

Price Forecasting for Palm & Lauric Oils

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Ladies and Gentlemen

I am delighted to speak at the annual GAPKI conference which has now been named as IPOC. I have spoken at these conferences each year since their inception and they epitomise the coming of age of the Indonesian Palm Oil industry.

Indonesia is blessed with abundant natural resources and climate that is most conducive to agriculture. Above all it has also a wise and enlightened government which encourages commercial farming and plantations. It is also working hard to give its large population a decent and rising standard of living. I am proud to say that the largest investment by our group GODREJ anywhere in the world outside India was made recently in Indonesia when we acquired PT Megasari. We hope to be in Indonesia for a very long time and to participate in its prosperity and development.

The recent Free Trade Agreement between Indonesia and India is also a very welcome step forward.

Developments so far

This year 2010 has been a very happy one for the palm oil industry. The GAPKI conference is well timed and for me personally, some of my most successful forecasts happen to be made at Gapki conferences. As many of you will recall last year at this conference on 4 December 2009, I forecast that Palm oil production in 2010 would face problems. I explained that the developing El Nino would hurt palm production precisely at the same time as the Low Turn of the Biological Cycle. This double whammy would curtail growth in CPO production in Indonesia, despite a rise in mature acreage. It would also push Malaysian production into negative territory. As a result I gave a bullish prognosis for 2010.

A few months later at POC in Kuala Lumpur on 9 March 2010, I forecast 2010 Malaysian production at just 17.2 million tonnes and Indonesia to grow by only 1.5 million tonnes. I also forecast CPO prices to exceed 3000 Ringgits in the second half of the year.

I also forecast a decline in the U S Dollar starting 1st July 2010.

Naturally I am delighted that all 3 of my forecasts have come true. The CPO production model which I have developed and refined over 30 years in this industry has performed extremely well this year.

Before I speak on production prospects for 2011 and the price outlook, let me make a few remarks about the current situation in the market. Firstly I urge the government of Indonesia to look once again at the Export Tax on palm oil and to review it and reduce it. At a time when major importers like India have removed or drastically reduced import taxes on palm oil, it is necessary for Indonesia to reciprocate that goodwill.

Measures taken by CHINA

As we all know, the Chinese government has become very concerned at domestic inflation and announced several measures to tackle it. The Chinese government has over the years displayed remarkable foresight and determination and therefore its actions have earned the respect of the market.

To my mind, a wise and astute government has 4 basic measures to undertake when it wishes to clamp down on domestic inflation

Firstly, it must curb and wipe out local speculation, black marketing and profiteering.

Secondly, it must tighten money supply and remove or reign in excess liquidity in the local market. Excess liquidity leads to speculation and hoarding.

Thirdly, it can allow the exchange rate to rise or it can raise interest rates so as to control money supply and liquidity

Fourthly, and most importantly, it can raise supply of goods and commodities in the local market. This is the best and most potent weapon in the hands of the government. Supply can be increased by releasing State Reserve Stocks or by undertaking large imports. An increase in supply can be made more effective by subsidising imports or by removing import taxes or by the government importing these commodities and selling them at a loss. All these measures are very effective and will lower inflation very quickly. Subsidies may be wasteful but for a short period they can be very effective. The Chinese government also has one other useful weapon. In 2009 it had bought a large stock of domestic Rapeseed oil as a price support measure. It can now release that stock to increase supply at reasonable prices.

There is one more weapon which is usually effective in the very short term but is very damaging in the long run. That is Price Control. This measure will lower prices for a few weeks but it will damage producers and lower future production and consign the country to shortages. It is not a market based solution and must be avoided at all costs. Governments resort to Price Control when they have run out of all options and when they have fired their last bullet. It is nothing but an acknowledgement that the government has failed. People and producers are not stupid. They will stop producing if they have to incur losses. People will consume more and hoard if they find prices artificially low. Price control is not a measure for a confident, astute and progressive government.

The government of China is wisely undertaking all four of the measures I have outlined. The first three have a mildly bearish effect on world prices. The fourth measure of Increasing Supply and undertaking large imports will have a positive impact on world prices. So on balance, the effect of all 4 measures on world prices should be neither positive nor negative in the medium term.

Prices will be made by fundamentals of supply and demand plus external factors such as worldwide investment funds and exchange rates.

My conclusion is that the Chinese government's measures should not be viewed as bearish or bullish except in the very short term. It takes the market a few weeks to absorb the shock and for the fundamentals to re-assert themselves.

With those remarks on the immediate worry of the market, I shall speak on the Incremental S&Ds for the oil year October 2010 to September 2011.

