

The outlook for palm and lauric oils in the face of a weak world economy



By Dr James Fry, LMC International,
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Outline of my presentation today

The world economy is facing difficult times thanks mainly, but not solely, to the failures of European governments. Therefore, I will start my talk today with a review of the global macro-economic outlook.

Then I will show you how this is affecting the cycle in commodity prices, all the way from palm oil and other crops to fertilisers, metals and petroleum.

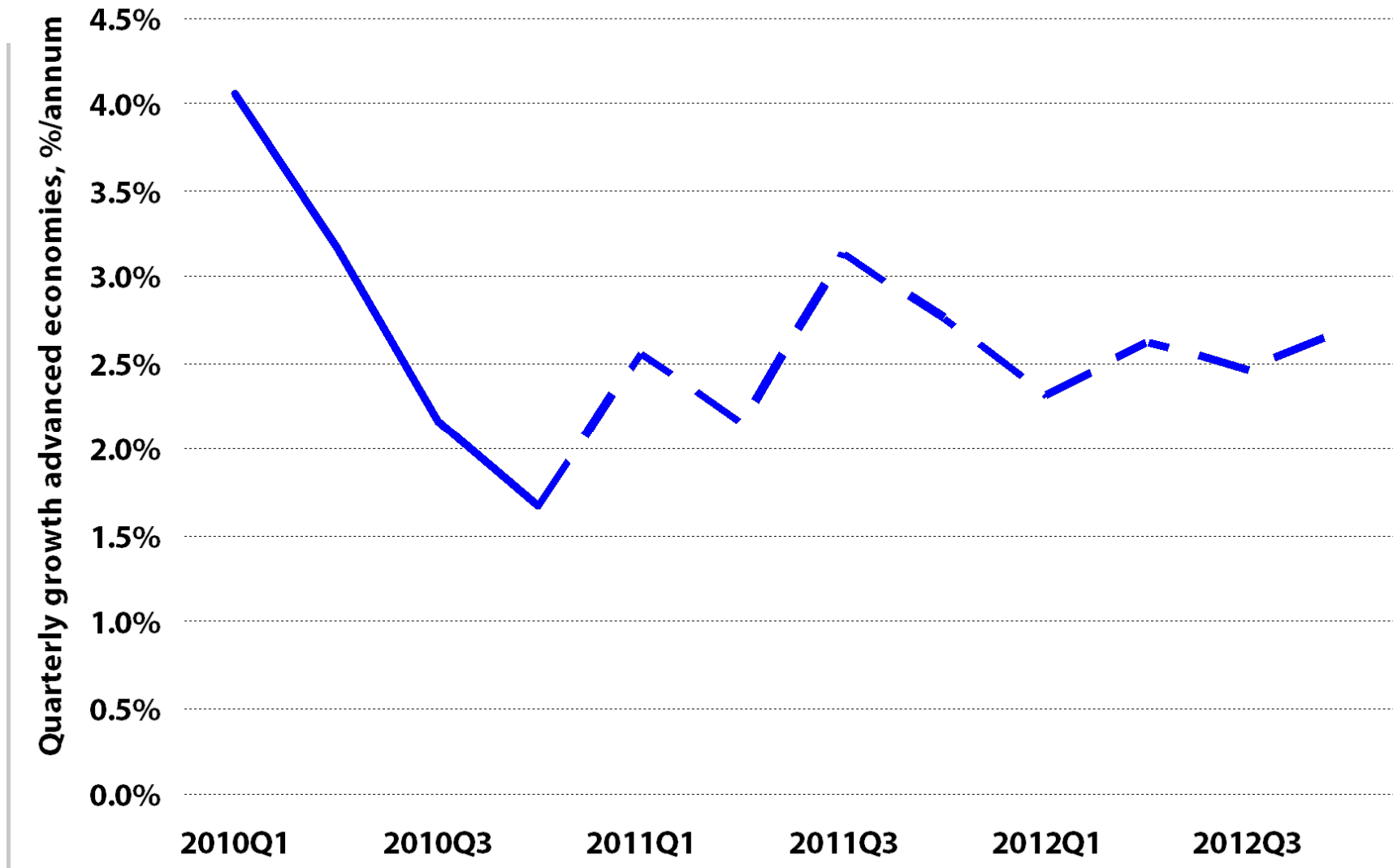
Since petroleum prices are now a key to CPO prices, I will discuss petroleum supply/demand prospects.

Next, I turn to the cycle in palm oil output and stocks.

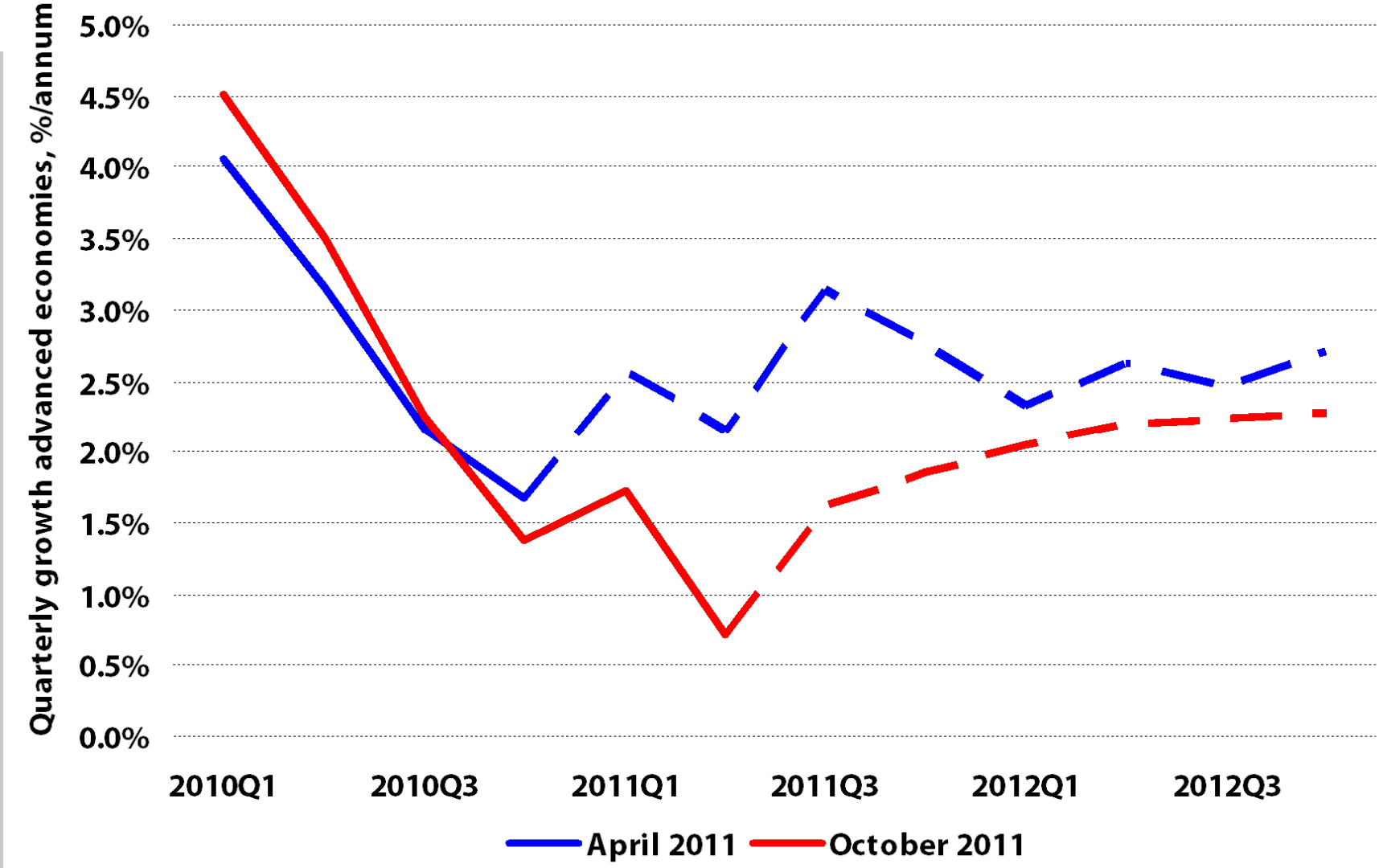
I will conclude with the implications of all these factors for the prices of CPO and PKO.

The world economic outlook

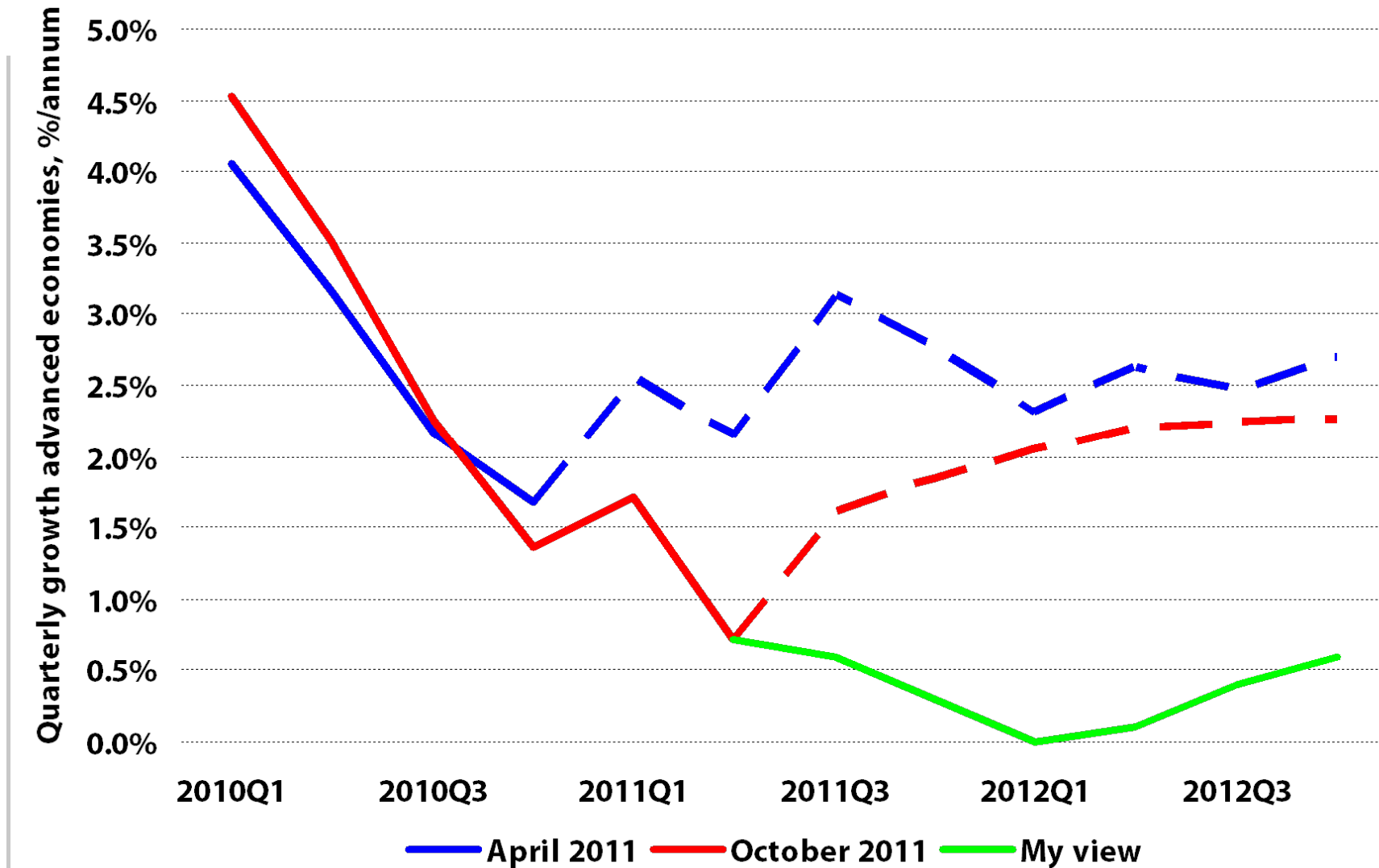
In April, the International Monetary Fund's forecasts of quarterly growth in the advanced economies implied a recovery after Q4.2010.



