Key factors driving vegetable oil prices today

Presentation by Dr James Fry,
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Outline of my presentation

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I will explain how the determinants of the prices of vegetable oils, and of palm oil in particular, have changed since 2007.

I demonstrate how the influence of stocks on the price level has been transformed in the same period.

I describe the influence of the global fuel and biofuel market on the price of palm oil.

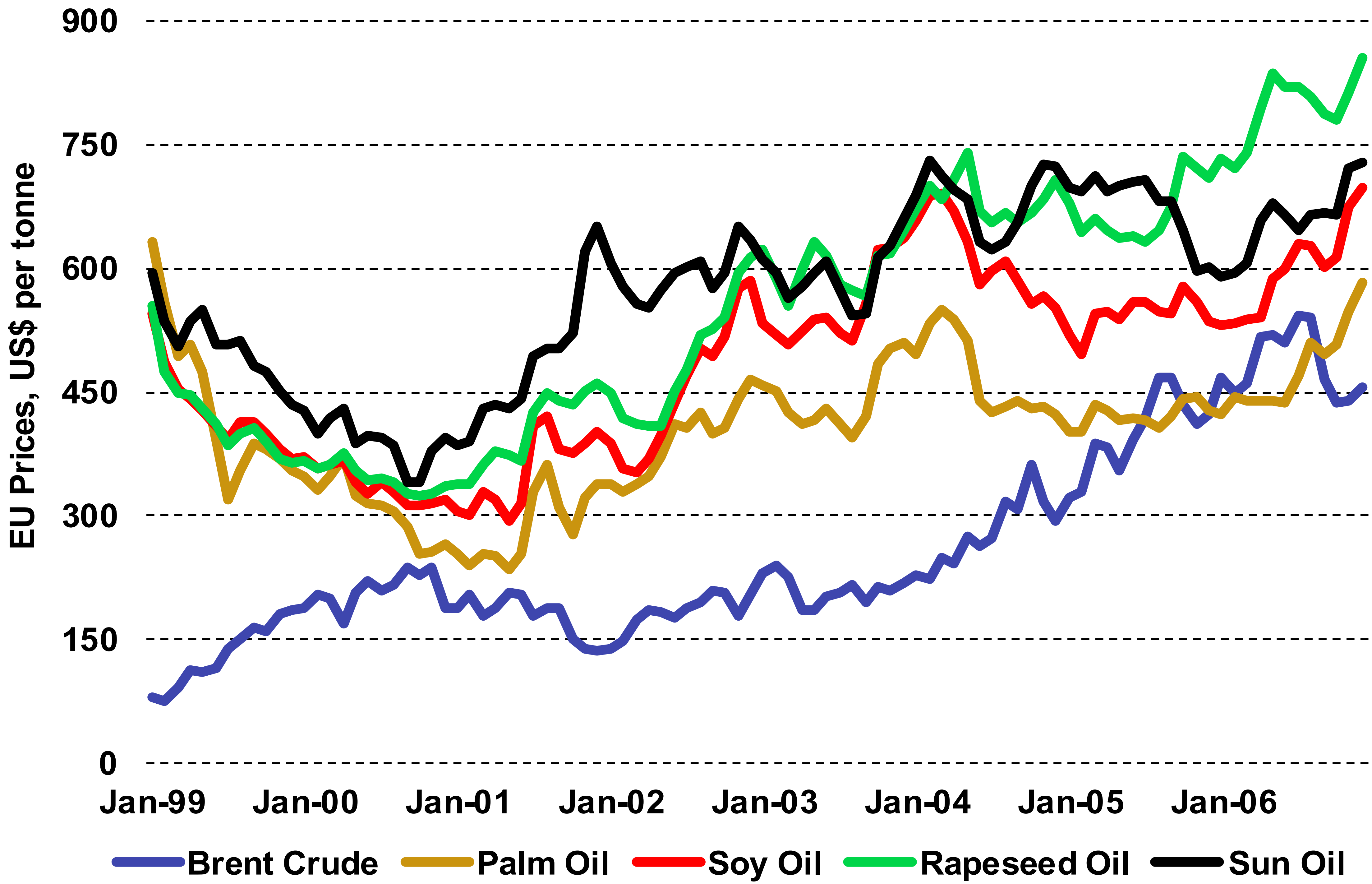
I highlight the impact of export taxes on CPO prices.

I analyse the growth in S.E. Asian palm oil output and the feedback from CPO prices to new plantings.

