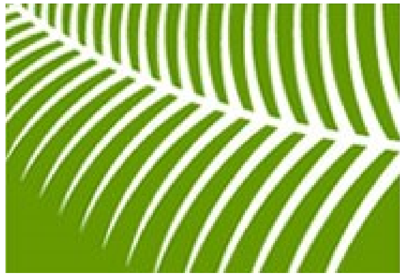

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A LOOK AT THE WORLD SUGAR MARKET

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Shortly after I agreed to speak at this session I received a package from the Department reminding me that the conference has been "redesigned to emphasize longer term agricultural prospects". In addition to discussing the current situation, I should also discuss some longer term issues. Well, what the author of this instruction probably did not realize is that, as a trader, this would open my horizon at least to the expiration of the March contract next week. Despite the possession of a trader's pre-disposition to the facts immediately in front of my nose, I will try to include some impressions for the longer term.

The world market, it is generally agreed, is in a surplus situation for the 1995/96 marketing year. The size of the excess supply is open for question and estimates range from 1.5 all the way up to 5 million tons. These forecasts have led to rather bearish outlooks for the current year. Despite these learned outlooks, the much heralded fall in sugar prices failed to materialize. In fact, a genuine tightness in nearby raw sugar has driven the New York No. 11 sugar futures contract to the highest level of the last 6 months. The March New York contract closed on the last trading day of December at 11.60 cents/lb. and steadily rose to a high of 12.92 cents/lb. on Tuesday. Even more interesting is the fact that the market is in a steep inverse with each month from March 1996 to October 1997 trading at a higher price than the succeeding delivery position. Should we not expect a market with a large surplus to be in a carrying charge configuration? This disparity between the bearish perception of the market and the reality of price resulting from the interplay of our old friends - fear and greed - is a real conundrum. Unwinding the riddle results in a better understanding of the phrase - the devil is in the details.

We began the 1995/96 marketing year with a very tight market. Refineries in the US, Korea, Morocco, China, and the FSU all shut down, or reduced production, due to lack of sugar during 1995. This is symbolic of the very low level of stocks carried in most countries. One of the primary reasons for the tightness was the heavy buying by China in 1995. By the late summer, or early fall, the warehouses of the world had been nearly swept clean and buyers were forced to wait for sugars from the new crop in November/December for their next source of supply.

The advent of this crop was delayed by wet weather in most of Central America and supply problems plagued the market through December. With everyone waiting for new crop supplies, the loading queues were severe and some vessels waited for over a month before getting placed on a loading berth. The continuing demand for nearby sugar in the first quarter was ensured by a delayed start to the Cuban harvest. In a deliberate attempt to maximize the crop (optimistically targeted at 4.5M tons) the start of the main harvest was delayed until the end of January. Those expecting delivery of Cuban sugars earlier sold for January shipment were forced to seek sugars from Central America or North Brazil to meet their requirements. Physical premiums for Central American sugars firmed as sellers withdrew and buyers scrambled to cover needs. As the crops in more and more nations have come into full swing the nearby tightness has become less severe, but prompt sugars still command a premium price.

Much of the attention over the last month has focused on the potential size of deliveries against the expiring March 96 raws contract. With the exception of Cuban sugars, there are few prompt sugars trading at a discount to the New York futures price. This structure suggests there will be little or no sugar delivered against the March contract and thus cannot persist if any significant long chooses to take delivery rather than pay the premiums for named origin sugars. The end result will be a convergence of the physical and futures prices. We have already seen a collapse of the nearby Thai sugar premium from 85 to 30 points. Similarly, tenderable sugars in the Western Hemisphere have traded at premiums of 15 to 30 points in recent weeks. The

willingness to pay a premium for the sugar is dependent upon the relative fear of receiving sugar on the wrong side of the globe if you take delivery of futures. A short to the US for re-export may be willing to pay a premium for Western Hemisphere sugar to ensure they are not caught with sugars from Thailand and subsequently higher costs of delivery.

The substantial premium being paid for March/May 15 shipment sugars has raised the possibility of limited supplies for the May contract. Most of the sugar available for May will already be produced and is deliverable against the March. Producers have jumped at the chance to capture the 70 to 100 point premiums over May offered by the market in recent weeks for the March delivery position. The sugar in the Western Hemisphere, with the exception of Argentina and South Brazil will largely be gone by the early summer.