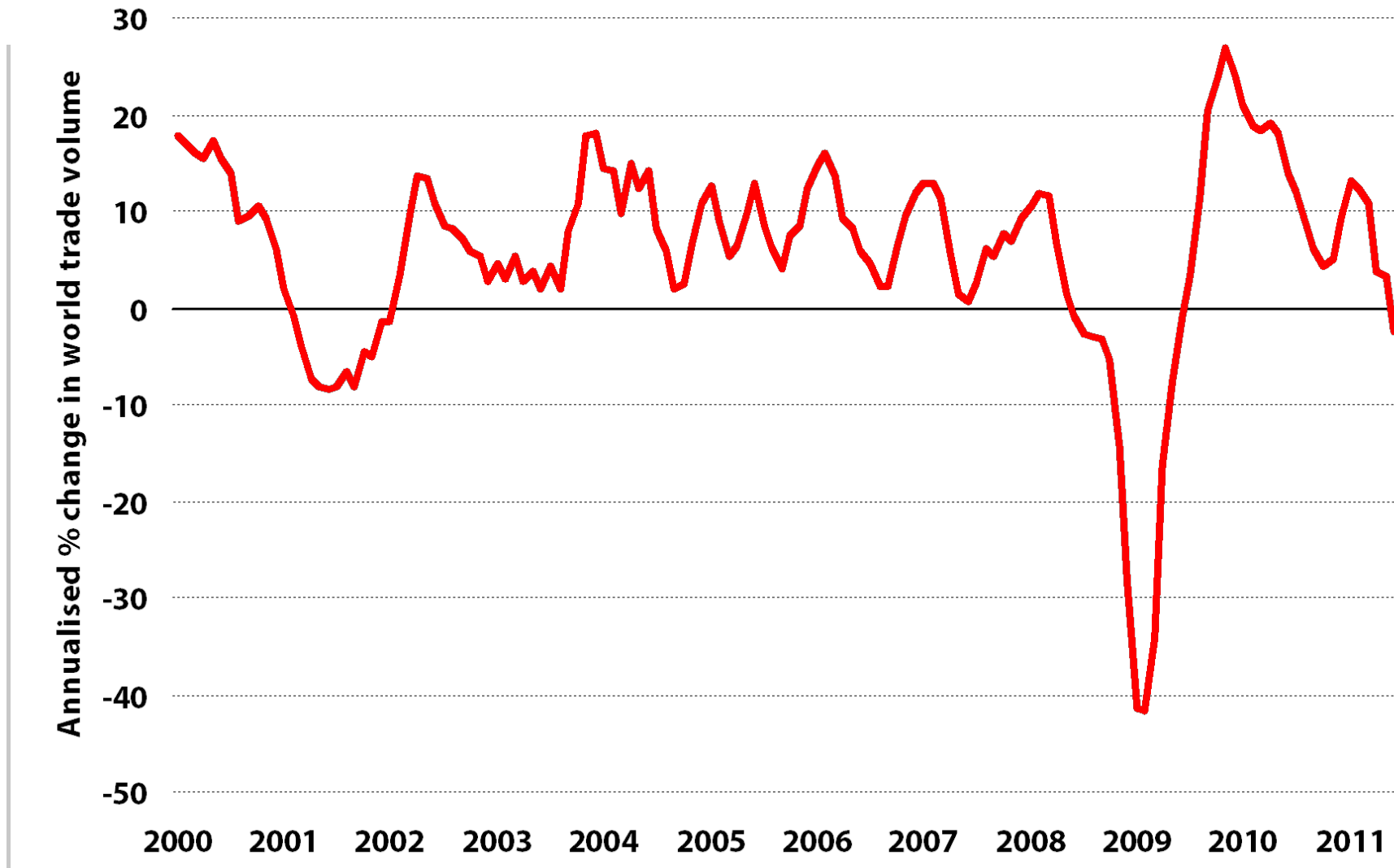
Last month, the IMF lowered its forecasts, but it now predicts a steady recovery from Q2.2011.



I think the IMF is over-optimistic. The EU is now in a recession, while the US super-committee's failure means cutting 2.6% off US GDP in 2012.



The slowdown is hitting world trade. The IMF's latest data (for July) show a decline – and this was before the disruption from the Thai floods.



We have to be prepared for bad news about the world economic situation

Watching the world economy today is very much like waiting for a train crash to happen.

EU governments seem blinded by the light and are doing too little too late, focusing on cutting their budgets, rather than boosting their economies.

The US, too, faces big budget cuts and tax increases, as required after the failure of the Super-Committee.

Each successive economic forecast from international agencies is a downgrade of their previous predictions.

With many signs of slowing world trade, this weakness will hit the growth in demand for oils, not only for food, but also for biofuels, as transportation is affected.

Economic policy in developed economies is now in the hands of central bankers

It is remarkable to see how economic policy and efforts to halt the slide seem to be left almost entirely to central bankers, rather than elected politicians.

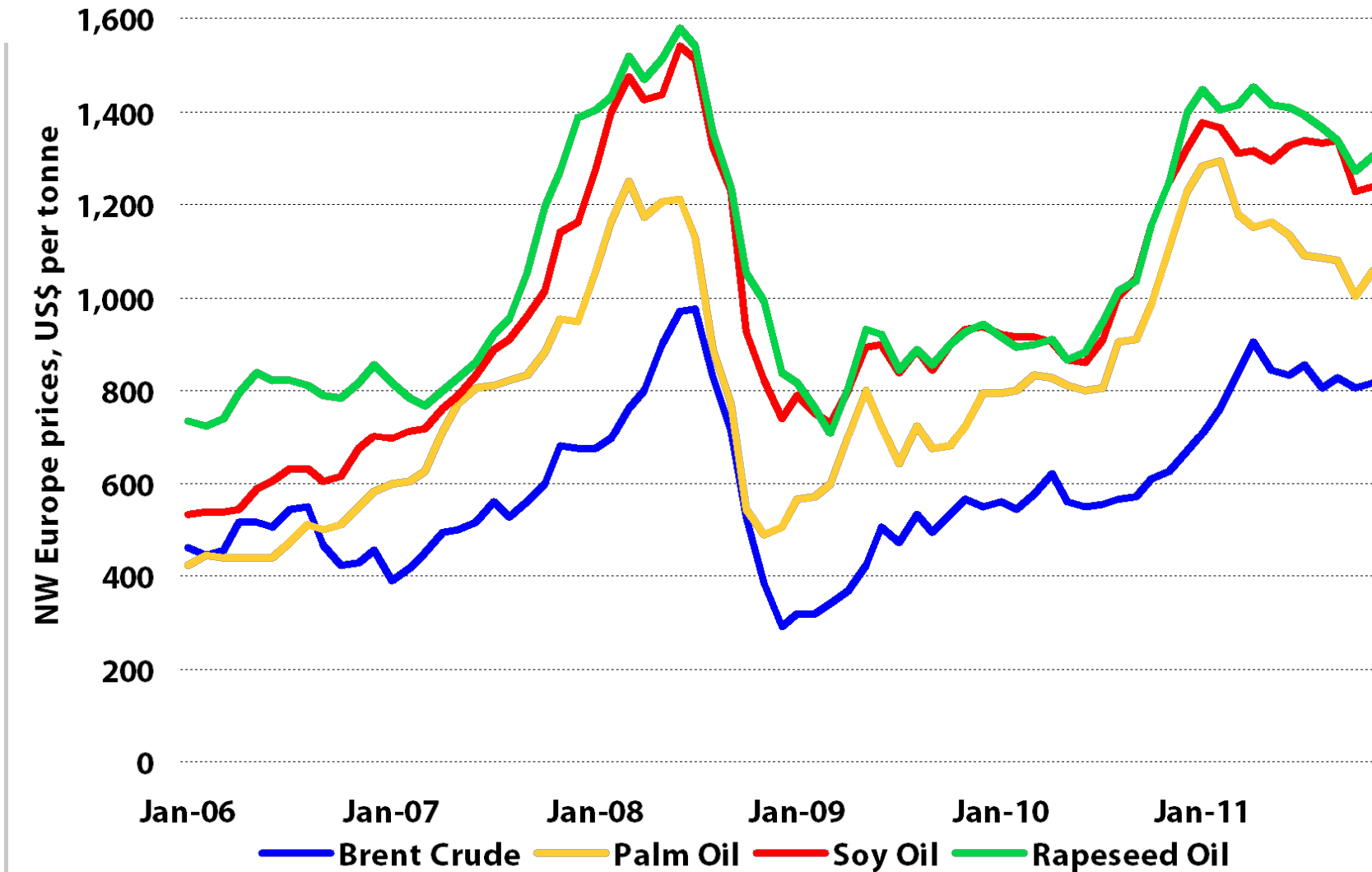
Unfortunately, these bankers have only two closely linked policy tools: money supply and interest rates.

It is doubtful whether these are anywhere near enough to solve the immediate crisis, as official interest rates in the US, EU and Japan are already virtually zero.

If companies do not want to borrow more and/or banks do not feel happy lending to them, boosting the money supply is much like “pushing on a piece of string”. Until governments “pull the string” by stimulating demand, the big risk is that QE3, 4, 5... will just stoke up inflation.

The price band driving vegetable oils

Since 2007, a price band has appeared, linking vegetable oil prices to petroleum prices, within a price band with vegetable oils at a premium.



