



Will bust follow boom this year?

Presentation to Globoil Delhi,
by James Fry, LMC, Oxford UK,
2nd February 2017

Summary of the topics I will consider today

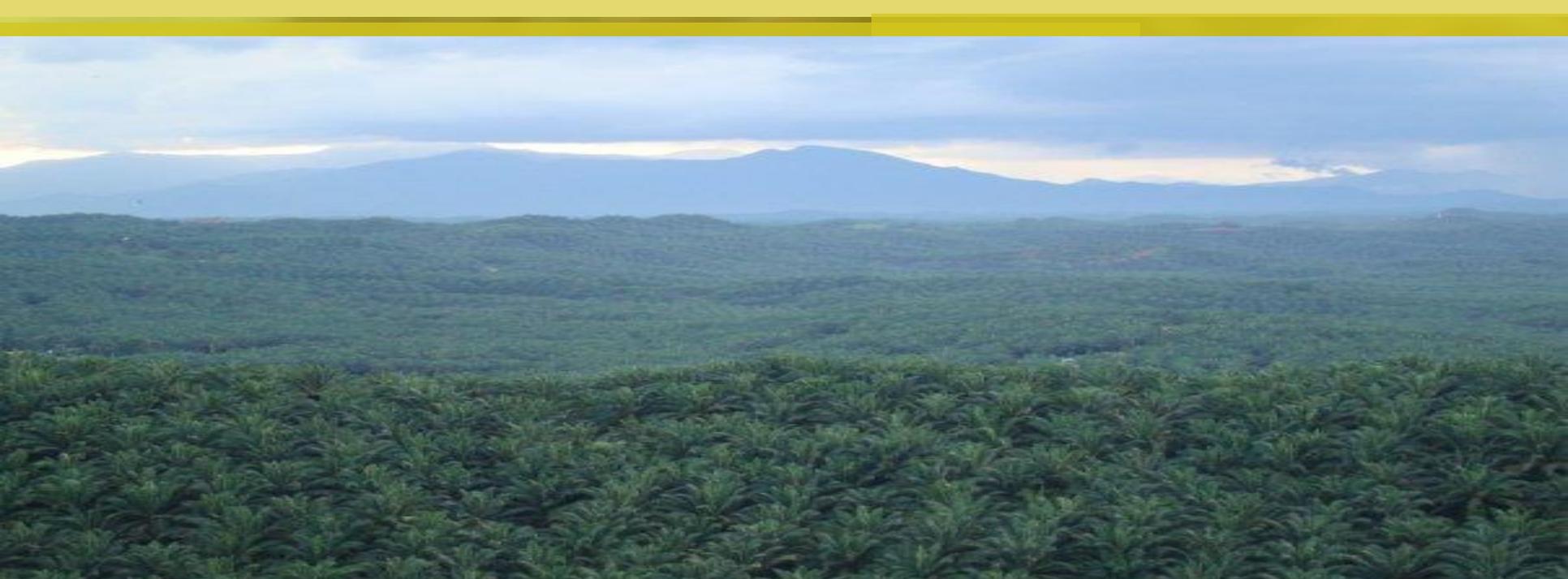
I start with a discussion of the two main reasons for the unexpectedly strong performance of vegetable oils prices in the past 18 months: the first is the worst El Niño since 2000; the second is Indonesia's CPO Fund.

I then examine how they affected CPO prices within the framework of the Brent crude-vegetable oil price band.

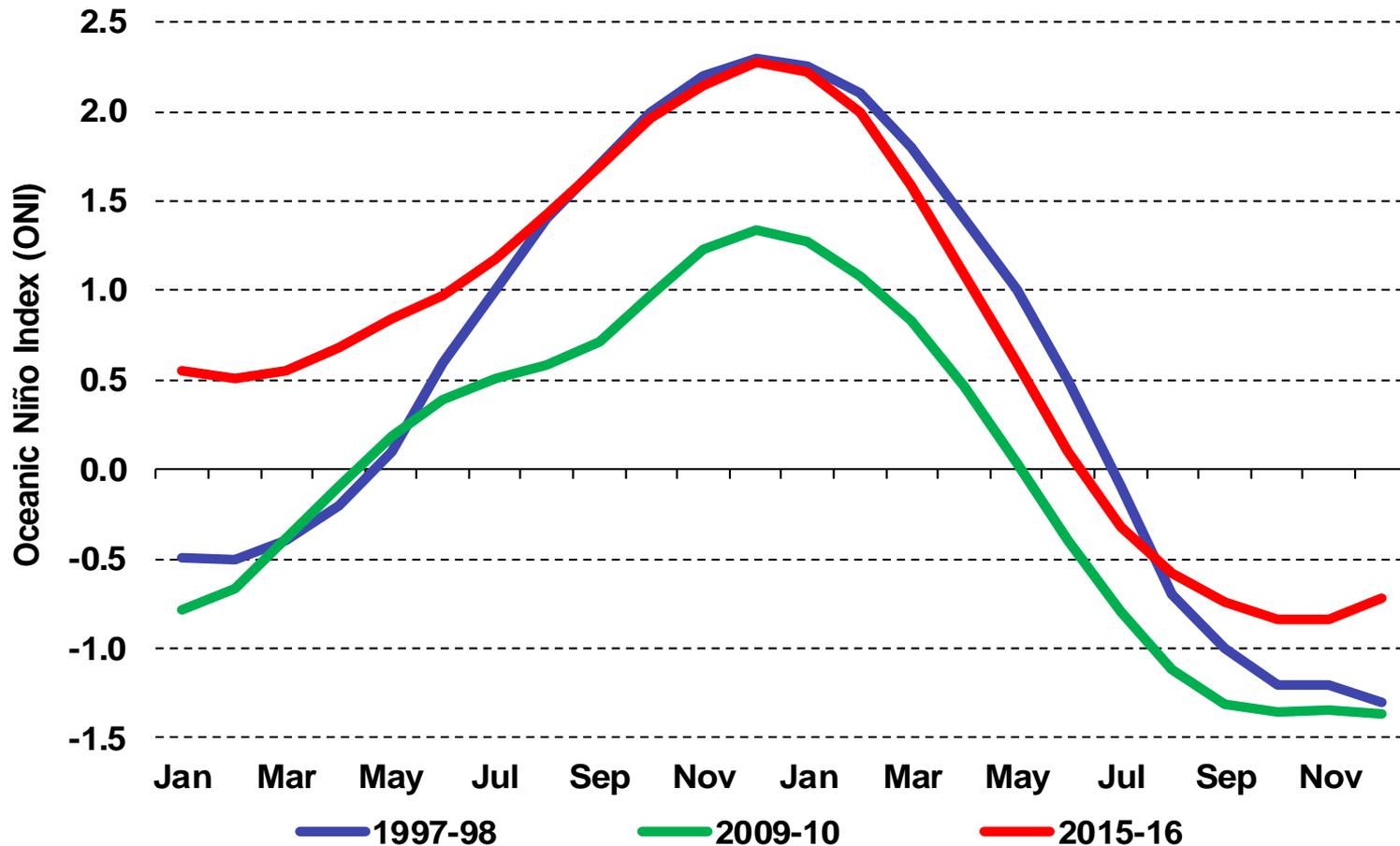
With El Niño replaced by a weak La Niña, we examine what the past tells us about the pace of output recovery.

