

Agriculture Digest

Arabica bull market flash – Brazilian tempest in a coffee pot...

- Commodities
- Agricultural Growth

- **Arabica coffee prices have surged c30% year-to-date amid a modest 2% total return for the balanced DJ-UBS index benchmark; thus outperforming all major commodity contract markets including high-flying [NYMEX natural gas](#).**

Underpinning the move is the unfolding of adverse weather 'tail risks' impacting production prospects for the preeminent global producer of premium beans—Brazil. Last month we [downgraded the 2014 Brazilian crop outlook to 54-mn bags and reverted back to our higher cal'14 average price target set in 3Q'13 of USd128/lb](#). At that time, we remained agnostic the curve absent a weather risk or fundamental catalyst materializing to boost the calendar strip. But an excessively dry weather outlook and a dearth of precipitation in key Brazilian areas during the critical cherry-forming February growing period is providing downside risk to the global supply outlook and its persistence can buttress elevated prices on ICE (despite the large overhang of exchange-certified Arabica stockpiles near 2.65-mn bags). The Arabica-Robusta spread has already blown out to TTM highs of USd59/lb and much closer to its historical mean of USd80/lb after printing at multi-year tights below USd30/lb just last quarter—a level whereby we see significant physical trade and roaster-switching support. Interestingly, the correlation between a weaker BRL currency and lower coffee prices has diverged rather than re-correlate to recent seasonal norms during this rally—failing to cap price cheer on these output risks.

- **Fund flow, forward term structure, technical charts and option markets all suggest the potential for a very volatile ride in the short-term whereby Brazilian weather and positioning can drive short-term sentiment.**

- Unlike the flat-price spike at the beginning of January—the 'February rally' has led to meaningful bull-spreading across the ICE curve—implying a tighter market; Mar-July, Mar-Dec, July-Dec and Dec-red-Dec carry all narrowing amid a c28% parallel shift higher for the curve. Fund net length has come back to its T5Y range but is still short on aggregate with significant potential upside of c40k lots.
- ICE coffee prices near USd143/lb have rallied firmly through the 55-week MA which has historically been an important level on the screen. In the medium-term this might push system/algo players trading charts to look to the 200-week MA near USd180/lb although there is some resistance at USd147-148/lb. But the extreme moves in the past week have been aggressive and momentum could be a bit stretched. A pull-back to the low USd130s/lb should the weather outlook marginally improve could then be support for the next leg up on the technicals.
- Option markets show volatility has spiked since last week to a two-year high amid these weather concerns. Near term at-the-money (strike 142.5) vols for prompt futures surged 37 vol points to an annualized 66%, implying another 4.2% daily movement for the remaining week before expiry; volume concentrated on out-of-the-money 140-150 calls, bidding up call skews. Vol term structure has inverted into extreme backwardation with the flattening of the futures curve, as generic 1M vol rallied by 16 vol points to highest point since 3Q'11, while generic 1Y vol moved only 2 vol points, much lower than regional high in mid-2013.

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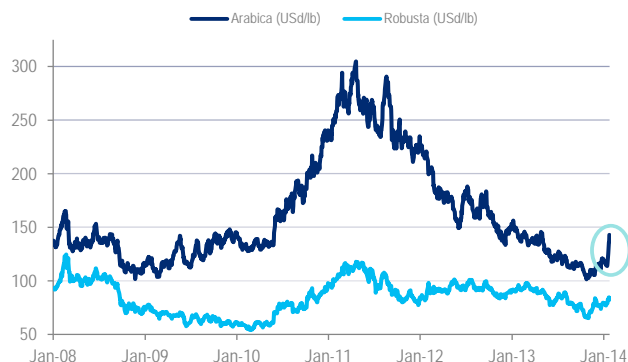
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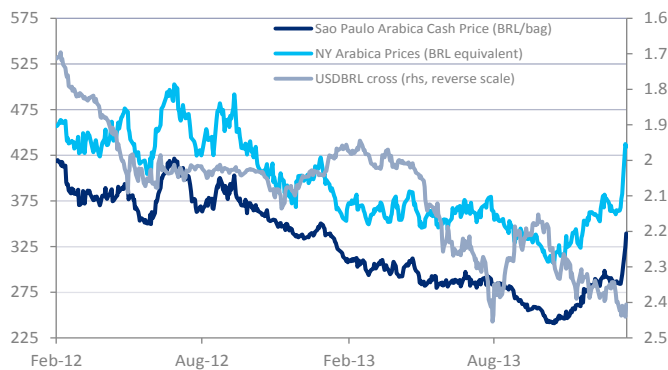
ICE Coffee Charts