The emergence of a price band is the major revolution in vegetable oil pricing

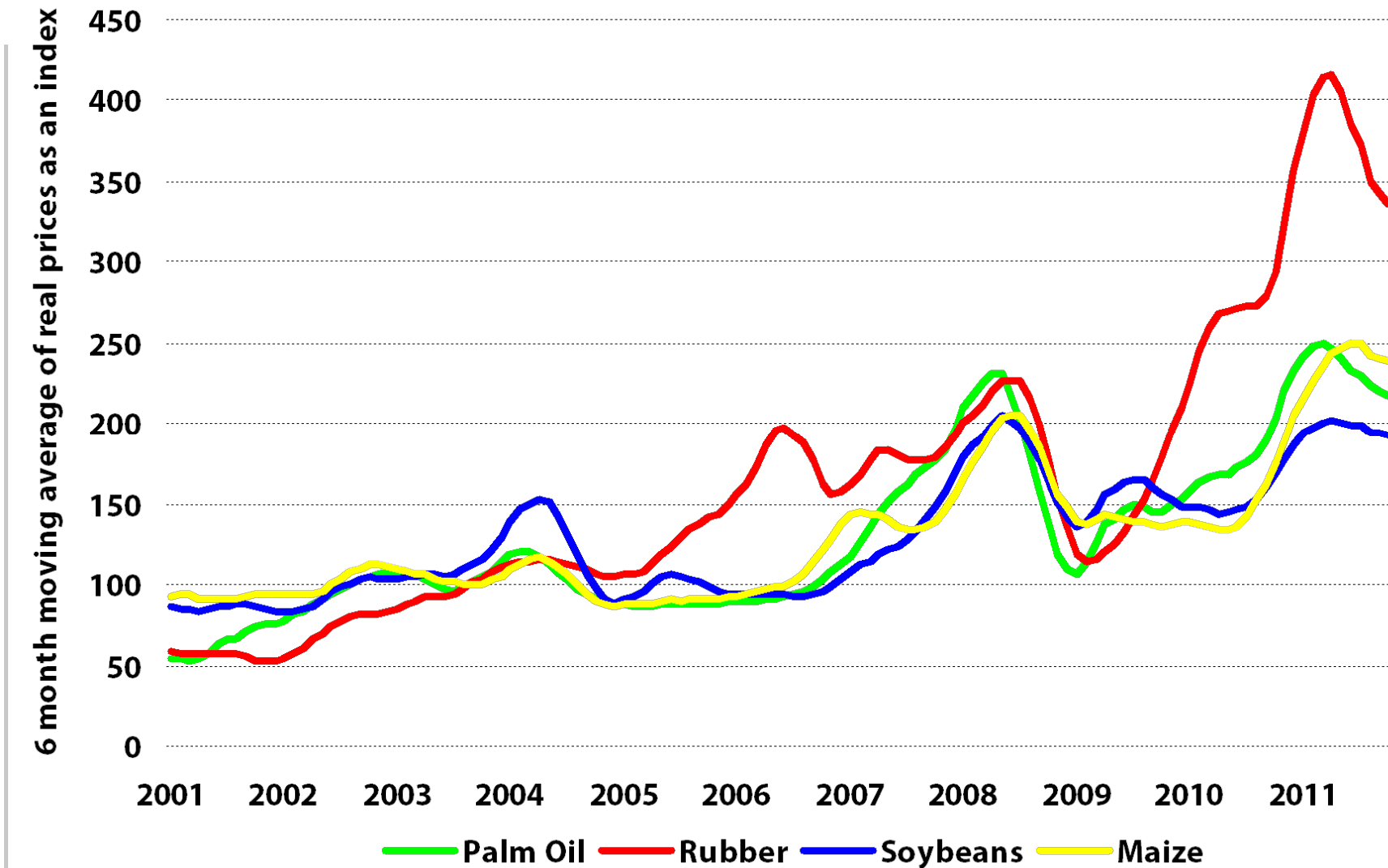
We see that a price band is in place, which only emerged in 2007. If prices of vegetable oils move too far above crude oil, a correction occurs to close the gap, and typically this correction occurs rapidly.

We saw such a correction in 2008 and there was again a quick correction early this year.

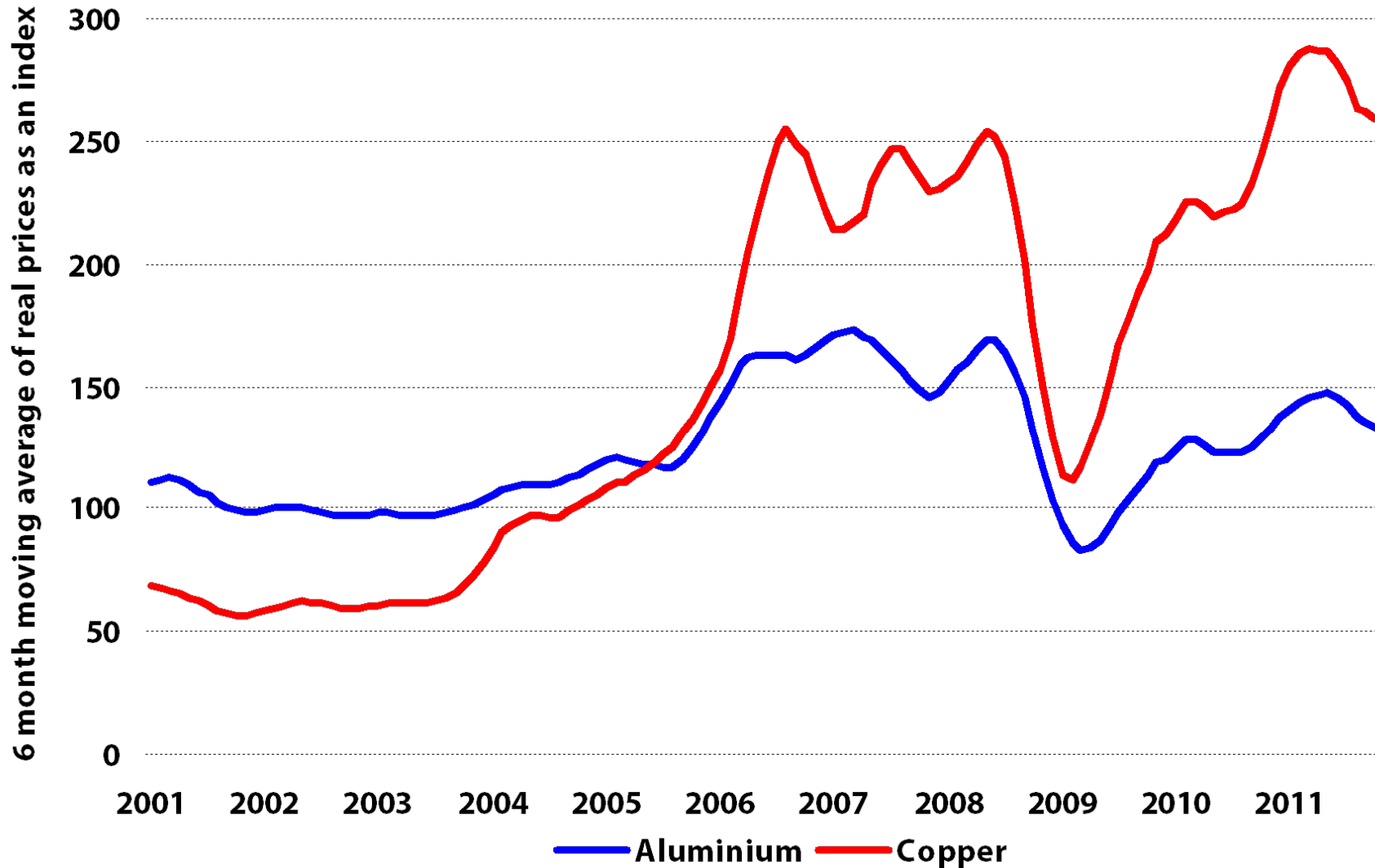
At past GAPKI conferences I have I explained how and why petroleum prices now set the floor to the price band for vegetable oils. The sensitivity of biofuel demand to the gap between vegetable oil and crude oil prices is what has created this new link between vegetable oil and petroleum prices.

Comparing the current cycle with 2008

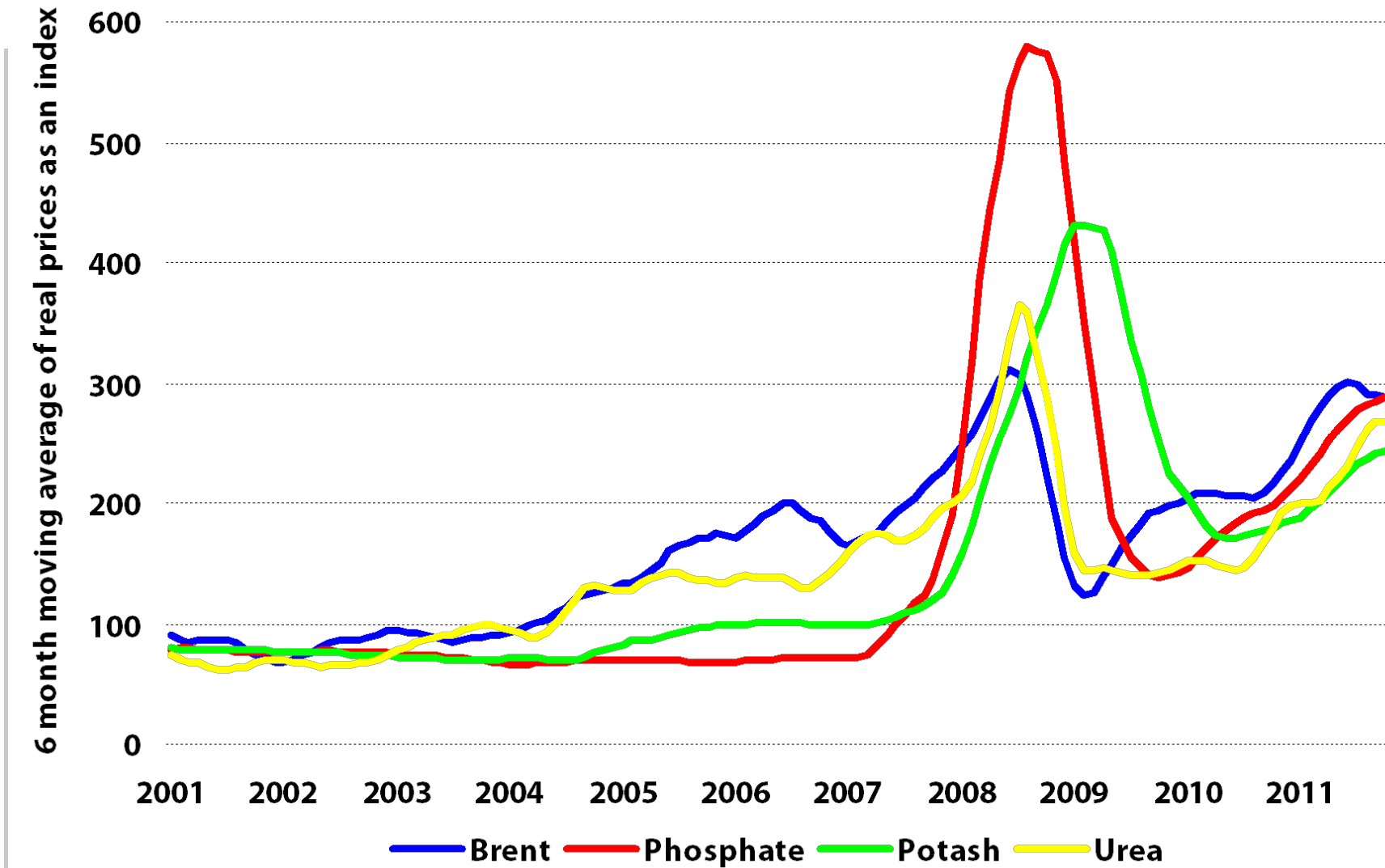
To understand the cycle, I prepared slides of 6 month moving averages of commodity prices. I will start with leading agricultural products.