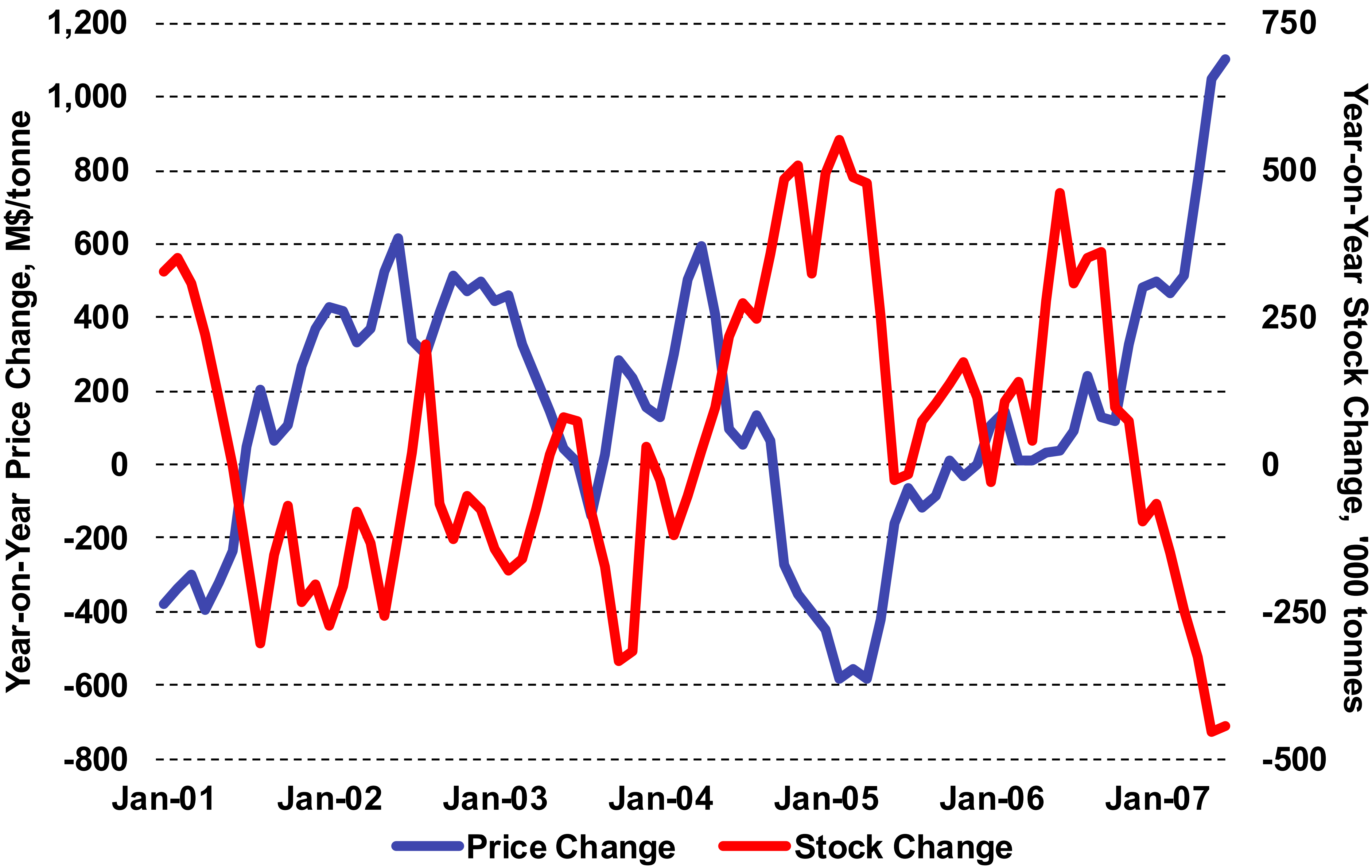
I will end by summarising the lessons to be learnt about preparing your own forecasts of palm oil prices.

What used to determine prices of oils?

Before 2007, EU petroleum and vegetable oil prices moved in different directions. CPO, as the cheapest vegetable oil, captured new markets.



At that time, changes in stocks and prices went in opposite directions. Rising stocks meant weak prices; falling stocks meant higher prices.



We can see that, until 2007, Malaysian stocks were the key determinant of world vegetable oil prices.

Palm oil stocks in Malaysia were the most important determinant of the price of palm oil until 2007.

Palm oil was by that time the world's biggest source of vegetable oils and accounted for most of the world's exports of oils. Consequently, palm oil tended to lead the prices of the other major vegetable oils.

So, you could say that Malaysian palm oil stocks were the most important driver of the prices of the main vegetable oils around the world before 2007.

Since there are no good data on Indonesian stocks, the stocks that the world follows are those published each month by the Malaysian Palm Oil Board.

The “new world” since 2007

Since 2007, the behaviour of vegetable oil prices has been transformed. They are now linked to petroleum prices within a very clear price band.