I will end with comments about biofuel policy in the US (trying to detect clarity, where none yet exists) and in Indonesia, and draw conclusions about the outlook for prices within the vegetable oils complex later in 2017.

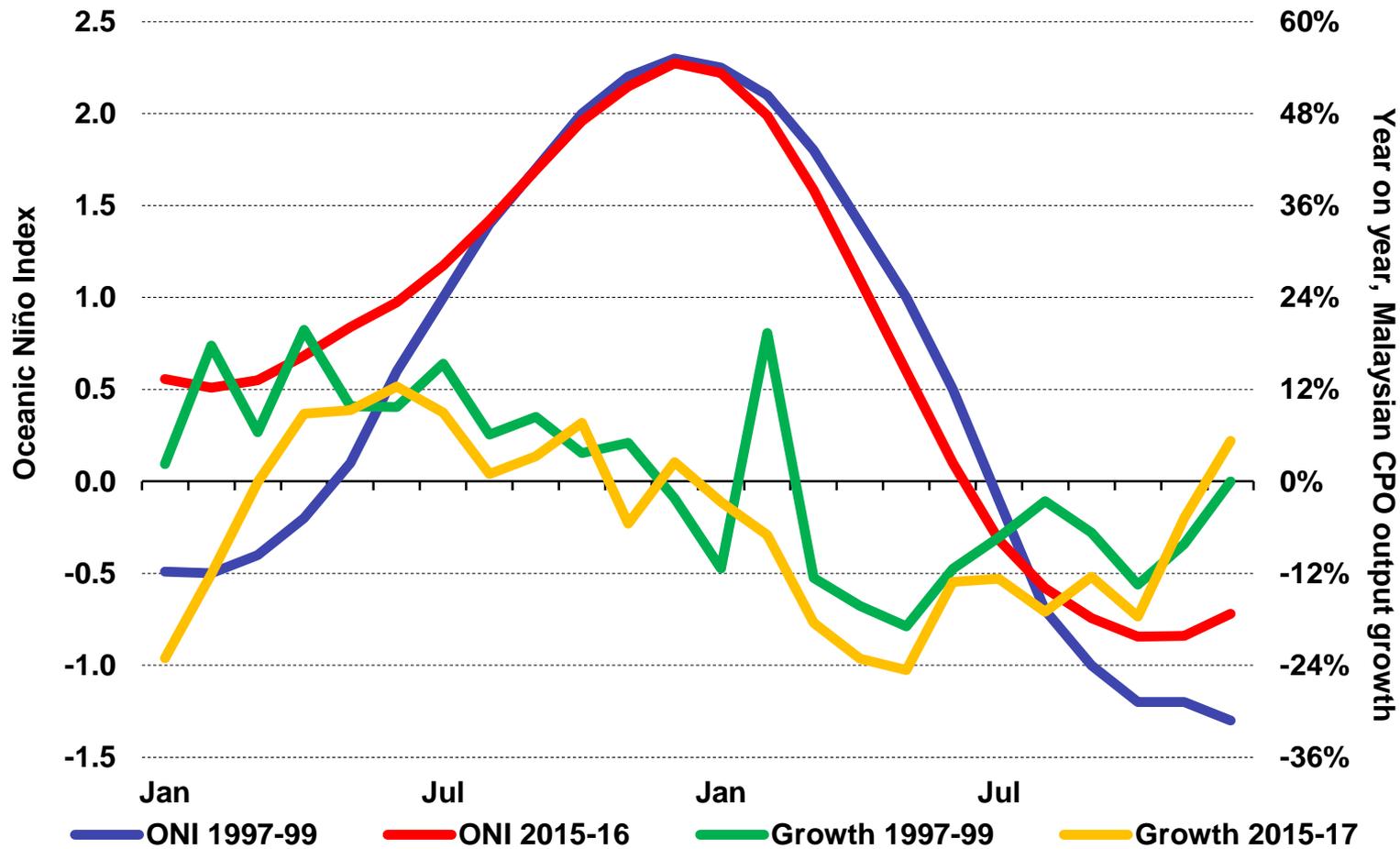
The arrival of a mega El Niño



The recent mega-El Niño has tracked a similar path in terms of the Oceanic Niño Index (ONI) to that in 1997-98. The La Niña is proving to be a weak one.



The impact of the El Niño on year-on-year growth in Malaysian CPO output has been very similar to that seen in the 1990s, as is strikingly evident here.



The El Niño had a big impact on CPO output

In terms of the usual way in which El Niño is measured (via the Oceanic Niño Index), the 2015-16 El Niño has been as large an event as the 1997-98 one, which also had dramatic implications for palm oil production.

As we have just seen, the pattern of year-on-year monthly Malaysian output growth rates in these two El Niño events has been very similar, possibly with the growth path shifted down very slightly this time round.

Reasons for slower growth this El Niño include the underlying expansion in new mature areas in Malaysia is slower than it was in the 1990s; also, there is some evidence that older trees suffer more from the drought.

The creation of Indonesia's CPO Fund



Indonesian biodiesel sales move in the opposite direction to domestic CPO-gasoil price spreads.