Incremental S&DS for 2010-2011

I remind you that in both previous years, the Incremental Demand outstripped Incremental Supply and we had to draw down stocks. Let us see if we have to draw down stocks further for the third year in succession.

PALM: I shall first speak on palm.

As I have been explaining over the last 12 months, the biological Low Cycle will run from September 2010 until at least March-April 2011. Hence CPO production in the first quarter of 2011 will continue to under-perform and stocks will continue to be drawn down. Supply will be most critical and tight during this period. We can expect a recovery to begin from April 2011 but this recovery will neither be as strong nor as impressive as previous ones. As time goes by and I have more data in hand, I shall expand on this in my paper at POC in Kuala Lumpur in March.

Last year as we were experiencing an El Nino, the signals were very strong of a pending shortfall in production. This year has been more normal and therefore the signals are not as strong. If last year my production forecast was made with 90 percent confidence level (that is why I never changed my forecast despite universal disagreement and ridicule from all other pundits), this year the confidence level is lower at about 75 percent.

My prognosis for 2011 calendar year is for Malaysian production to recover by 500,000 tonnes and for Indonesian production to recover by 2 million tonnes. Most of this recovery will be seen in the second half of 2011 and will spill over into 2012.

Generally the recovery after an El Nino year is fuelled by 2 powerful engines – - higher fertiliser application during the period of high prices which kicks in during the later part of the production decline and the new acreage that begins to produce once rainfall improves.

This time round, the extra kick provided by accelerated fertiliser use will not be so strong because too much fertiliser has already been applied thanks to very high CPO prices throughout 2010. In fact we may see the law of diminishing returns come true! Acreage expansion has also slowed down dramatically due to the activities of NGOs and the regulations enacted by the Indonesian government.

Soya: The world is anxiously watching the current growing season in South America. The La Nina is in force but we have to see if it results in dry weather and how much that impacts soya yields. Currently, world S&Ds are based a crop of 67 million tonnes in Brazil and 52 million in Argentina. Yet the S&Ds are very tight. If we lose a few million tonnes, the soybean S&Ds will get to rationing levels. We shall then have to rely on a big expansion in acreage in USA in 2011 plus almost ideal growing weather.

For the present, the world is also focussed on Chinese monthly imports of beans. If the Chinese government releases State Reserves and they skip one month's imports, it will have a bearish impact on prices in the short term. The recent downswing in prices has already perhaps taken that into account. If on the other hand, Chinese monthly bean imports remain at their level of the past few months, prices will quickly recover and resume their upward march. For world prices to be driven down and kept down, the Chinese government has to demonstrate convincingly that estimates of Chinese bean imports are exaggerated by 3 to 4 million tonnes and that they can skip one month's imports without replacement. So the fate of prices in the short term rests on Chinese import demand and on South America weather.

I must draw your attention to the fact that the current La Nina is one of the strongest in recent decades. It must affect crops in South America. The present indications are that we shall lose at least 5 million tonnes of soybeans as compared to earlier crop expectations. We cannot be complacent on this score. Most analysts under-estimated the effects of the El Nino of 2009 and appear to be doing the same with this La Nina. In this day and age, we are making our farms and our plantations perform almost to perfection. By banging in fertilisers and growth promoters, we have pushed yields to extremely high levels where growing conditions need to be almost ideal. Any disturbance on account of drought or flood leads to a dis-proportionate effect on yields. I invite you to imagine an old truck which is being run round the clock. It will run well on good roads in good conditions but give it some rough terrain and it will break down. As world climate gets more capricious, world agriculture will fail to keep producing record high yields. And we have come to rely on super-high yields. I have already lopped 5 million tonnes from current South America soya crops and I stand ready to reduce estimates further as the season progresses.

Further forward we shall have to crush an additional 8 to 10 million tonnes of beans to find the extra soya oil required by the world.

Rape seed: Production numbers have improved slightly in the last few weeks and prospects for the Indian crop are distinctly brighter. I am therefore reducing the shortfall in rape oil production this year to 800,000 tonnes from my earlier estimate of 1 million tonnes.

Sunflower seed: Prospects for sun seed production have also improved in the last few weeks in Ukraine. We are still wary of the Argentine production. Therefore I am keeping the shortfall in sun oil production at 300,000 tonnes.

I continue to believe that Groundnut oil and Cotton oil will increase by about 500,000 tonnes due to higher crush.

I also continue to believe that production of Coconut oil will decline and will balance the additional availability of Palm kernel oil.