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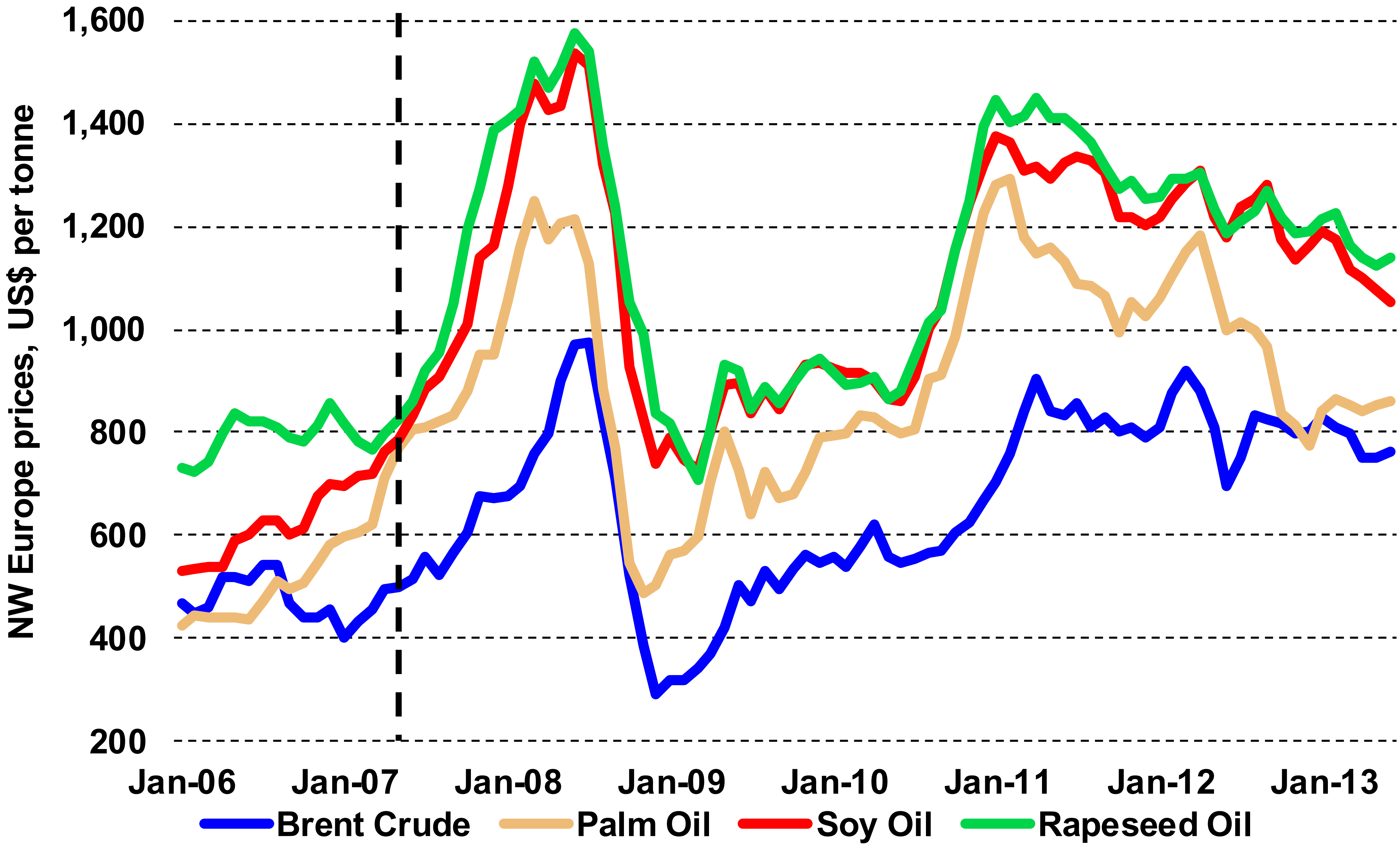