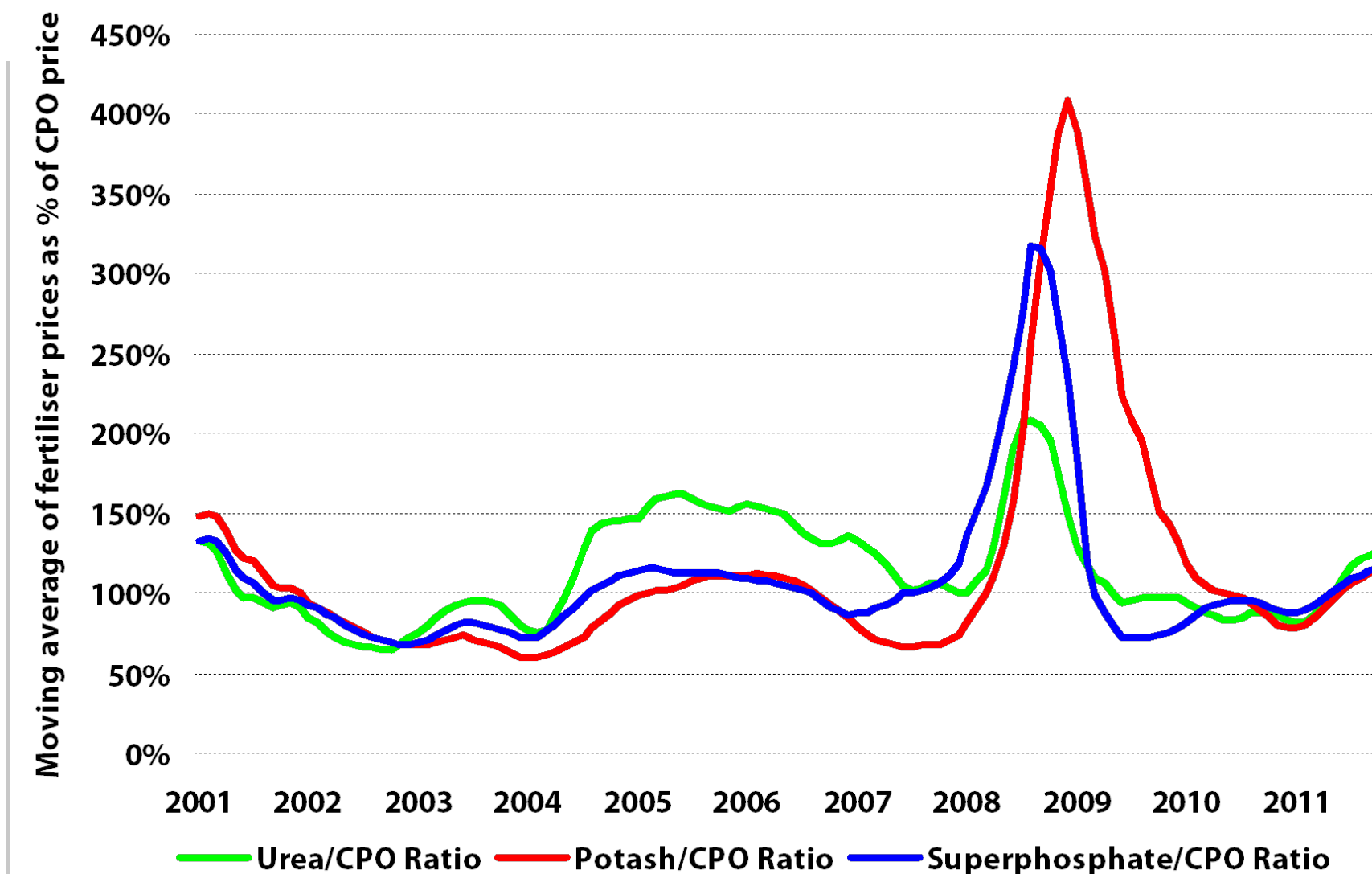
This slide describes the cycle for two leading industrial metals, copper and aluminium. Once again, prices peaked earlier a few months ago.



The picture is slightly different for Brent crude oil and the main fertilisers: urea, phosphate and potash. As in 2008, fertilisers are peaking later.



Fertilisers are very important for oil palm. The fertiliser/CPO price ratios soared in 2008-09, as CPO prices fell long before those of fertilisers.



This table lists the months of peak prices in the 2008 cycle and in 2011. Industrial inputs and foods turn down first; fertilisers turn last of all.

2008-09

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Mar-09
		Alumin.	Copper		Maize	Brent	Urea	P ₂ O ₅			Potash
		Cotton			Rubber						
		CPO			Soybean						

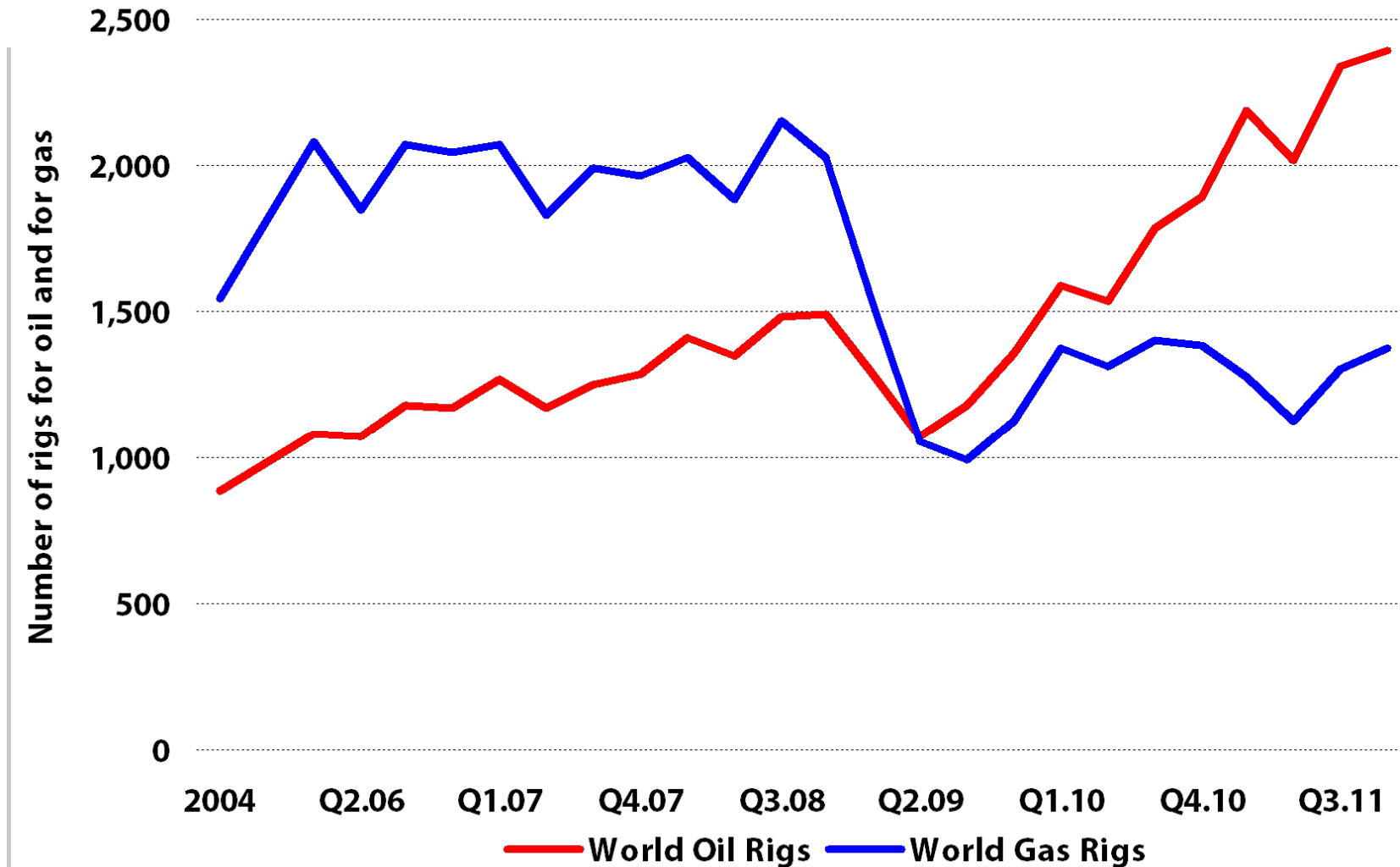
2011

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
	Copper	Cotton	Alumin.				Potash	Urea	P ₂ O ₅
	CPO		Brent						
	Rubber		Maize						
	Soybean								

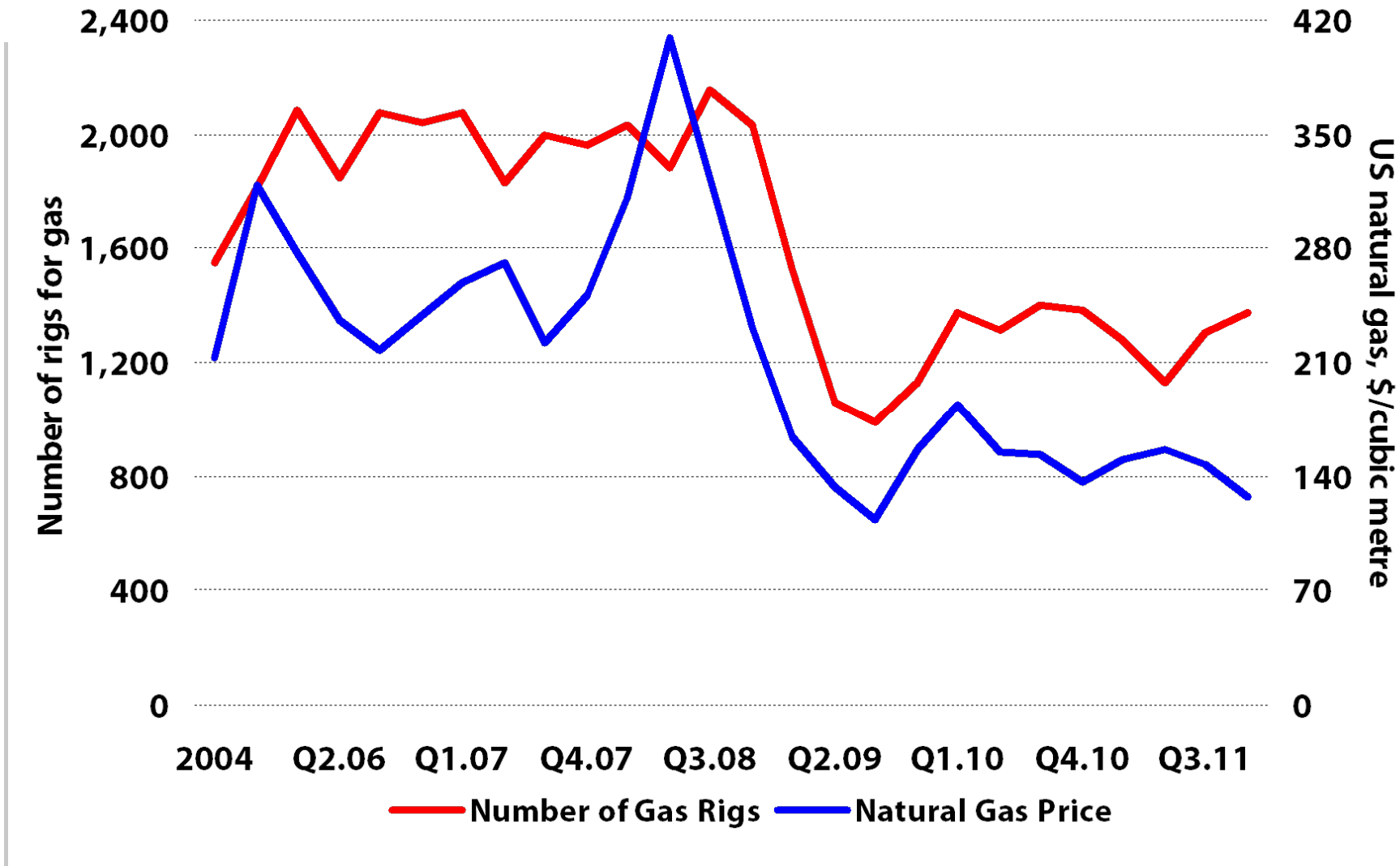
Aluminium, copper, rubber and cotton are industrial inputs; CPO, maize and soybeans are food products; superphosphate (P₂O₅), potash and urea are fertilisers; Brent crude is the sole fuel in the list.

