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Sugar – Nearing a peak

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- Sugar prices resume their uptrend after a sharp fall in the first week of March
- Sugar deficit in India expected to widen this season, but negative processing margins will dampen import demand
- We now expect the market to flatten out near USc14-15/lb in 2009, but upside risks remain over the next 3-6 months

We reiterate our expectation that sugar prices will rise this year

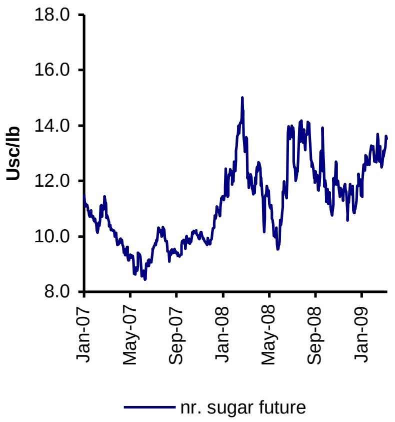
Sugar has enjoyed one of the most consistent rallies among soft commodities since the start of the year, rising from USc 11/lb at the end of December to touch USc 13.8/lb at the end of February (+25%). In January, we were of the view that a recovery in investor sentiment as well as a weaker dollar, stronger oil prices, and continuing ethanol use would help sugar prices post big gains this year. At the time, we expected industry estimates of a large sugar deficit this season to be supportive (see **Commodity Outlook, 29 January 2009, `Sugar - still attractive**'). The sustained rise in sugar prices since January vindicates our position. We now believe that expectations of a sugar market deficit have been factored into prices and that, in the absence of any major supply or demand shocks, gains will be limited. We expect the market to flatten out near USc 14-15c/lb as the market rationalises previous expectations of high import demand from India.

Table 1: SCB sugar forecasts
(previous forecasts in brackets)

		USc/lb
Current price	Mar 20 close	13.54
Quarterly	1Q 09	13
	2Q 09	14.5 (15)
	3Q 09	15 (15.5)
	4Q 09	15 (16.5)
Annual	2009	14.5 (15)
	2010	15 (16)

Source: SCB Global Research

Chart 1: Rolling near-month futures, sugar



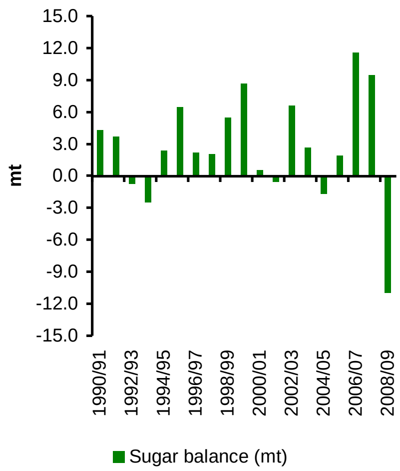
Sources: Reuters, SCB Global Research

Important disclosures can be found in the Disclosures Appendix.

Sugar is not decoupled from global markets

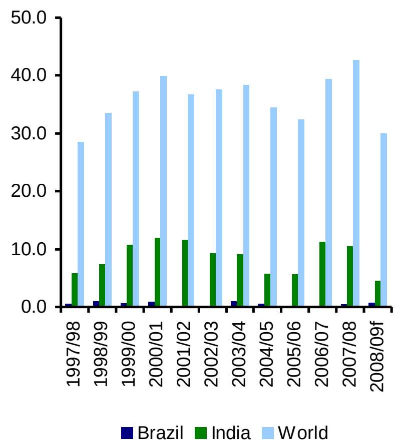
Despite supportive fundamentals, sugar suffered a significant drop on 2 March. This coincided with further weakness in equity prices (the Dow was down 4% on the day), an 11% intraday decline in WTI crude oil prices and a four-year low in open interest reported at the end of February. These moves suggest that (1) despite good fundamentals, sugar is not decoupled from global markets, (2) external factors, including energy prices, are important, and (3) investor sentiment influences the market. For now, we find that fund and speculative investors are momentum- rather than value-inclined, meaning that they take a short-term rather than a long-term approach and are likely to take profit on rallies. This is reflective of current risk aversion in the marketplace.