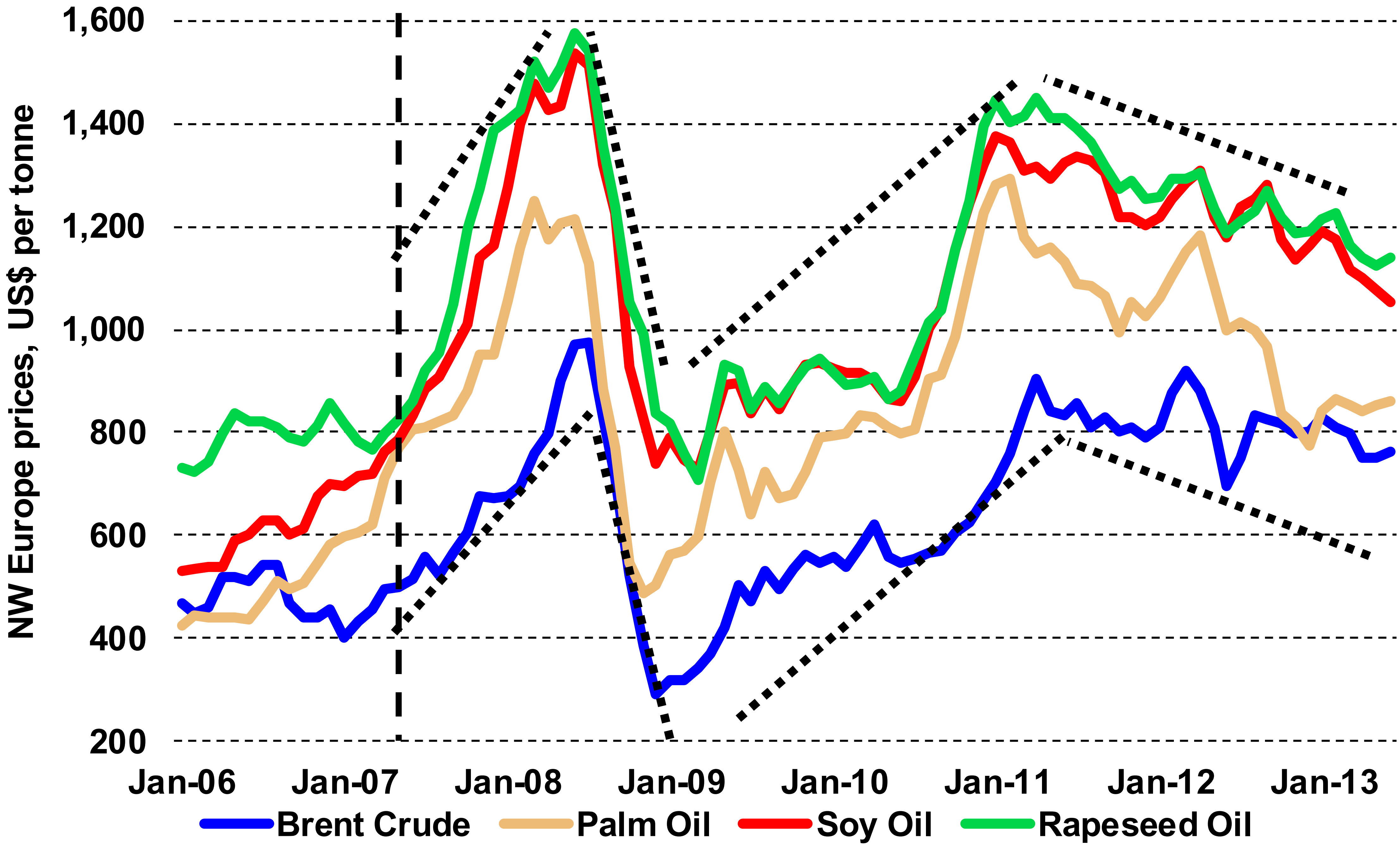
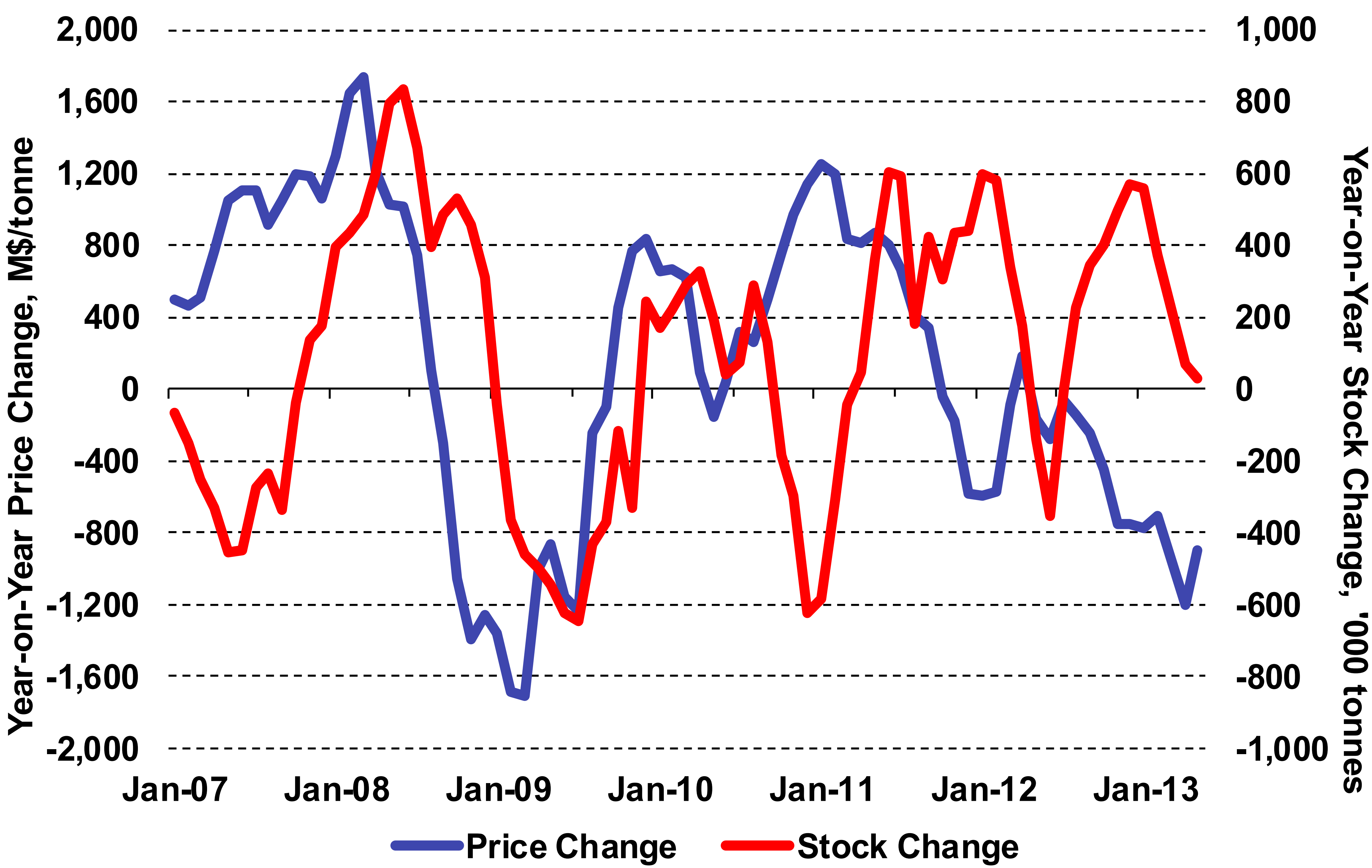