Petroleum market supply and demand

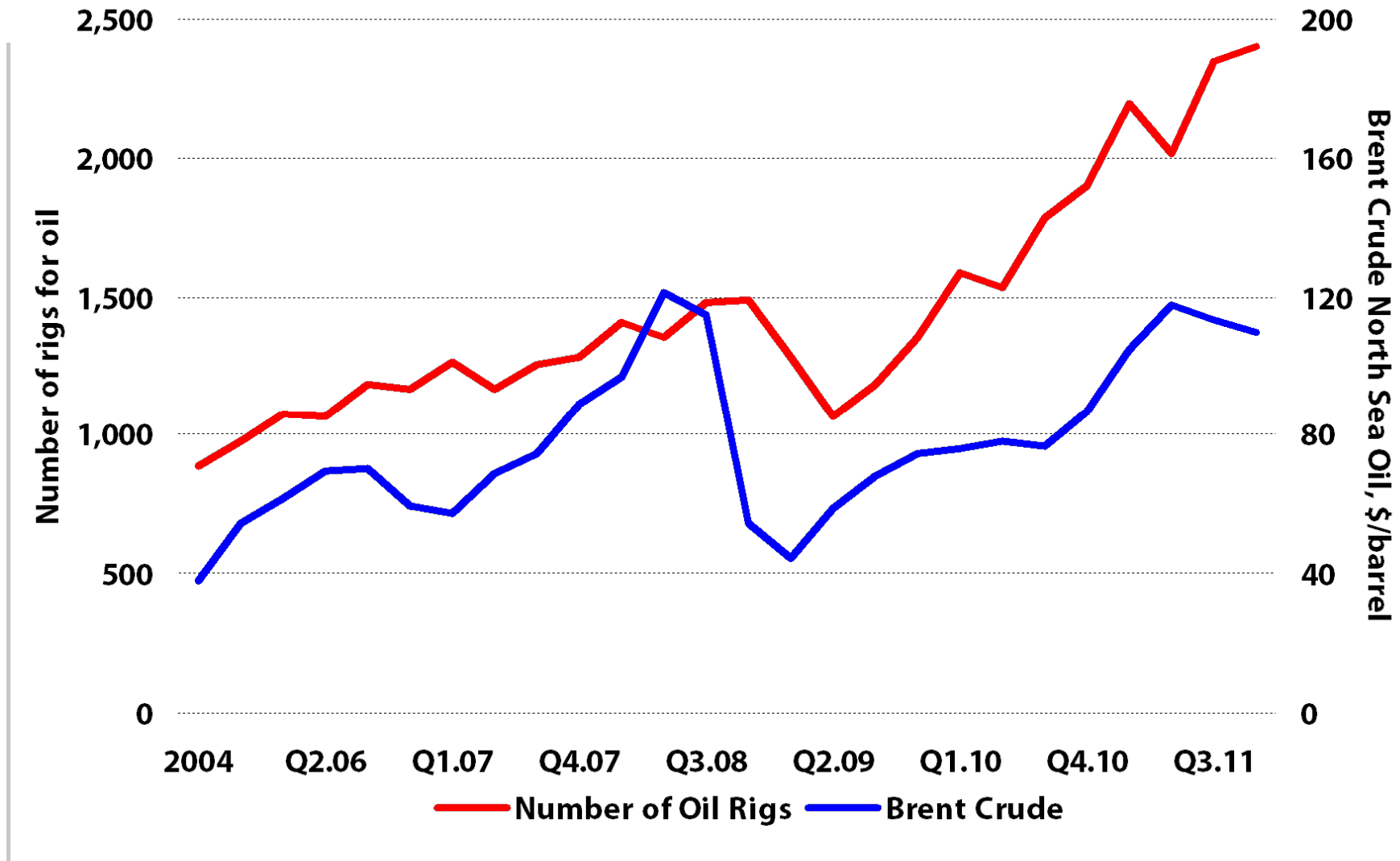
I want to start with a fascinating diagram. In recent years, rig operators have switched their attention from natural gas to looking for oil.



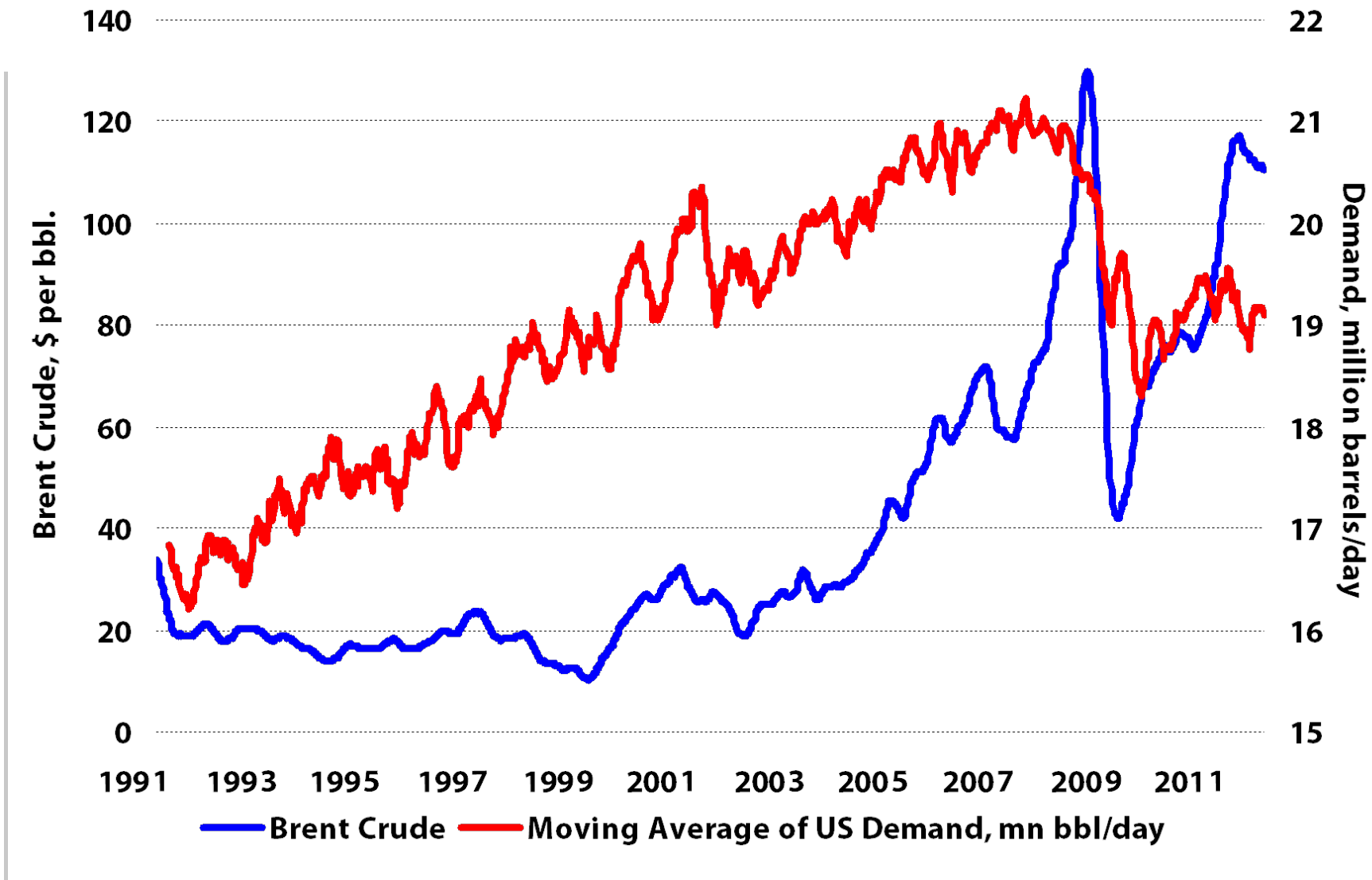
The reason for the loss of interest in natural gas is easily understood when one plots the number of gas rigs against the US natural gas price.