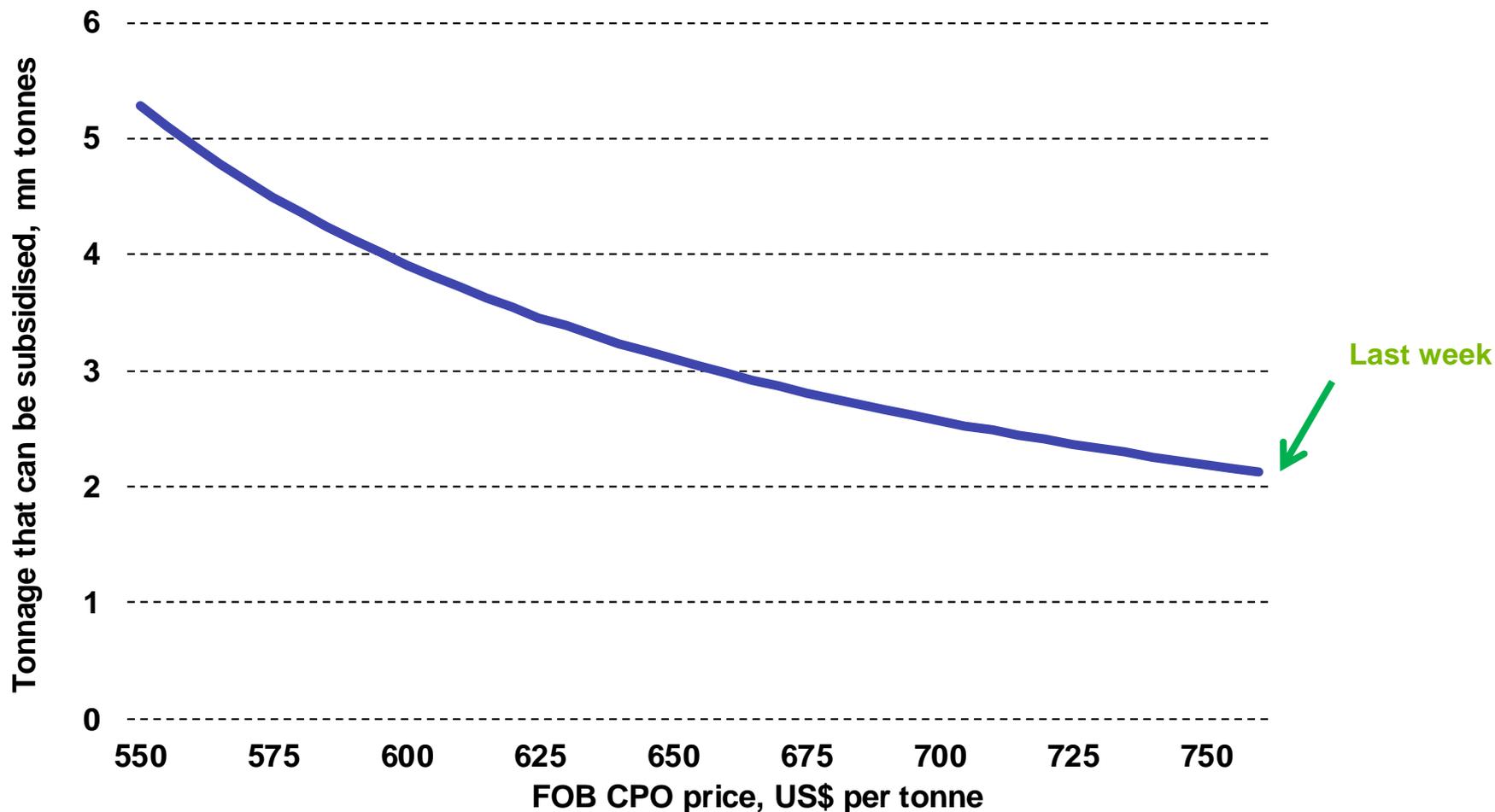
The Indonesian CPO Fund is very ingenious. It has a fixed pot of cash each year raised from export levies.

This is shared among local biodiesel (PME) suppliers, who are guaranteed a good margin; yet, Pertamina pays no more for PME than it pays for gasoil (diesel).

That is not the end of the story. Producers do not mind paying the levy because taking the oil out of the world market has raised world prices by more than the levy.

This works like a price stabilisation fund. When CPO-Brent spreads are high, Indonesian biodiesel sales (locally and for export) are small, but when the spread is low, biodiesel sales are much larger.

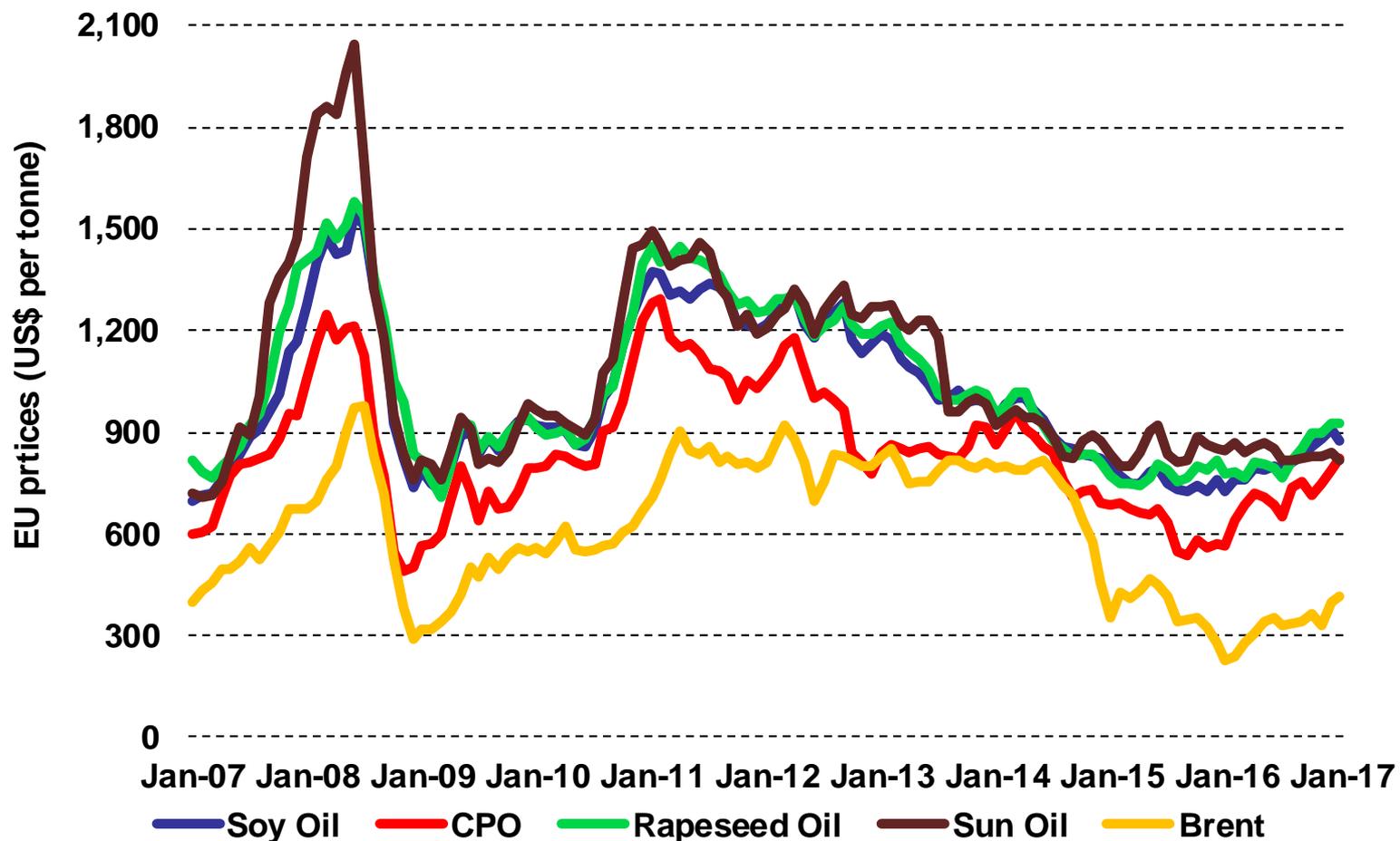
Indonesia's biodiesel use varies with CPO's premium over diesel. If Brent is \$55/bbl, 2 million tonnes/year can be funded at \$780 FOB CPO; 3 million at \$660.