Here I have drawn a very simple price band.



As a result, there is no longer a straightforward relationship between movements in Malaysian palm oil stocks and changes in CPO prices.



The forces that determine vegetable oil have changed. Vegetable oil prices now behave as if they are part of the petroleum complex.

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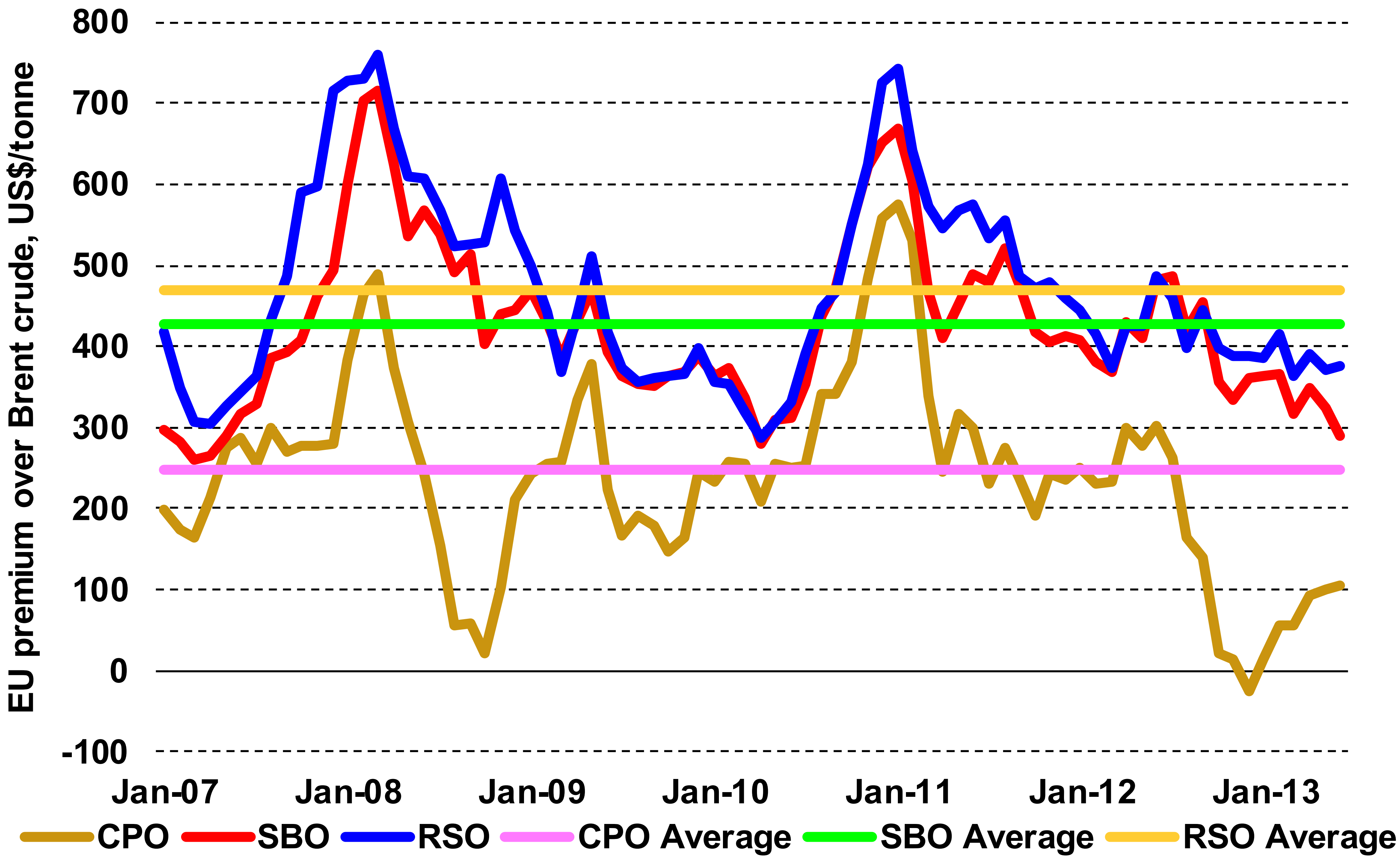
We can see that prices of the main vegetable oils are more or less trapped in a cage that links them to petroleum prices. (The petroleum price that we use is the Brent North Sea crude price, which is the price reference for most world trade, and is very close indeed to the crude oil price quoted in Singapore.)