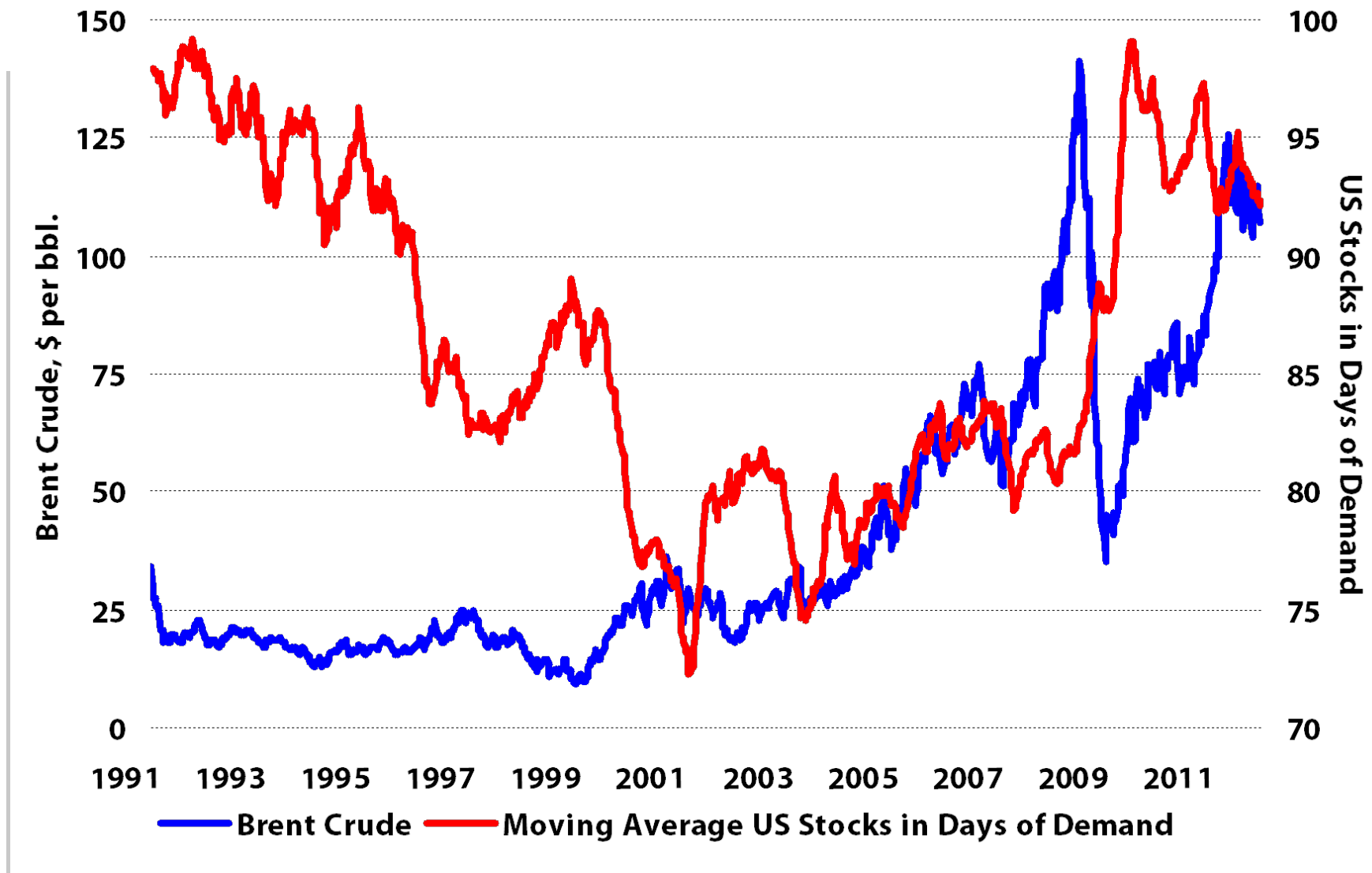
The picture is very different for petroleum: high prices are encouraging drilling. Even with a low success rate, this will surely increase output.



Turning to demand, petroleum use in the US, the biggest consumer, has fallen 10% since 2008, hit by high prices and cheap natural gas.



You might suppose that the reason for the high petroleum prices is that stocks are low; but US stocks are actually very high in days of demand.



It is ever more difficult to see why crude oil prices should stay at their high levels

“The cure for high prices is high prices.”

This is as true for petroleum as it is for other markets.

High crude oil prices are stimulating new discoveries and output, including from deep offshore fields and from unconventional sources such as tar sands.

At the same time, high crude prices are hitting demand.

In the background, the world economy is getting into deeper trouble every day, and high petroleum prices will make the double dip recession more severe.

These are why I believe petroleum prices must fall.

When this happens, it will hit all vegetable oil prices, since they are linked to petroleum via the price band.

The impact of stocks on prices of oils

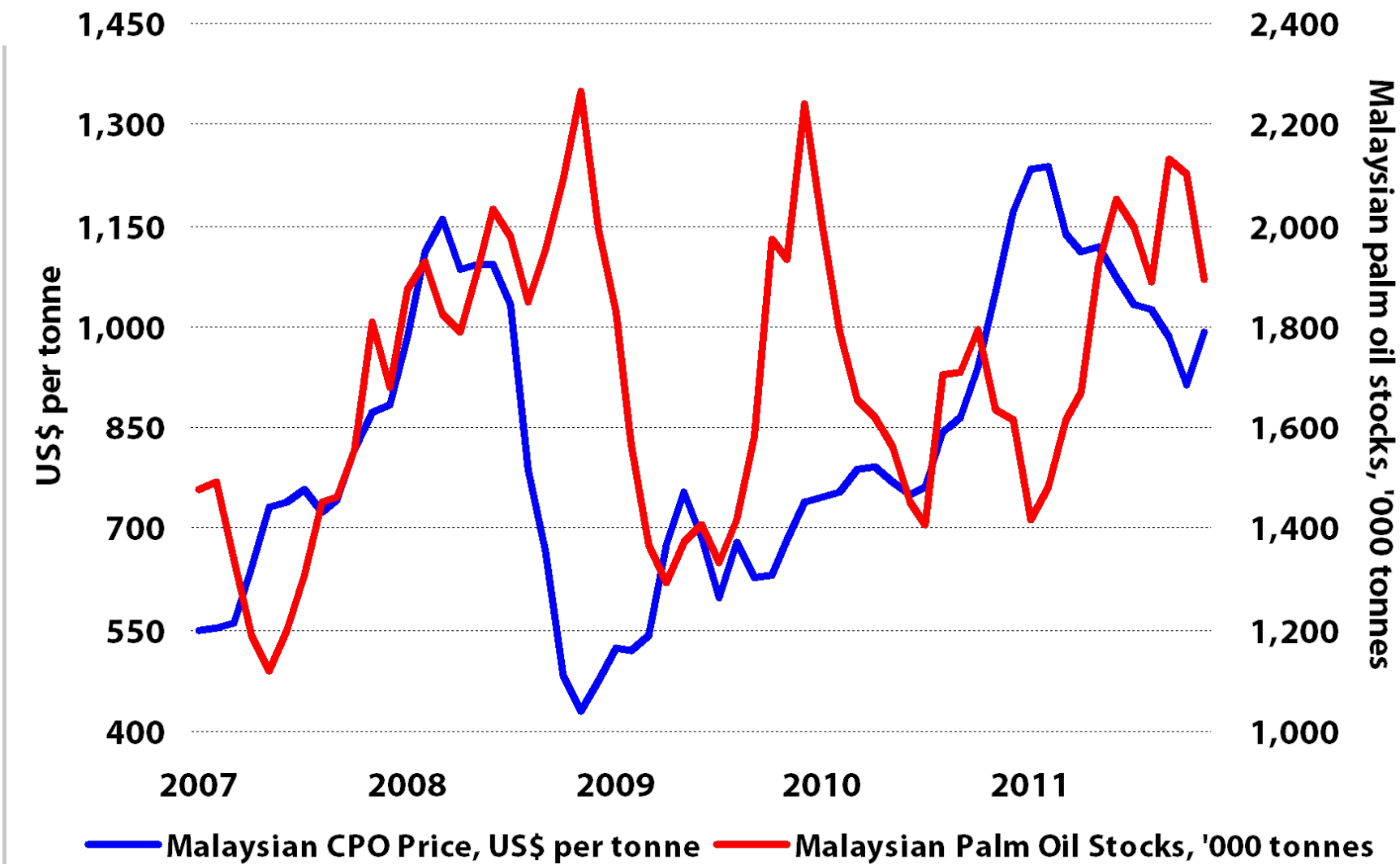
Stocks now lie second to the petroleum price as a driver of vegetable oil prices

Because of the price band, petroleum prices are undoubtedly the single most important factor behind the level of prices of vegetable oils today.

This does not mean that stocks no longer influence prices. They definitely do still matter, but they are now secondary to the impact of the petroleum price on vegetable oil markets, which arises via biofuels.

By far the most important stocks in the vegetable oils sector are those of palm oil. I assure you I am not saying this because I am here at a palm oil conference. The vital importance of palm oil stocks arises because only oil palm among oil crops holds all its supply surpluses as oil, rather than as seeds.

To understand why stocks no longer explain CPO price levels, see how difficult it is to find a clear relationship between stocks and prices.



How will stocks set CPO prices in the new world where CPO lies inside a price band?

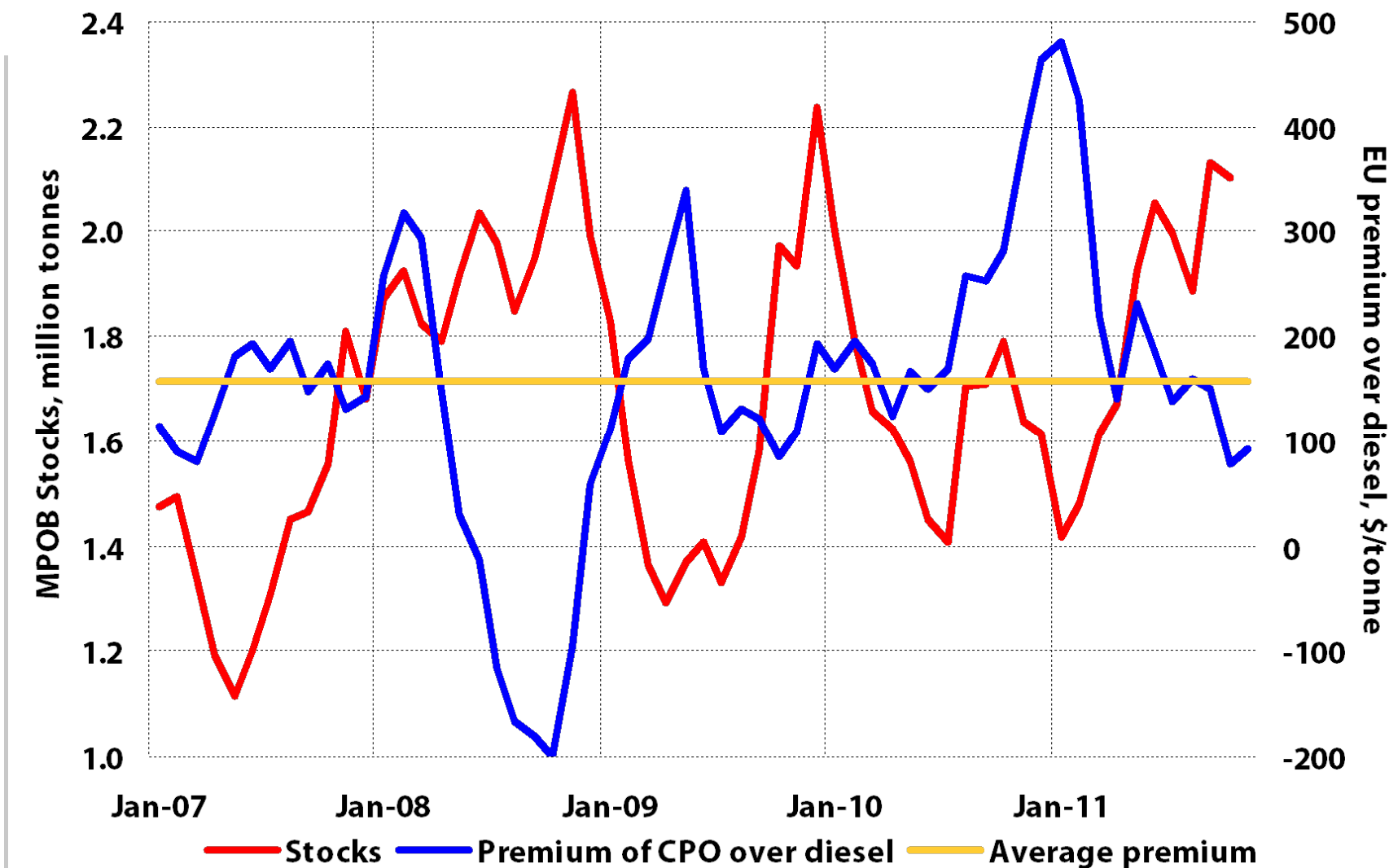
If palm oil stocks are no longer the main determinant of CPO prices, we must adapt our theories to reflect the existence of the new price band.