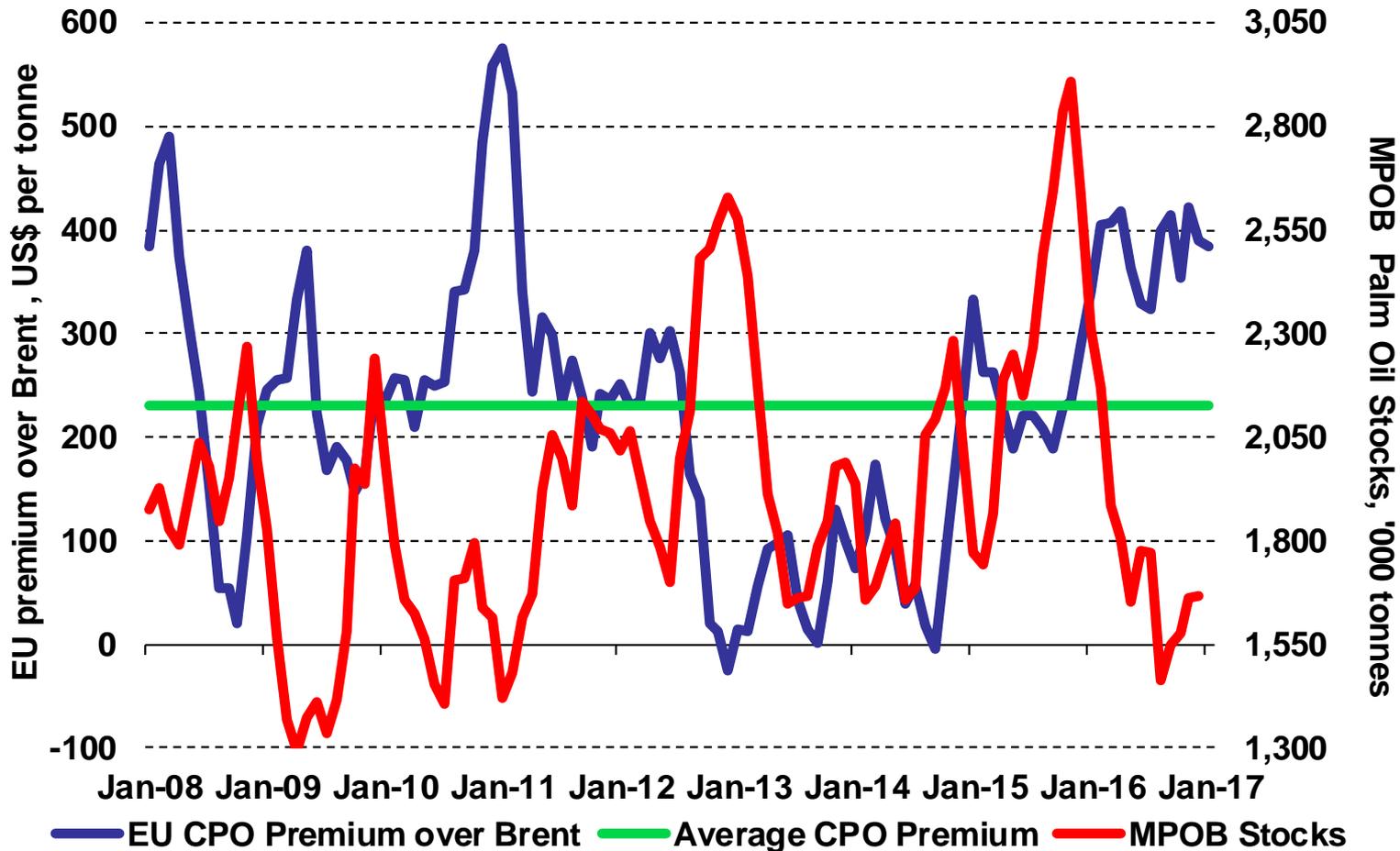
How did the Indonesian biodiesel mandate and the El Niño affect the price band?



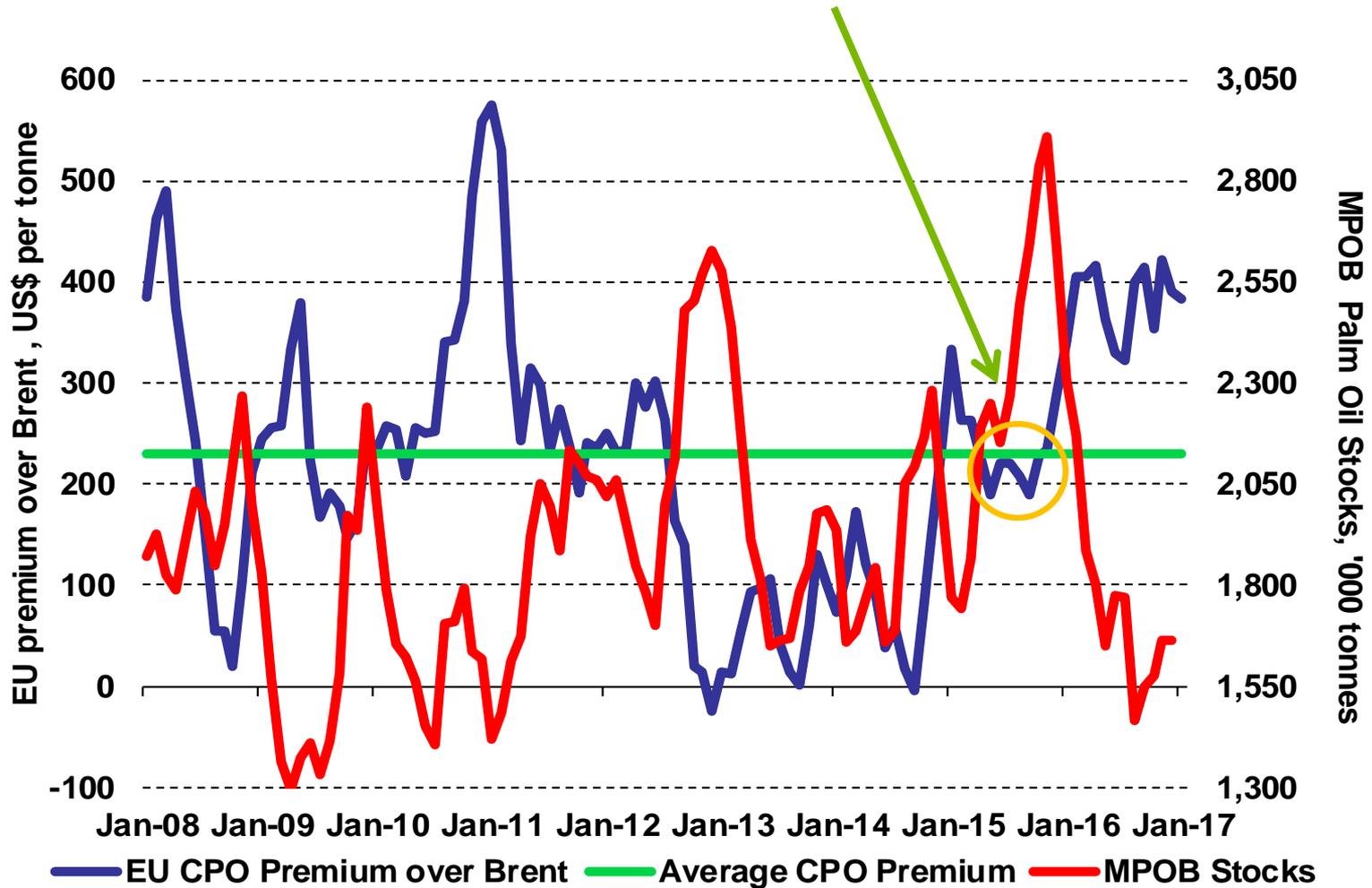
A price band linking vegetable and crude oil prices is clear. Other things being equal, a \$10 per tonne rise in Brent prices lifts EU and FOB CPO prices by \$10.