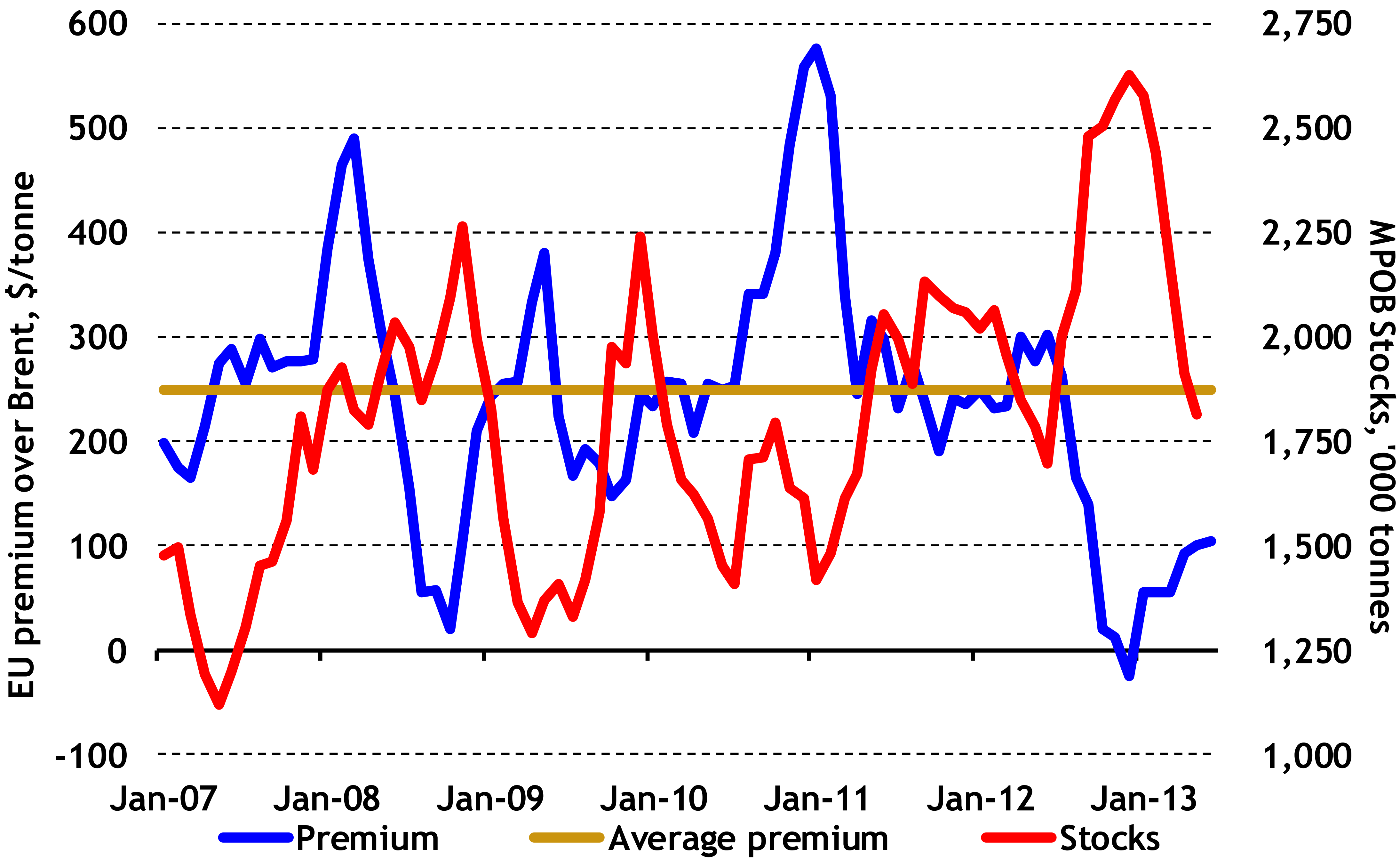
Brent crude sets the floor to the price band, while CPO is the vegetable oil whose price is closest to this floor.