Chart 2: Global sugar balance
(mt)



Sources: USDA, Kingsman, SCB Global Research

Chart 3: Comparative ending stocks
World, Brazil and India (mt)



Sources: USDA, ISO, SCB Global Research

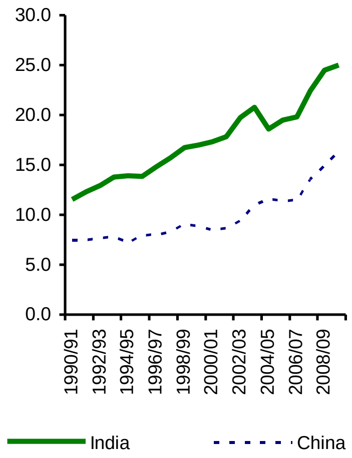
A much tighter sugar market

Since our last sugar report in January, industry estimates for the global sugar balance have tightened, and sugar has attracted renewed interest from investors. In February, consultants Kingsman raised their estimate for the 2008/09 global sugar deficit to 11.56 million tonnes (mt) from 9.66mt previously on account of a downward revision to India's output. At that time, market estimates put India's output at around 17-18mt. Now, with the prospect of even lower output from India, the global deficit could widen by a further 0.5-1mt. Moreover, output in China could fall by almost 2mt on account of severe frost and rain and lower fertiliser use in cane-growing regions last year, especially in Guangxi province, which produces around 60% of China's raw sugar.

Higher sugar prices to dampen import demand from India

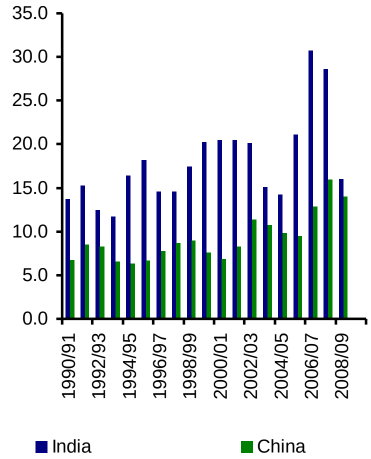
As noted above, India is now expected to produce up to 11mt less sugar (-42% y/y) than it did during the previous season, compared to the 8.5mt decline initially forecast. **This is bullish for the market given India's strategic position as the largest sugar consumer globally**. Even so, expectations of a flood of import demand from India have been dampened for two reasons. Firstly, India has enjoyed two consecutive years of large surpluses, with carryover stocks averaging 10mt over the last two campaigns. Secondly, due to significant price regulation, private processors must discount processing, freight, and currency costs over local prices before the decision to import is made, and current margins are negative.

Chart 4: Sugar consumption in India and China
(mt)