The relationship between MPOB stocks and the CPO premium vs. Brent drives CPO price forecasts. Low stocks \Rightarrow a high premium; high stocks \Rightarrow a low one



Late in 2015, something was different. Despite record high MPOB stocks, the EU CPO premium over Brent never fell on a monthly basis at all far below \$200.



What happened to the price band in 2015-16?

The EU CPO price equals the crude oil price (per tonne) plus a premium that is linked to MPOB stock levels. When palm oil stocks increase, the premium falls; when stocks fall, the premium rises.

However, the EU premium for CPO over Brent crude oil did not fall back to zero late in 2015, despite the all-time record MPOB palm oil stocks. The reasons?

One was El Niño, whose arrival had become clear to plantations by Q4,2015. The market was intelligent and anticipated the impact of the severe drought.

The other was Indonesia's CPO Fund. It guaranteed that 2.5 million tonnes would be taken from an already rapidly tightening world market (due to the El Niño)

To recap the conclusions so far

The price band links CPO prices to that of Brent crude oil, with MPOB stocks a key factor. However, the El Niño had a big impact, in that temporary very high stocks were not a signal for a total collapse in the CPO premium over Brent. Instead, the market was intelligent and took account of the coming drought.

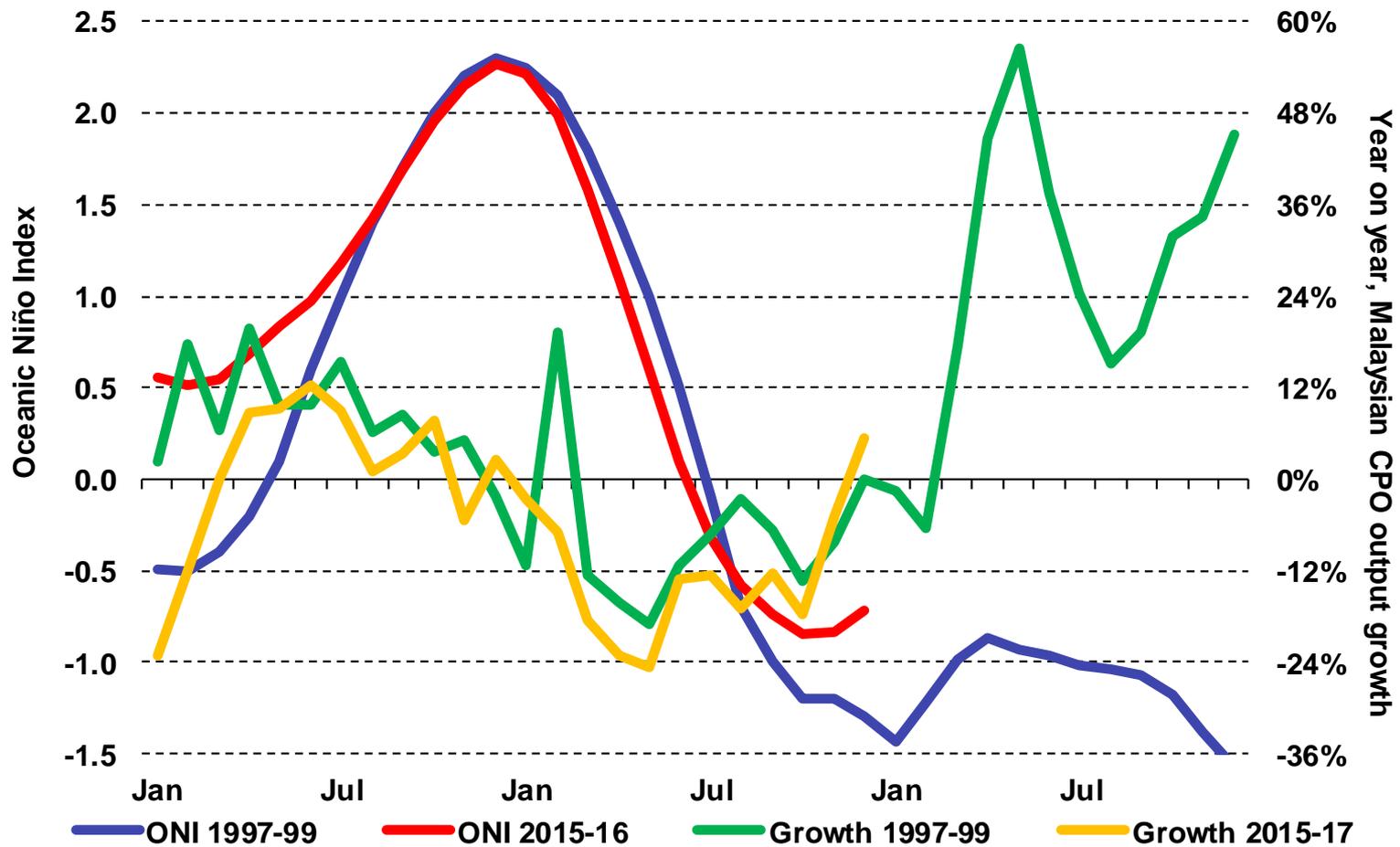
Another development has been the creation of the CPO Fund in Indonesia. This is not a fixed mandate. Rather, it is a very important new price stabilising mechanism, under which Indonesia's use of palm biodiesel moves in the opposite direction to the CPO premium.