The prices of the other two main vegetable oils, those made from soybeans and rapeseed, trade very close to one another and are more stable within the price band.

Attention should now switch to understanding differentials inside the band. Here I plot the premia of oils over Brent crude since 2007.



What is the role of palm oil stocks? Here I plot the CPO premium in the EU over crude oil, and contrast it with the movements in stocks.



Since 2007, we see that Brent crude oil has set a floor to EU CPO prices. MPOB stocks now determine CPO's premium over Brent.

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Palm oil stocks in Malaysia are still very important in setting the CPO price, but we have just seen that, when crude oil prices rise and fall, the prices of palm oil and other vegetable oils move in parallel.

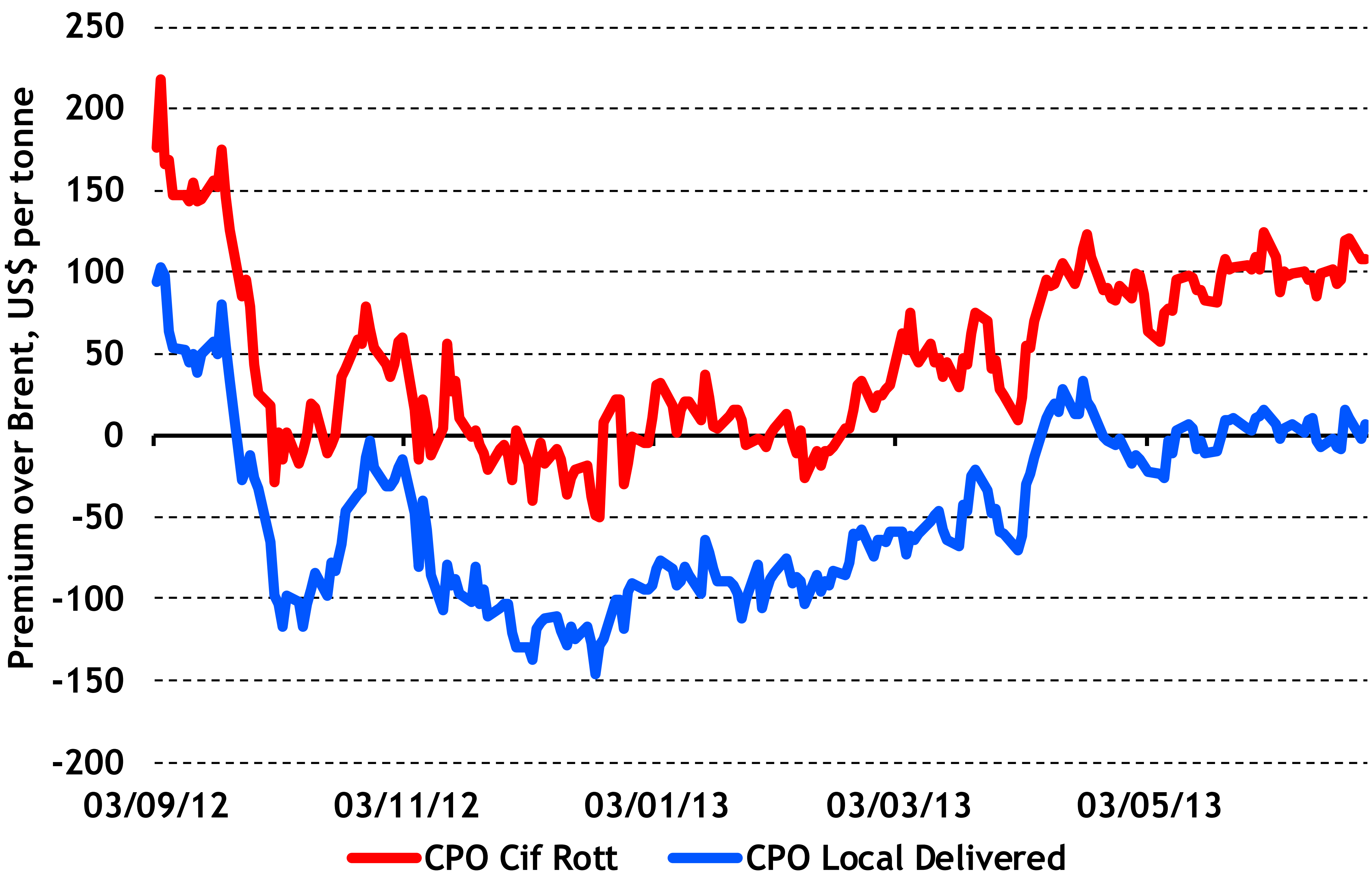
The influence of stocks on prices is now found in its influence on the CPO premium over crude oil prices.