Figure 1. Exchange Benchmark Coffee Prices (2008 – Present)



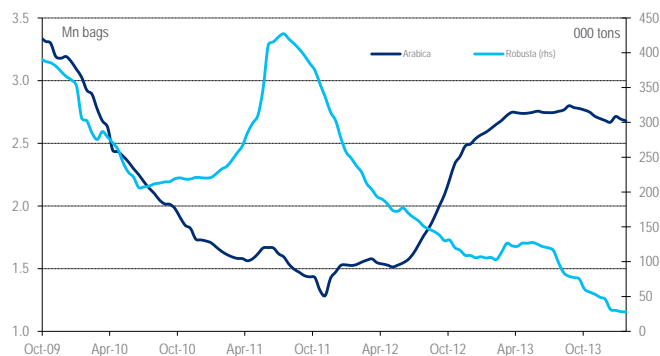
Source: Bloomberg, Citi Research

Figure 3. Divergence between Arabica Coffee Bean Prices and BRL weakness strengthens rather than returning to prior cycle trend



Source: Bloomberg, Brazil Center for Economic Studies, Citi Research

Figure 5. Certified Coffee Inventories – Still Suggest a Large overhang of Arabica Beans albeit Stocks appear to have stabilized



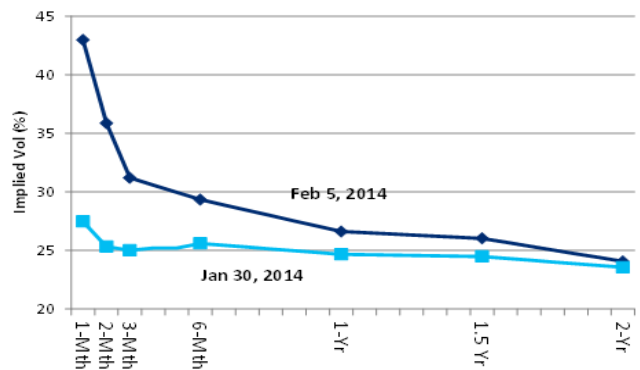
Source: ICE, LIFFE, Citi Research

Figure 2. ICE Coffee Spreads – Curve differentials finally rally



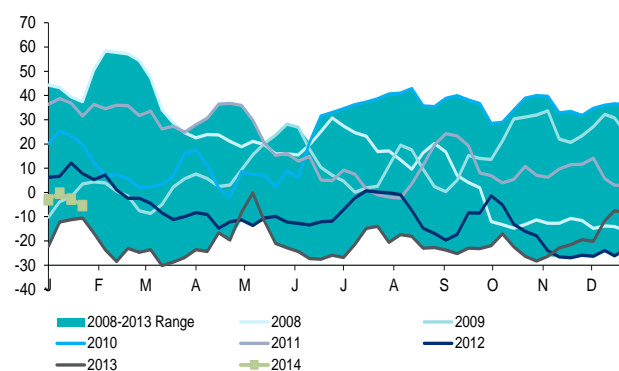
Source: Bloomberg, Citi Research

Figure 4. Implied Vol Term Structure for ICE Coffee



Source: Bloomberg, Citi Research

Figure 6. Money Manager Net Positioning (F&O, 000s lots): ICE Coffee
If output risks continue, there is still significant room for non-commercial market participants to further 'bull-up' the market—and in the short-term could make trading volatile and choppy



Source: CFTC, Citi Research

Appendix A-1

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