This will now reinforce the CPO-Brent crude price band.

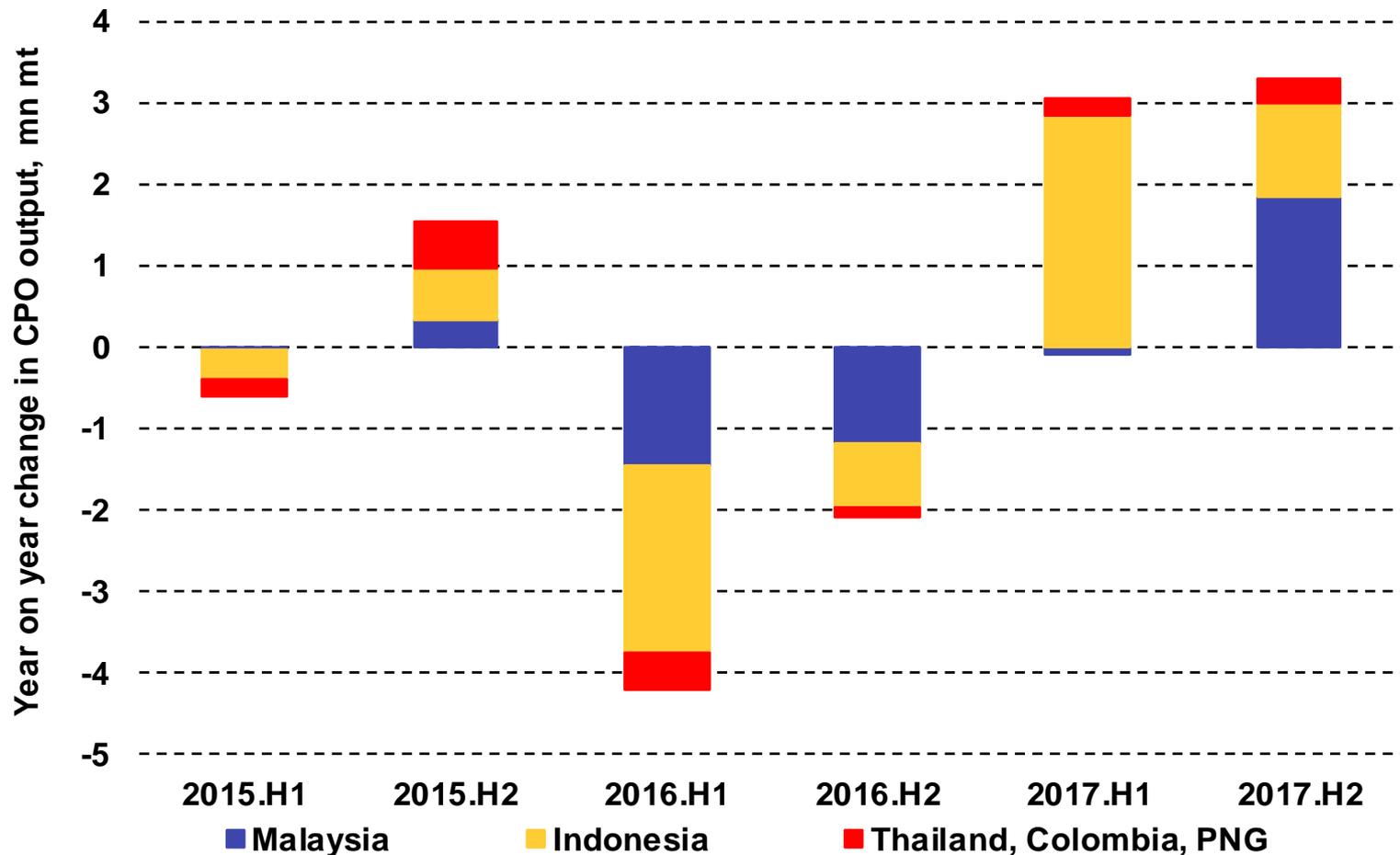
What does history tell us about the recovery in output after an El Niño ends?



In the last mega-El Niño in 1997-99, the recovery in the year-on-year rates of growth in Malaysian CPO production was very rapid indeed.



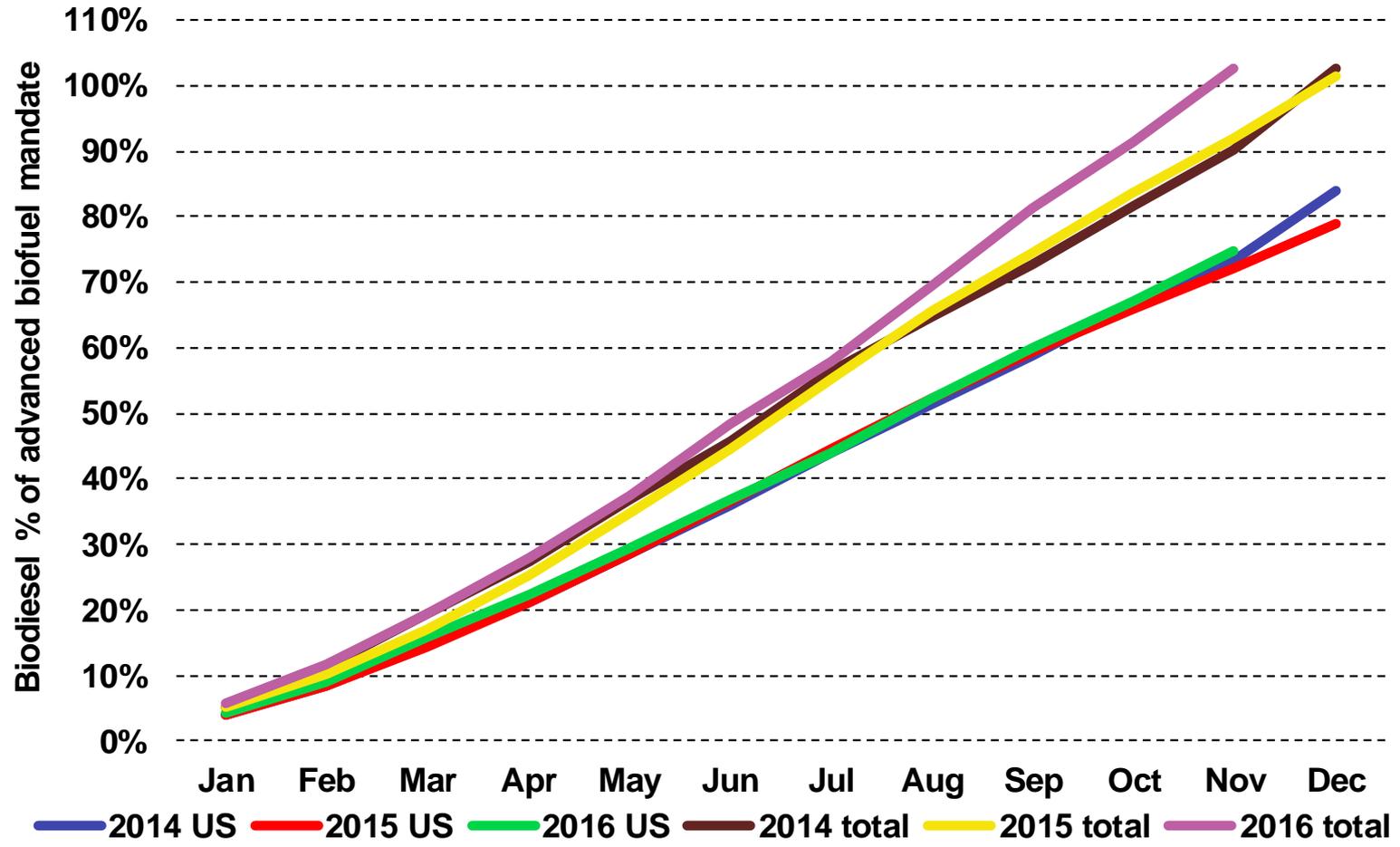
This plots half-yearly year-on-year changes in CPO production worldwide. We expect the 2017 recovery to offset the global collapse in CPO output in 2016.