Logic suggests that, with a price band, a floor exists to CPO prices at a point where high stocks drive prices down so far that it becomes profitable to make and use biodiesel with limited benefit from subsidies.

However, when stocks are low, food demand for oils will have to compete these oils away from biodiesel output, and this will pull CPO above the price floor.

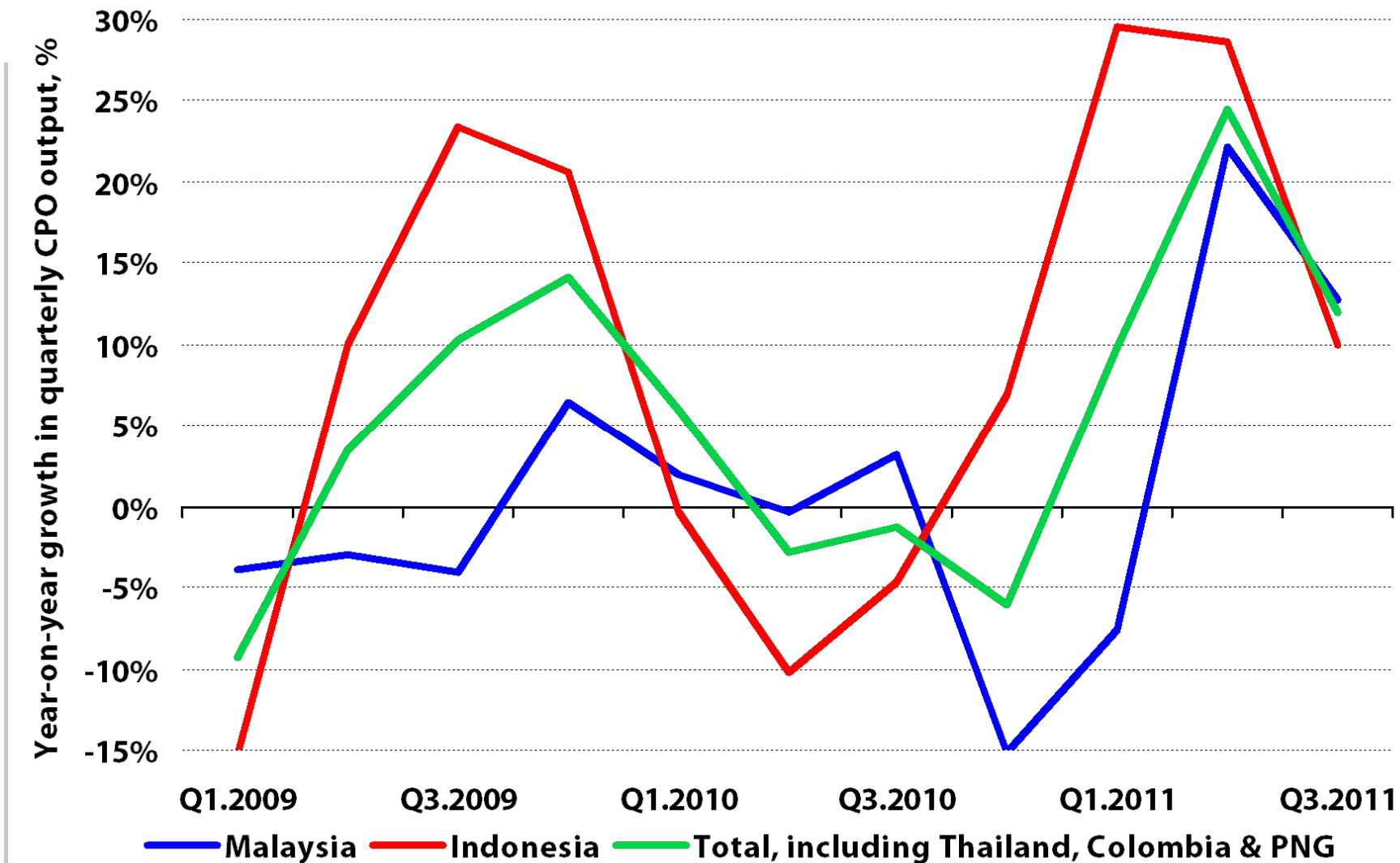
Accordingly, the CPO premium over diesel should be inversely related to the stock level, i.e., the premium should be high when stocks are low and *vice versa*.

The new theory works. When we plot MPOB stocks against the EU premium for CPO over diesel, higher stocks push down the premium.

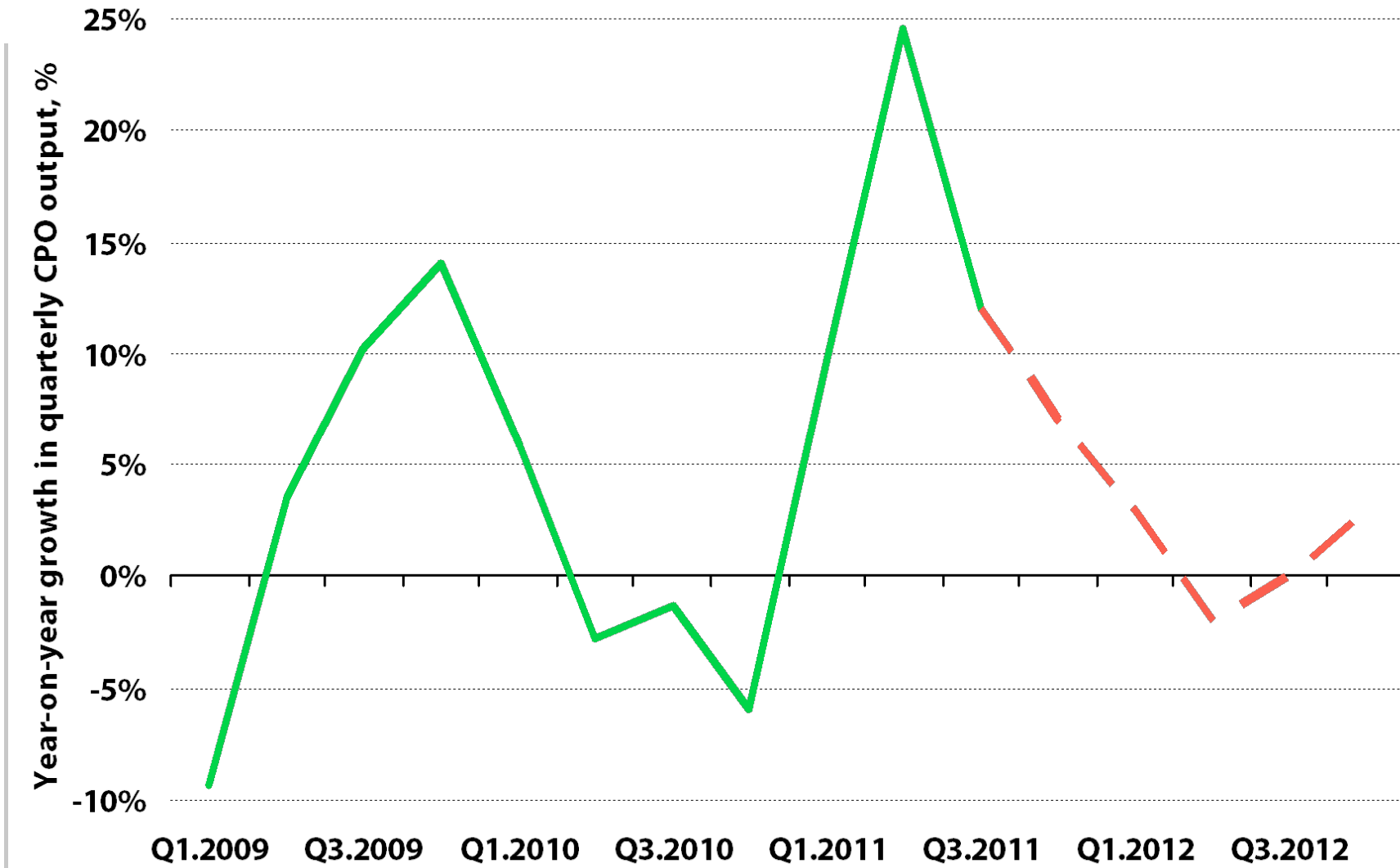


The outlook for palm oil stocks

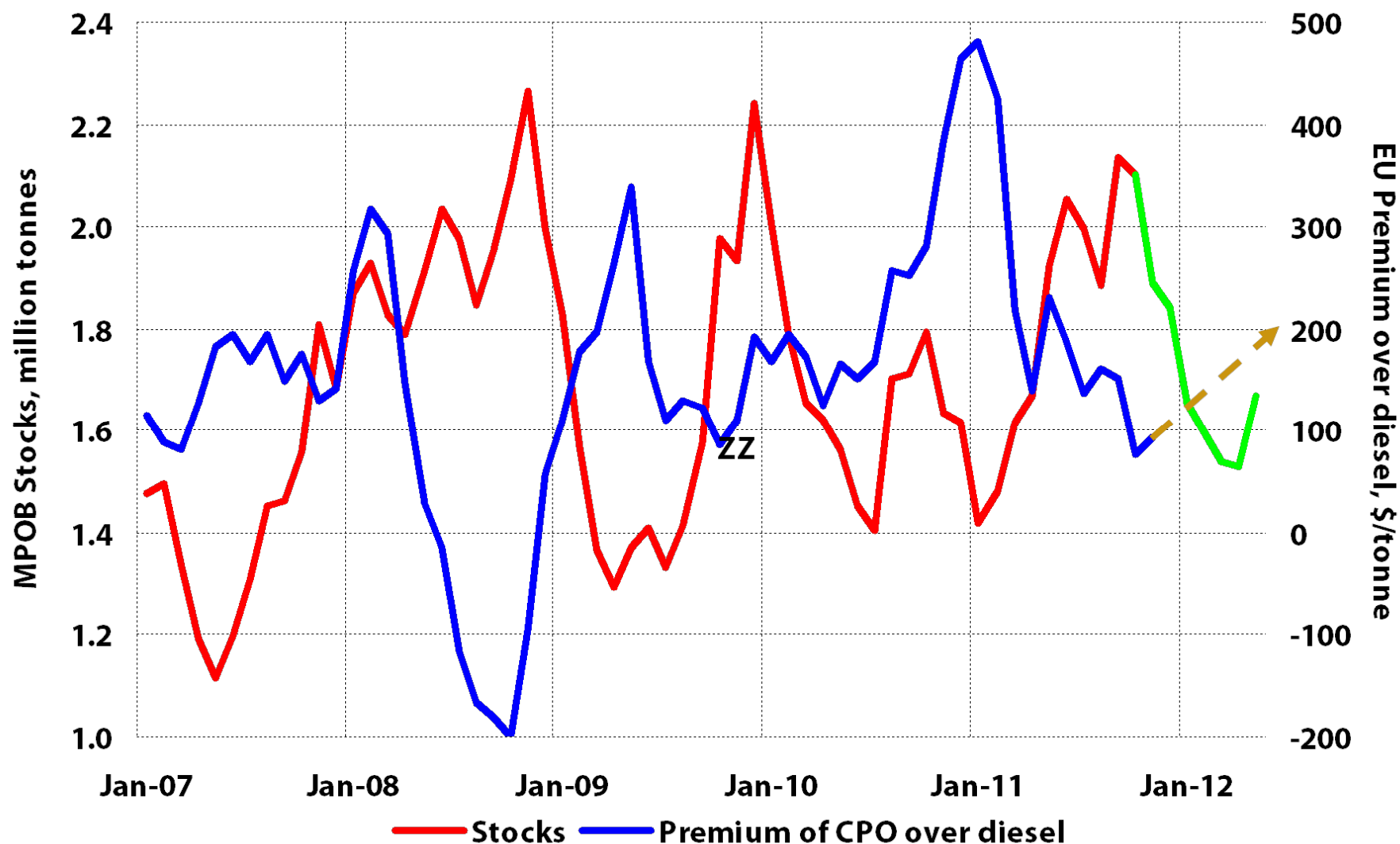
For palm, year-on-year output growth is now starting to slow down all over the world after a period of exceptional growth early this year.