Whether or not the decision by Cuba to delay the start of the harvest is successful in bringing about larger production remains to be seen. Early reports of sugar yields do not look too promising, and the much trumpeted 4.5M crop could prove difficult to achieve. If reports from recent visitors to Havana are to be believed, Cuba may not produce 4M tons. A crop that small could result in the Cubans having to buy back sugar to avoid shorting their previous buyers. A crop of 4M will also raise doubts about whether the large protocol sales to Russia and China will be fulfilled.

The tightness in the Western Hemisphere has been exacerbated this year by activities in the US market. The recent increase in the US sugar import quota of 400,000 tons tightened up the Western Hemisphere significantly. It seems likely that further quota increases will be needed to ensure adequate supplies in the US this summer. Increases in the import quota have a major impact on the Western Hemisphere balance sheet since about two thirds of the quota is allocated to Central and South American nations.

The market is already wondering if the Philippines and the Dominican Republic, both suffering reduced crops, will be able to fulfill their quota deliveries. Certainly both will have to import sugars in order to

supply both their domestic markets and the US quota There is talk of re-allocating shortfalls if these or other countries fail to fulfill the increased quota.

In addition to the larger quota imports, the US is also expected to drastically increase the amount of sugar imported under the re-export program. Part of these imports are replacing white sugar exports that occurred during 1995, while the balance reflect a healthy amount of tolling into the relatively high white sugar premiums offered by the world market this year. Buyers of sugar for re-export are largely forced to obtain their supplies from the March or May as sugars later in the period are either too high in polarization to be acceptable in the US, or are more geographically remote and dutiable. Recent changes in administrative policy make it harder for refiners to take advantage of the inverse in world market prices and delay imports until 1997.

While physical premiums in the Western Hemisphere have remained firm the premiums in the Far East have come under severe pressure over the last month. Early yield reports from Thailand have shown high sugar content in the cane. With production now forecast at between 6 and 6.3M tons and white sugar exports likely to be limited to around 1.3M by logistical constraints, over 3M tons of raw sugar will be available for export. The increased availability of Thai raws is likely to coincide with another record crop in Australia and a more normal crop in Southern Africa. The advent of these crops in the late spring and early summer may spell the end to the tightness manifesting itself in the first half and bring prices to levels closer to those forecast at the beginning of the year.

While supplies are likely to be plentiful by the end of the year, much attention will focus on potential demand, particularly in China. Total Chinese imports last season were estimated at 3.2M tons, but this season imports should be less than 1.5M tons. Lower import requirements have resulted not only from a considerable recovery in production but also from the ability to draw down stocks built during last seasons hectic buying activity. Thai premiums have weakened with the realization that a large proportion of Chinese requirements have already been

shipped from Australia and another large proportion will be accounted for by the Cuban protocol business. Forecasting the likely direction of Thai premiums will require an accurate assessment of how much sugar the Australians will sell outside the Far East and also how much South African sugar will reach the Far East.

While the Cubans delayed the start of their harvest it is expected that millers in South Brazil will seek to take advantage of the large inverse in the world market by starting their harvest earlier than normal and once again selling sugar for May/July 15 delivery. Of potentially more interest than the starting date of the harvest will be the quantity of raw sugar available for export. The local sugar market is much higher than world levels and alcohol for the local market also yields a higher return than raw sugar exports. Given these relative values and the current world market structure it seems likely that millers will concentrate first on local market opportunities, secondarily on white sugar exports and dedicate the residual to raw sugar exports. Certainly millers will try to put some of their raw sugar sales into the May 1996 position to take advantage of the high relative premium, but dedicating too much attention to this will result in lost opportunities in the local market. It is possible that the Brazilian government may allocate less export quota in the early season until local market demands for both sugar and alcohol are more adequately met. This could further delay the flow of exports to the world market and trap some of the surplus in Brazil until the next marketing year.

Turning to the whites market, the physical whites premiums for non-tenderable sugars have eased significantly over the last month. Thai white premiums have eased reflecting ample supplies in the Far East. The historically high white premium has encouraged a recovery in the level of tolling in countries such as Malaysia, Korea, China and the US. Always looming large in the background is India, who are facing the prospect of a massive build-up in stocks. These stocks, if realized, are likely to put a financial strain on the millers. Reports from India suggest that debts to the farmers are starting to grow a situation that could result in a reduced crop in 1996/97.

Despite making export sales of around 0.5M tons only around a third of this sugar has so far been shipped, mainly to Sri Lanka, Russia and Indonesia. A much accelerated program must be embarked upon if export projections are to be met. Achieving sales of 1M tons will require major additional sales and will force Indian sugar into markets in direct competition with Thai and Brazilian sugar. Even if India does achieve exports of 1M tons this would still leave internal stocks approaching 6M tons. This high local stock will trap a significant portion of the global surplus within India and keep the full burden of the global surplus from being felt in the marketplace.

