alike have found out at great cost in recent months. This market is more of a detonation, or series of detonations, resulting in an unprecedented price rise to levels not seen for 34 years. It is worth noting that unlike any price rise in history, this rally has no fundamental supply crisis (such as drought or frost in Brazil) as its catalyst. This market is the perfect storm. A coming together of series of random events that have no obvious links, only the common denominator of occurring at the same point in time. The burning question is if the recent dramatic downward correction represents the end of the storm or only the eye, with gale force winds yet to come.

In a bid to follow the story so far, let's take a glance at events leading to up to the market's recent breach of the 300 cent per pound mark.

- In 2009 Colombia's Arabica crop drops dramatically due to low yields brought about by old trees, disease and lack of inputs. A story common to most washed Arabica countries due to low prices from 1999 to 2005.
- Differentials for first Colombia and then all Central American milds begin to rise dramatically in the face of this shortfall.
- Arabica prices rise through 120, 130 and 140, stalling in the 140's for some months as Brazil is due to deliver a 60 million bag crop, the largest ever seen in the history of coffee. No-one believes the market can sustain in the face of such a mammoth crop.
- At the same time, roasters begin to run down inventory and reduce taking the usual forward cover. The world is in financial crisis, cash flow is paramount and no one knows what will happen to consumption in a recession beginning to gain momentum. No-one wants excess stock now or in the future.

- Roasters increase purchases of coffee out of spot warehouses rather than forward from origin. By living hand to mouth, the costs are reduced and money is turned around more quickly. This results in a huge drawdown of “buffer” stocks in Europe and the US, taking certified stocks down to record lows.
- Coffee producers start to fix forward into the market at levels from 130 upwards at the best levels they have seen for 11 years. Roasters refrain from fixing, waiting for the behemoth Brazil crop to knock the market back down to reality. The result is that the selling is done early and the buying is postponed, placing a disproportionately heavy skew on buyer price fixing to be done. This will prove to have a significant influence in the months ahead as every price dip is met with a swathe of roaster buying, creating price support levels that allow the market to springboard up from one support level to the next.
- Hedge funds start to look outside of financial markets where returns are low and risky and start to diversify their portfolios into commodities in greater percentages. The immense cash liquidity of the funds drives gold, silver, cotton, cocoa, coffee and a host of other commodities to record highs.
- Markets no longer behave as single organisms driven by individual supply and demand but start to move in unison, with alarming volatility as global macro-economics and other factors dictate the ebb and flow of cash into these markets.
- Hard currencies go mushy and experience the exchange volatility common to banana republic during a coup.
- Add to this mix Fukushima, Libya, Tunisia, Egypt and Bin Laden, as world events trigger fight or flight responses in all markets.

Price becomes impossible to predict as there is no chart in existence that can map the range or direction. Rock, paper, scissors is about as effective as Fibonacci in plotting the range.

The result is a supply pipeline between origin and consuming markets that has emptied. Although there is sufficient coffee in the world, it is in origin and has to ship as it becomes available. Brazilian ports break record after record for TEU's handled and get bogged down with a two month backlog.

The cash required to participate in this market has trebled at a time when money is the hardest thing to borrow. The cash liquidity pouring into the futures market from hedge funds (ironically) creates a cash drain in the physical market as traders and exporters struggle to finance at higher values and battle defaults.

Roasters are caught like deer in the headlights and chase the market up and up and up.



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So here we are at 300 cents per pound..... So what happened to the show stopping 60 million bags from Brazil? Well it turns out that it was needed. All of it. That Colombia had two consecutive poor crops is only part of the answer. While I honestly believe that coffee is grossly overvalued at 300, it is vital to understand the fundamental roles supply and demand are playing out in this market as this is the key to the future.

Virtually all origins have experienced a decline in production over the last 10 years brought about by low prices, increased production costs, lack of finance and the impact of climate change. Marginal coffee producing regions have switched to other cash crops as bio fuels and rising food needs offer easier, often more lucrative options.

Simultaneously, global consumption is on the rise at a steady 2% per annum. For me, this is the real bull in the ring and in the longer term, the one that bears watching. (No pun intended).

Global population growth is augmented by the economic growth in the BRIC countries and others. These exploding middle classes are all potential coffee drinkers, witnessed by Starbucks focus on expansion into China and India that includes land acquisition for coffee production.

While Europe and the US show far more sedate consumption growth overall, the growing demand for high quality, ethically sourced coffees is reflected in the premium differentials these coffees command, even at current market levels.

The arbitrage between Arabica and Robusta prices is also an anomaly in this price rise as Arabica prices have crested at \$6500 per ton while Robusta prices have hung around the \$2500 per ton level. A staggering difference if one's view is that coffee is coffee. One would think that in a recession, with scarcity and massive premiums for Arabica, the percentage of Robusta as a blend component should rise. It must have, but not as much as I would have thought. The high Robusta stocks underpin that fact.

So where to from here?

As interest rates rise in the BRIC nations and economic recovery remains sluggish in the developed world, speculators and funds have to wonder if coffee is still a buy at 300 or whether it is time to take some profit off the table. I expect the latter in the northern hemisphere summer months as buying dries up and stocks creep up as unsold coffees keep arriving. How deep will this correction be? I would expect (and hope) all the way down to the 230 mark or thereabouts.



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Further out gets hazy but as Central American crops dry up and winter approaches, buying has to return in a market that remains tight on supply. Word in the market is that many roasters do not have price or physical cover for the last quarter of 2011. I expect another up cycle into the last quarter of the year that may well last to April of 2012. By that time the Brazil "on cycle" will be fruit on the trees and another bumper harvest is anticipated. Colombia too should be back to more normal numbers and by then, these good prices should have translated into better husbandry and increased yields, creating some relief for the back half of 2012 and front half of 2013. That is as far out as I am willing to go.

From here to there remains a gauntlet to be run with the usual weather villains lining the route. We have very heavy rains currently in Colombia and Brazil frost season looming, followed by the drought season before Christmas. Hurricanes have become both an Atlantic and Pacific oceans phenomena in recent years and El Nino is on the rise once again. Any and all of these threaten what is already a very delicate balance between supply and demand.

As a good coffee friend once pointed out, "When supply and demand are neutral, the price scenario is bullish." Well, with crop forecasts what they are, neutral is about where we will be for the next two years.

Thank you

**Konrad Brits**

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