As the cycle unfolds, year-on-year quarterly CPO output growth worldwide is briefly likely to turn negative towards the middle of 2012.



Looking ahead, the slowdown in CPO output round the world will cut palm oil stocks, which will raise the premium for CPO over diesel.



Summarising the key influences on CPO price trends over the next few months.

We are now in a “new world” in which vegetable oils trade in a price band, created by biofuels

The old drivers of vegetable oils prices, i.e., the supply-demand balances, are still a factor, but they only influence prices within limits set by petroleum

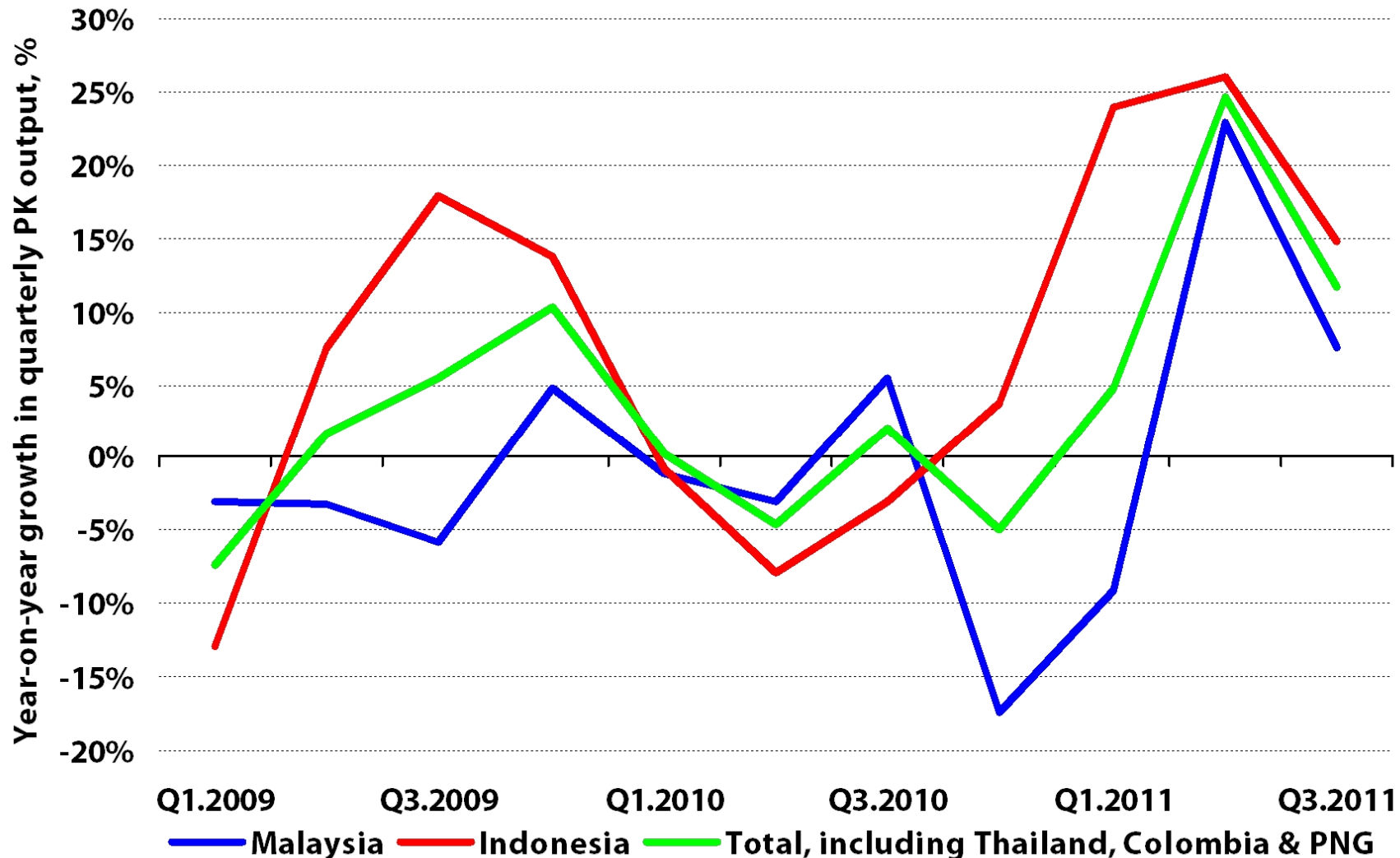
In the background, the oil palm production cycle is turning down after a boom in 2011.

This points to a higher premium for palm oil prices over diesel prices during the next six months.

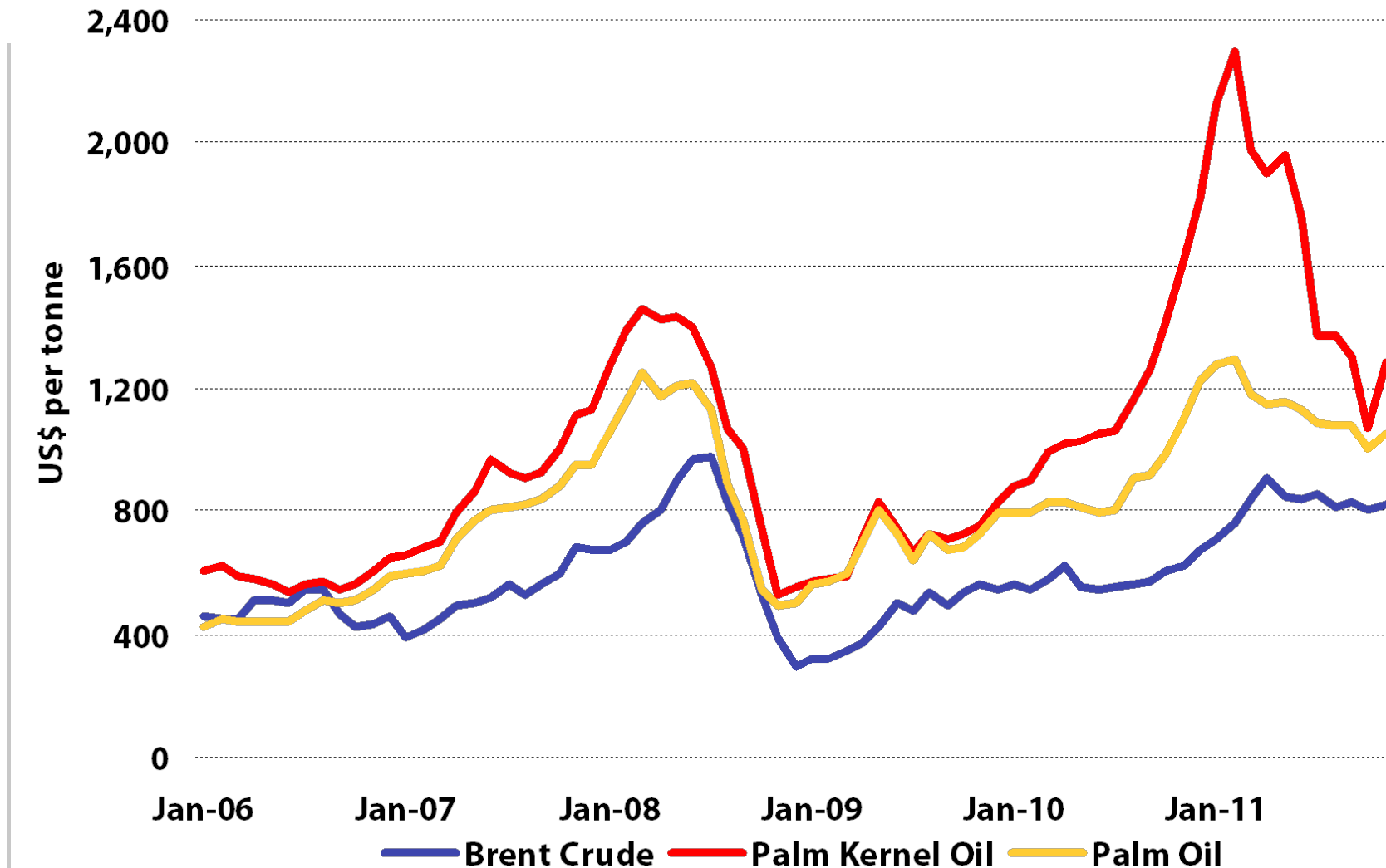
However, to understand how the price of CPO will move, we must also predict the petroleum price.

The palm kernel oil market

Year-on-year swings in PK output growth have been as strong as those in CPO. This explains this year's remarkable PKO price fluctuations.



The PKO price is not part of the new price band, because laurics are not used in biofuels; but the floor to PKO is set by the price of CPO.



PKO price prospects depend on Philippine CNO output and world oleochemical sales.



The timing of a revival in coconut oil output is the key to lauric oil prices over the next few months, since we know that the palm kernel output cycle will follow the CPO cycle in the first half of 2012. Therefore, supplies of PKO will be low for the next six months.

These two factors have to be balanced against the impact of the economic slowdown on oleochemical demand. Some weakness of sales is already evident.

If you share the Philippine authorities' optimism that exports will rebound quickly, the PKO premium over CPO will not rise any further.

If however you feel, like me, that a CNO output upturn will be delayed, the PKO premium will move up.

Outlook for vegetable oil prices

The implications for vegetable oil prices

When the petroleum market corrects, each \$10/bbl drop in the crude oil price reduces prices of all food oils by \$70 per tonne (i.e., roughly 3 US cents/lb.).

In the oils sector itself, a slowdown in palm oil output growth over the next six months and a lower US soybean area will raise the premium for both palm and soybean oils over diesel by \$100 per tonne.

To put today's high crude oil prices into context, in 2010, when the world macro-economic outlook looked brighter, Brent crude oil prices averaged \$79/barrel.

If Brent prices fall back to \$79/bbl by June, S.E. Asian CPO prices would be in the region of \$850 per tonne, with PKO prices \$275 higher at \$1,125.

Thank You



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