The current abundance of non-tenderable white sugar in the Far East is further exacerbated by the potential for increased exports out of Central and South America. As previously mentioned, Brazil is likely to maximize white exports in the early summer while Mexico will continue to be a major whites supplier into the second quarter. For the first time in many years Argentina will also feature as a potential whites exporter.

The EEC white physical premiums have fallen over the last month, but to a lesser extent than Thai whites. Given the re-stocking of EEC supplies, both in the context of statutory minimum and blocked stocks, the export availability in the community should fall by 1.6M tons. This is the fundamental factor behind the historically high white sugar premiums we have seen this year. A major market for EEC sugar this year is likely to be Turkey, where increased domestic consumption and a poor crop should result in imports of around 600 thousand tons. While they have already bought a substantial amount of white sugar there are rumors now circulating that the Turkish authorities have considered switching their purchases from whites to raws. If this proves to be correct it would have significant implications for white sugar values.

The world market this year can be divided into two distinct halves. In the first half we see the culmination of the tight markets of the last year. The advent of the Southern Hemisphere crop should see the end of the tightness and open the way for a lower priced

and more amply supplied second half. If analysts are correct, the market is faced with a potential build-up of stocks of over 4M tons. Economic theory suggests that when supply exceeds demand prices should fall. Whether they do or not will depend upon how soon (or even if) the surplus is brought to the market. The most likely scenario in my mind is that the March and May expire at a premium and the market is left facing summer prices not substantially different than those reflected by current futures values for July and October.

One of the reasons why prices appear reluctant to fall to the most pessimistic of forecasts is that homes have already been found for a large proportion of this surplus. With India's apparent inability to export more than 1M tons and the EEC's statutory re-stocking over half of the world's stock building can be accounted for these 2 nations alone. The market will now have to decide where the rest of surplus is to be held and in what form, be it Thailand or Brazil, in raws or in whites.

One of the features of the sugar market in the last several years has been the increasing interactions that many nations have allowed with their local markets. The FSU, Eastern Europe, Mexico, Chile, China, and Brazil have all allowed more interaction of their local industries with international markets. The US has also allowed considerable interaction through the re-export program.

In Mexico, for example, producers are taking advantage of market inverses to export the stocks needed for the last months of the year early in the season and replace those sugars with cheaper supplies late in the year. This has obvious market benefits and eliminates or substantially decreases the cost of financing these inventories. Others have allowed a more straight forward access to their internal markets through variable duty systems.

These interactions allow the usual straight forward supply and demand considerations to be passed through the market mechanism into world markets. They also allow the influences of relative interest rates, exchange rates, and local governmental energy and agricultural

policy to be passed through the system. In my opinion this is all to the better and will allow markets to function more efficiently in the future. Through initially controlled access both the world market and internal market participants gain experience with how the "other" markets work without overt damage to either side. It does make it increasingly important to broaden the base of information gathered in making decisions on either world or domestic markets.

Internal markets around the world are used to stable prices at levels substantially higher than current world market levels. Few nations have internal markets that are directly linked to world values. Most have substantially higher prices. These prices are often compared to world market values and calculations of the cost of the domestic program are calculated. These are the engines of change in policy throughout the world and over time, the clear trend will be toward more interaction in all markets.

One should not expect to achieve prices that are as low as reflected in world markets. The pricing of sugar in world markets reflect the least common denominator of price and do not reflect the many contributions of local producers, processors, warehousemen and distributors that add value in local markets. Longer term, prices will probably move toward the actual cost of production as economic theory suggests. Local markets that move to allow greater access will ensure that their are reflected through price signals into world markets.

Another longer term trend that has occurred in many nations is the move toward minimal inventories. As governments are removing themselves from the market, private interests find it prohibitively expensive to carry large stocks. The resulting system is cost efficient, but more fragile than in the past. The result are periodic shortages in local markets and the need for a more direct interaction internationally. This may result in quicker price responses in both world and domestic markets in the next several years.

The gradual move toward freer trade will result in somewhat lower prices. It will also likely result in more volatile local markets as the price signals from

exterior sources are passed back into local markets. The traditional benefit of stability of price in local markets will become less and less true as trade becomes freer. Opportunities will present themselves in external markets that attract sugars, if only temporarily, from local markets. This will cause price changes not initially expected or welcomed by all local participants. I think that the longer term benefits of trade will more than offset these short run discomforts.