Demand scenario

It now looks as though the dreaded Double Dip is not going to happen. The calendar year 2010 will end with average world growth in excess of 4 percent with a forecast of even better growth in 2011. Bio diesel mandates in several countries will continue to expand and so will growth in population and in per capita consumption in the developing world. However we are at very high levels in terms of price and hence we must estimate growth in world demand to be 4.5 to 5 million tonnes only for oil year 2010-2011.

Now we can see the developing Incremental S & Ds for next year

000 tonnes	Oct 10 to Sept 11
Soya oil	+ 1,600
Rape oil	800
Sun oil	300
Gn oil & Cotton oil	+ 500
Palm oil	+ 2,500
Lauric oils	-----
Total Increase	+ 3,500
Demand	+ 4,500

The US Congress has re-assembled from 29 November and we must watch its actions on the Ethanol subsidy and the Blenders Credit for bio diesel. The implementation of RFS2 also needs to be watched. Even if only one of these 3 factors comes into play, it will be very bullish for corn, beans and bean oil.

At present, it looks like for the third year in a row, Incremental Supply will not match Incremental Demand. There is a shortfall of at least one million tonnes.

Whilst palm production will recover, we shall encounter lower production of Soybeans and Sun seed in South America. Overall oilseed and oil production will not have a chance to recover strongly.

PRICE OUTLOOK

I expect prices to rise from current levels in the next 6 months. Any price decline will have to wait until June-July when northern hemisphere crop prospects can begin to weigh on the market. My price outlook extends to the next six months. I also expect Inverses to assert themselves because stock levels in the next few months will be extremely tight.

I am presuming that there will be no unexpected war (North Korea or Iran?), that the U S Dollar will run out of steam by January 2011, that mineral oil prices will hold at current levels and gradually move higher, that the Euro zone will be stable and that monetary policy in USA and in Europe will be easy and relaxed.

PALM – My November prognosis for CPO futures on the BMD to reach 3300 Ringgits was fulfilled within 2 days of the forecast. These are days of instant gratification. So I have to be extremely careful as to what I say. However it is better to be forewarned than to be surprised. Too often the market is giving out wrong signals. I repeat that the price declines of May and June 2010 were based on wrong production forecasts by over –optimistic pundits and led to unjustified price declines. Demand boomed at lower prices and we now have to ration demand with higher prices.

Based on my production prognosis, the period of greatest tightness will be between February and May 2011 and we need prices to rise now in order to reign in demand and to stimulate plantings. At some stage in December – January I expect RBD Palm Olein to trade at US\$ 1250 FOB with CPO futures on the BMD trading at M\$ 3600

Soybean oil – Soya oil also needs to rise because too much incremental demand from sun oil and rape oil consumers is migrating in its direction. A level of between US\$ 1250 to 1300 FOB Argentina is to be expected.

Sunflower oil will maintain a premium of about US\$ 200 over soya oil prices.

I expect Rapeseed oil prices also to maintain premium of US\$ 100 to 150 over soya oil.

Palm kernel oil has already touched US\$ 1650 CIF Rotterdam. Demand for FMCG products in the West as well as the East is very strong and it is quite possible that PKO prices will go close to an unprecedented level of US\$ 1800 cif Rotterdam. The outlook is the same for Coconut oil.

What are the threats to this forecast?

The threat of Contagion is the most prominent. Equity and bond markets need to be stable and must not fall. Countries like Ireland, Greece, Portugal, Spain or Belgium need to keep their house in order. The flow of investment money into commodities must also remain stable.

RSPO

Over the years I have remained a strong supporter of the Round Table on Sustainable Palm oil. Much progress has been achieved. On the other hand the take up of certified sustainable palm oil has been disappointing. Those who talk of sustainability need to put their money where their words are. And finally it is time for the Executive Board of the RSPO to reflect more proportionately the interests of all stakeholders, not merely in terms of functionality but also in terms of geography. Asia produces 95 percent of the world's palm oil and consumes 80 percent of it. Asia has preserved most of its forests and millions of its people depend on this industry for their livelihood. Yet on the RSPO Asia is in a minority. Make no mistake. There is no forum other than RSPO to handle this agenda but RSPO needs to be reformed. I sincerely hope such reform will be taken up without delay.

Conclusion

I once again congratulate GAPKI on making this conference such an important event on the palm oil calendar. I shall conclude by reminding you of what the **Sage of Omaha said once "When the tides goes out, we can see who has been swimming naked"**

Swimmers need to be aware the palm oil tide is running out.

My next paper will be on 25 January 2011 at the F O Licht Bio fuels conference in London.

Good Luck and God Bless