Trump biofuel policy will be a crucial factor in the soy oil market in 2017



Fears about future US biodiesel tax credits caused its imports to surge. By November, biodiesel sales already exceeded the 2016 mandate for all advanced biofuels.



The significance of US biofuel policy

In the US, biodiesel is the main fuel in the advanced biofuel mandate, which has been growing steadily.

Till December all biodiesel (local and imported) enjoyed a blenders' tax credit of \$1/gallon (\$300/tonne).

Post-Trump, nothing is certain. Will the EPA continue to increase the mandate? Will tax credits be reinstated? If so, will they specifically exclude all foreign biodiesel?

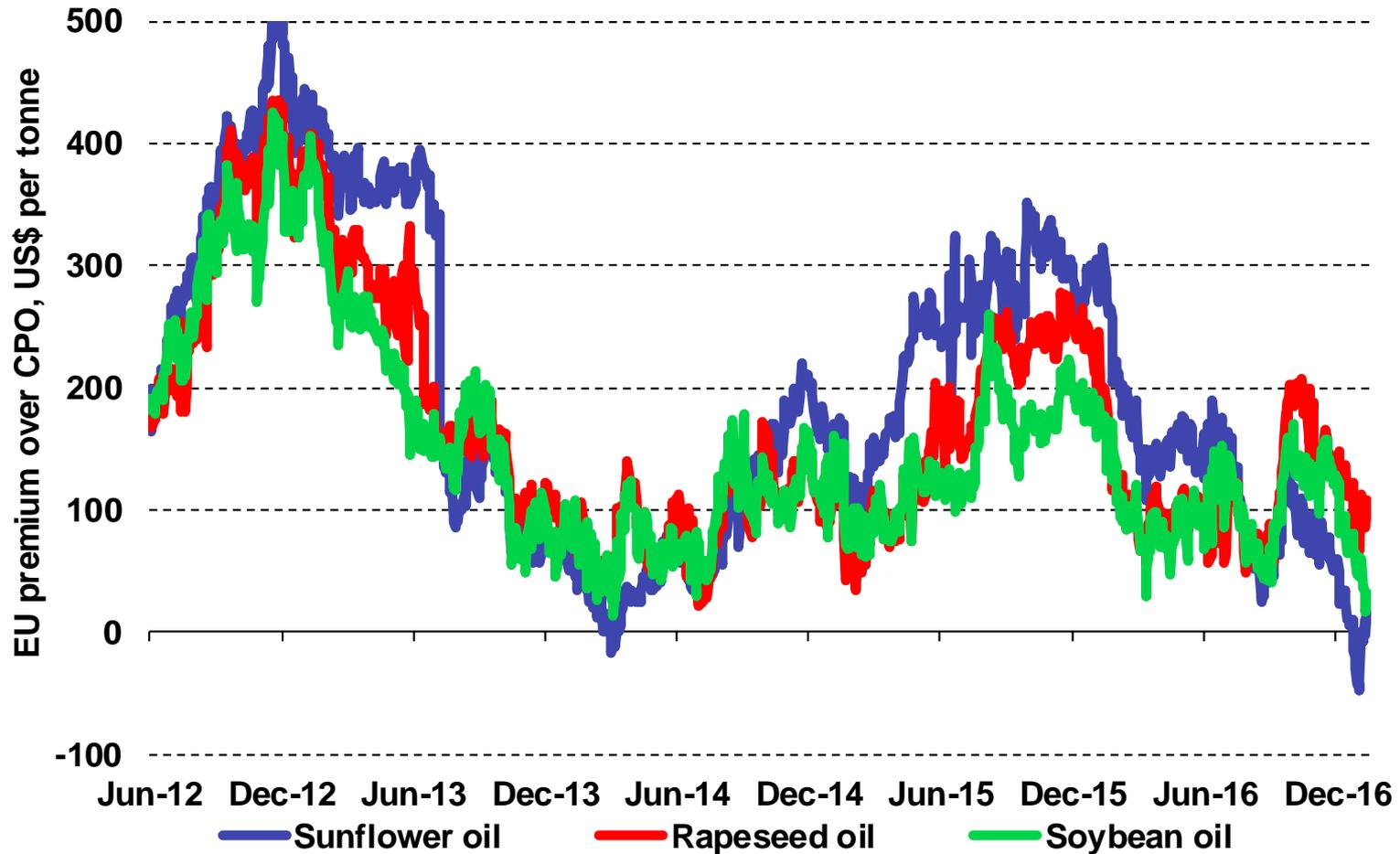
With these uncertainties, foreign suppliers sent large volumes to the US, to meet some of the 2017 mandate.

Without this outlet in the US, Argentina (which shipped close to 1.5 million tonnes in 2016) will divert soy oil as oil to the world market, reducing the SBO-CPO spread.