Sources: USDA, SCB Global Research

Chart 5: Output in India and China
(mt), expected to fall this year



Sources: USDA, SCB Global Research

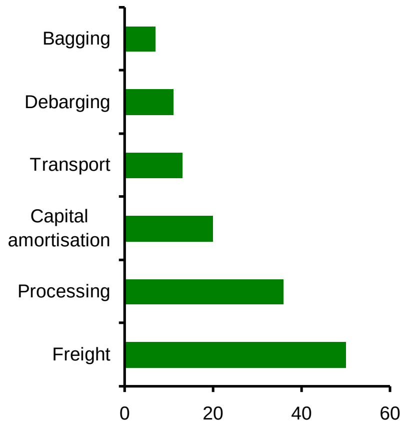
Policy response in India

One of the key policy challenges in India is to keep inflation contained, especially in 2009, an election year. Given its potential impact on inflation, the steep drop expected in sugar output will make this objective even more challenging. Over the last six months, sugar prices in Maharashtra state have risen by more than 30%. In response to the threat of inflation, the government has imposed stock limits on processors in an attempt to tap last year's surpluses. The government has also allowed duty-free imports of raw sugar under the 'tonne-tonne' agreement provided that importers ship out the equivalent amount of refined sugar in two years. Our understanding is that by providing a two-year window, the government aims to encourage processors to buy now and service the local market in anticipation of excise-free access to international markets when output in India recovers. The main weakness with this policy is that it assumes that processors will make their processing decisions based on future expectations about prices and output. We do not find this credible given price and output volatility, current risk aversion in the industry, and high processing costs for raw sugar relative to market prices.

Prohibitive processing costs in India

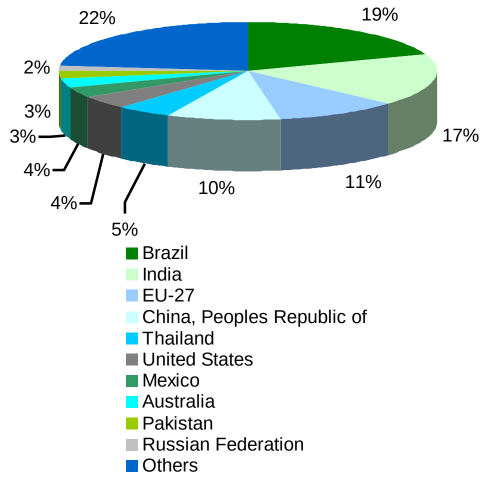
Feedback from meetings with processors in India suggests costs of 100/t (for refining imported raw sugar) for the most efficient processors, excluding excise and storage costs. Assuming raw sugar prices at USc 13.4/lb and freight costs at around USD40/tonne, this translates into USD 445/t as the breakeven price for refined sugar. However, domestic refined sugar prices are currently at around USD 402/t (the simple average of prices in Calcutta, Uttar Pradesh, and Maharashtra as at 18 March). This compares USD 407 for Liffe no. 5 on 20 March.

Chart 6: Rough estimate of raw sugar processing costs in India, USD/t



Source: SCB Global Research

Chart 7: World sugar major producers, 2007/08, *(mt)*



Sources: USDA, Reuters, SCB Global Research

Between a rock and a hard place

Although financial reports released by sugar processors in India revealed good results for Q4-2008, primarily due to low-cost inventory, import demand is likely to struggle due to negative margins at current prices. Nevertheless, we do not expect demand from India to be completely stifled. In fact, we believe risks to current import estimates are to the upside given the demand profile of the country – India's consumption of sugar has grown at an average rate of 10% p.a. over the last two seasons, largely due to low prices. For this season, our forecasts assume a more conservative growth rate of 3%, but consumption of 25mt will still be substantially above output of 16mt. Current stocks in India can just about cover the deficit but will leave ending stocks at historical lows, which is why we see the need for at least 3mt of imports. Moreover, we are of the view that some processors will choose to keep refineries running rather than idle capacity completely. Overall, despite tough import conditions, we expect India's historically large demand to force the hand of importers.

Outlook – external events need to be watched closely

We do not expect the global deficit, which is mainly the result of a production shortfall in India, to be funded entirely by imports. The policy response has been to encourage destocking in order to minimise costs. Still, globally, we expect traded volumes to rise on demand from India coupled with an expected supply crunch in China. This will provide an elevated floor for sugar. That said, downside risks are beginning to emerge, and we now expect these to cap sugar in the USc14-15/lb range this year. These downside risks are based on a less bullish outlook for 2009/10 – the emerging policy maker view is that output in India will rise by around 25% during the season – and our expectations of a shift in the sugar/ethanol ratio in Brazil in favour of sugar. Nevertheless, these risks remain distant, as it is still too early to accurately estimate next year's crop. More immediate risks to our view lie with external market events. Our expectations of a weaker dollar, renewed fund interest in commodities, and higher energy prices could amplify the upside for sugar above the near-term ceiling.

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