The palm oil market today and tomorrow

Presentation to the Fedepalma Congress,
Cartagena de Indias, September 2015
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The key themes in today’s palm oil market

I will start by reviewing the current state of the price band linking vegetable oil and petroleum prices.

I review the special role of oil palm in meeting the new balance of demand growth between oils and meals as a result of the surge in biofuel output.

I examine the mandated and discretionary demand for biodiesel in oil palm producing countries.

I conclude by looking ahead to the short and long term prospects for palm oil output and prices.
The price band is the best place to begin
A price band has linked EU vegetable oil prices and crude oil prices since the start of 2007, with Brent prices setting the floor to the price band.
Malaysian stocks are the key to the EU CPO-Brent price differential per tonne
The EU CPO premium over Brent is negatively correlated with stocks. High stocks imply a low premium, as now, and low stocks a high premium.
CPO prices remain linked to crude oil, fluctuating within a price band whose floor is set by Brent.

It is evident that palm oil prices are still led within a price band by prices in the world petroleum market.

There is also compelling evidence that the most important single factor determining where EU CPO prices stand in relation to crude oil is MPOB stocks.

MPOB stocks play this role because they are the only reliable stock data available to the market and are published within two weeks of the end of the month.

A question raised by price movements since early this month is whether the market is now looking ahead to stock movements next year rather than stocks today.
What changed CPO pricing from the traditional analysis of supply-demand balances? Biofuels
Biofuel demand for oils has made the world’s need for oils grow faster since 2000 than the steadily rising demand for meal for animal feed.
Oil palm is ideal for the biofuel era. The world wants oil more than meal. Oil palm has 8 times soybean’s oil yields/ha., without too much meal.
Biofuels, by creating a demand for oils without a parallel demand for meals, has favoured palm oil

Forecasters have usually assumed that rising incomes and population raise demand for both oils and meals.

What is so special about biofuels is that they are an entirely new form of demand for oils, without any corresponding impact on the demand for meals.

As a result, the world has needed faster growth in the supply of oils than in meal, and palm helps to do this.

This does not mean that palm has met the new biofuel demand; instead, as soy and rapeseed oil are diverted to make biofuels, palm oil fills the gap in food oil supply.
Biodiesel’s success among oil palm producers
In biodiesel use, Colombia has been particularly dynamic. Biodiesel accounts for most local palm oil use and for close to 45% of total CPO output.
Malaysia is slowly raising its biodiesel mandate and has raised exports (to the EU, as Indonesian imports are now blocked by anti-dumping duties).
Indonesian local biodiesel sales and exports move erratically. Now that the EU door is shut, exports rely mainly on free market, price-sensitive sales.
Discretionary biodiesel (PME) use emerges when CPO competes as a fuel. Indonesian exports to price-sensitive markets, like China, illustrate this.
Discretionary, price-sensitive, biofuel demand has been crucial in absorbing surplus oils stocks. Many countries do not fill their mandates because their governments do not take proper action to enforce them.

Among oil palm producers with mandates, Colombia has been particularly successful in meeting its targets. Malaysia has been slow in raising mandated biodiesel demand. Indonesia has not yet filled its mandates.

However, Indonesia has seen the emergence of price-sensitive demand for palm biodiesel (both for export and locally) when PME can compete on price with diesel fuel.

In 2014, maybe four million tonnes of biodiesel, primarily from Indonesia and Argentina, went to discretionary uses.
Price competition has evolved between palm oil and other leading vegetable oils
EU spreads between palm oil and other vegetable oil prices have been rising recently. This will help CPO to capture price-sensitive markets, like India.
India, the world’s biggest importer of vegetable oils, is very sensitive in its balance of imports to the local discount of CPO on soybean oil.
Indian annual imports of vegetable oils are now approaching 12 million tonnes. A change of just 8% in palm oil’s market share is 1 million tonnes.
Competition between palm oil and other oils

For a long period that lasted for almost two years, and extended until a month ago, the premia of soybean and rapeseed oils over palm oil were quite low by historical standards.

These premia have jumped a great deal in the past few weeks as CPO prices in US$ fell back, while the prices of the other major oils have remained steady.

This will help palm to recapture export markets, such as that in India the world’s largest oils importer, where palm oil lost sales to other oils. Palm oil is also a more competitive feedstock for EU biodiesel output, but will soon face cold weather limits on PME blending.
Looking ahead: the seasonality of output
There is a regular cycle of 18-24 months in year-on-year CPO output growth (i.e., Q2.15 on Q2.14). The cycle is currently having an upswing.
The outlook for stocks and the CPO premium
Returning to our diagram of stocks vs. the CPO premium vs. Brent, you see why we have been bearish about the premium for much of this year.
High stocks have lowered the CPO premium over Brent in different markets. Indonesia’s premium has shrunk most, thanks its new $50 export levy.
However, studying daily price movements, we see that, after Indonesian CPO prices came very close to Brent for one day, the premium widened rapidly.
The price may be anticipating the fall in stocks that will occur in 2 months as output growth slows due to lower fertiliser use and recent droughts.
The outlook for palm oil prices going into 2016

The failure of fertiliser prices to follow CPO prices downwards over the past year has reduced fertiliser application rates and this will start to affect output. This will happen during the usual slowdown in S.E. Asian production after November. Monthly output will fall at a time when CPO’s discount on soy oil is wide.

So far, while there have been a series of droughts in eastern S.E. Asian palm regions, it is impossible to blame them on El Niño, but it is affecting sentiment.

The testing time is the next 2-3 months. Higher stocks cannot be absorbed via discretionary biodiesel sales without a fall in CPO prices from recent levels – or a rise in Brent crude prices, which I do not expect to see.
The longer term outlook for prices
Long cycles in real (inflation-adjusted) prices around a long run trend are fairly common, partly because of lags between price signals and output.

The long run trend line in real prices fell by 1.6% per annum.
In the past month, EU CPO prices have moved below their long run trend values.

The price was -5% below trend in September 2015.
One cause of weak prices is the growth in palm areas. Indonesian palm seed sales reveal how new plantings follow CPO prices up … and down.
Looking further ahead in the palm oil crystal ball

Petroleum will set the future floor to the CPO price. The discretionary biofuel “tap” can be switched on whenever palm biodiesel is cheaper than fossil diesel.

Crude oil has its own investment cycle, like oil palm. So, while Brent prices might fall for a short while, their long term average level should be above today’s level.

Palm oil’s investment cycle is now moving firmly into a down phase due to low prices and NGO pressures.

CPO output growth will slow. This means that the need for the discretionary biofuel “tap” to absorb surpluses will decline. As a result, the FOB S.E. Asian premium of CPO over Brent, which averaged barely $50 since 2012, should settle down to a more normal $150.
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