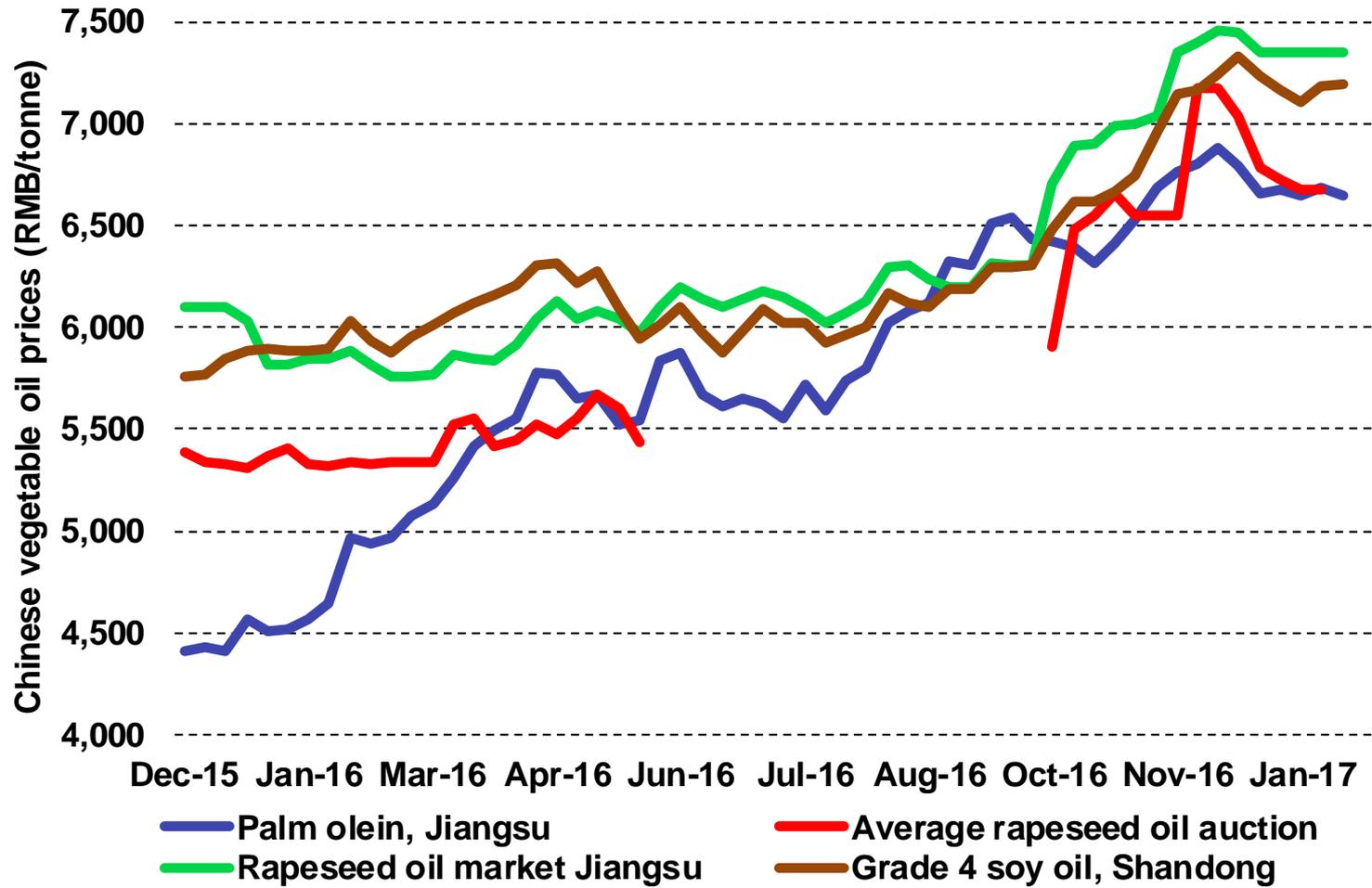
Sunflower and soybean oils become increasingly competitive with palm oil



Upward pressure on CPO prices at a time of high sun oil exports and a switch by Argentina from biodiesel to soy oil exports is narrowing spreads among oils.



China's weekly auctions of 100,000 tonnes of rapeseed oil from its large State Reserves are putting downward pressure on vegetable oil prices in its domestic market.



The influences on soft oil markets

Uncertainties about US biofuel policy mean that soy oil from Argentina will be exported as oil, not biodiesel, for a while. In the meantime, large soybean crops and good meal demand are keeping soy oil supplies high.

Record sunflower crops have pulled sun oil down to parity or even briefly below CPO prices in the EU.

For rapeseed, China's auctions and record canola crops have largely offset the impact of a poor EU harvest.

As a result, soft oils are filling the gap in supplies in the period while CPO output is seasonally low, and while it awaits the recovery in palm oil supplies that history suggests will emerge after the El Niño has ended.

Lessons from 2016 and the outlook for 2017



How did the market plug its shortfall in 2016?

(Red = gap gets worse) and (Blue = better)

El Niño cut CPO output by over 6 million tonnes in 2016.

Indonesia's mandate added 2 million tonnes to biodiesel use in 2016. Other end-use demand rose 3 million tonnes.

Thus 11 million tonnes in all were needed to meet this gap.

Soybean and sunflower plantings rose, but EU rapeseed areas fell. Crushing some of the available quantities of annual oilseeds supplied an extra 3 million tonnes of oils.

China auctioned 3.8 million tonnes of oil, both as direct sales of rapeseed oil and indirectly, via soybean auctions.

Total palm oil stocks fell 4 million tonnes.

Together, these supplied the 11 million tonnes needed.

Implications for prices

With output reviving, palm oil stocks and inventories will be replenished, putting the CPO price under pressure.

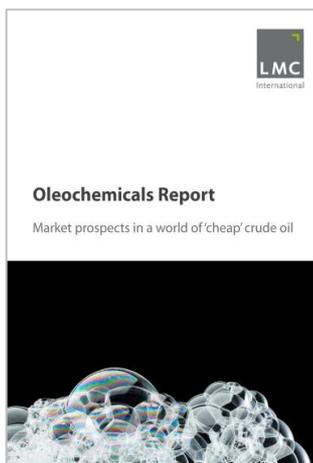
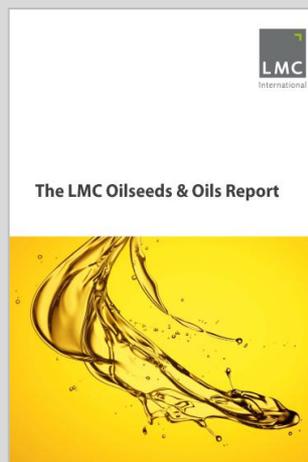
CPO's discount on soft oils must widen to avoid too much of the extra output ending up in burdensome stocks.

China is only likely to stop its weekly auctions from its State Reserves if oils prices fall back significantly.

Indonesia's mandate will rise. A \$100 fall in CPO prices from current levels adds 1 million tonnes to the mandate; a \$200 fall would add 3 million tonnes. So, I think that:

CPO FOB will fall \$150 by Q3 to M\$2,500 BMD; sun oil will fall \$75; and CBoT soy oil by only 1.5 c/lb, helped by Trump restoring the tax credit, but only for US producers.

Thank you



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