This premium has varied between a peak of $300 a tonne roughly 12 and 24 months ago, when stocks were low, and a floor of zero six months ago, when stocks touched their all-time highs.

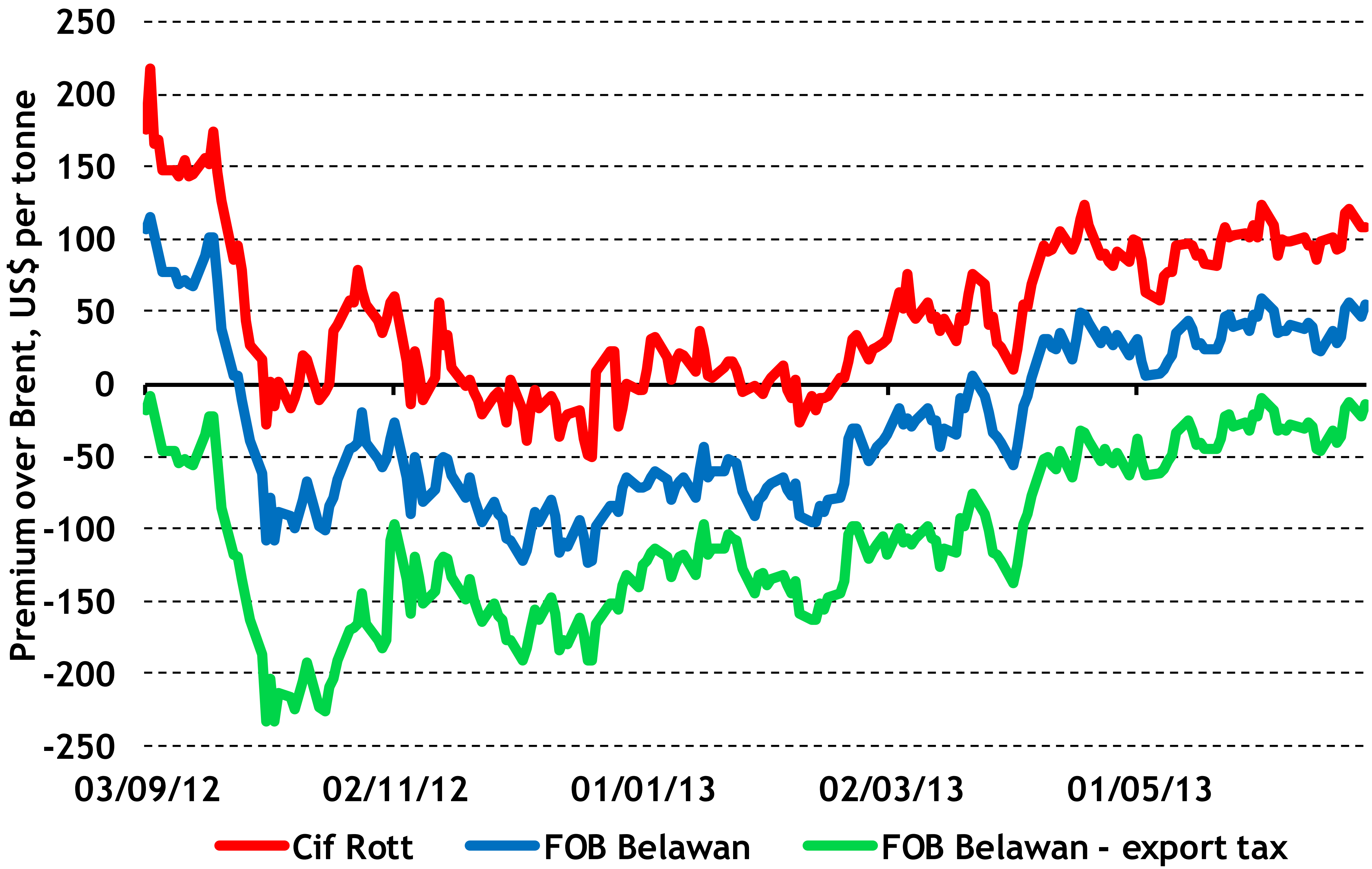
We can therefore conclude that high stocks mean a low premium; while low stocks mean a high premium.

How has the price floor held firm in the face of the highest ever stock levels?

The answer is: CPO was cheaper than crude oil in S.E. Asia because of freight. Here I plot EU (red) and Malaysian (blue) premia over Brent.



Indonesian export taxes pulled local CPO prices (green) down to a much bigger discount to Brent than those at a FOB level for exports (in blue).



Conclusion: Freight costs and export taxes have reinforced the floor to the price band

There is no doubt that fuel uses of palm oil (without any official subsidies) became profitable in S.E. Asia.

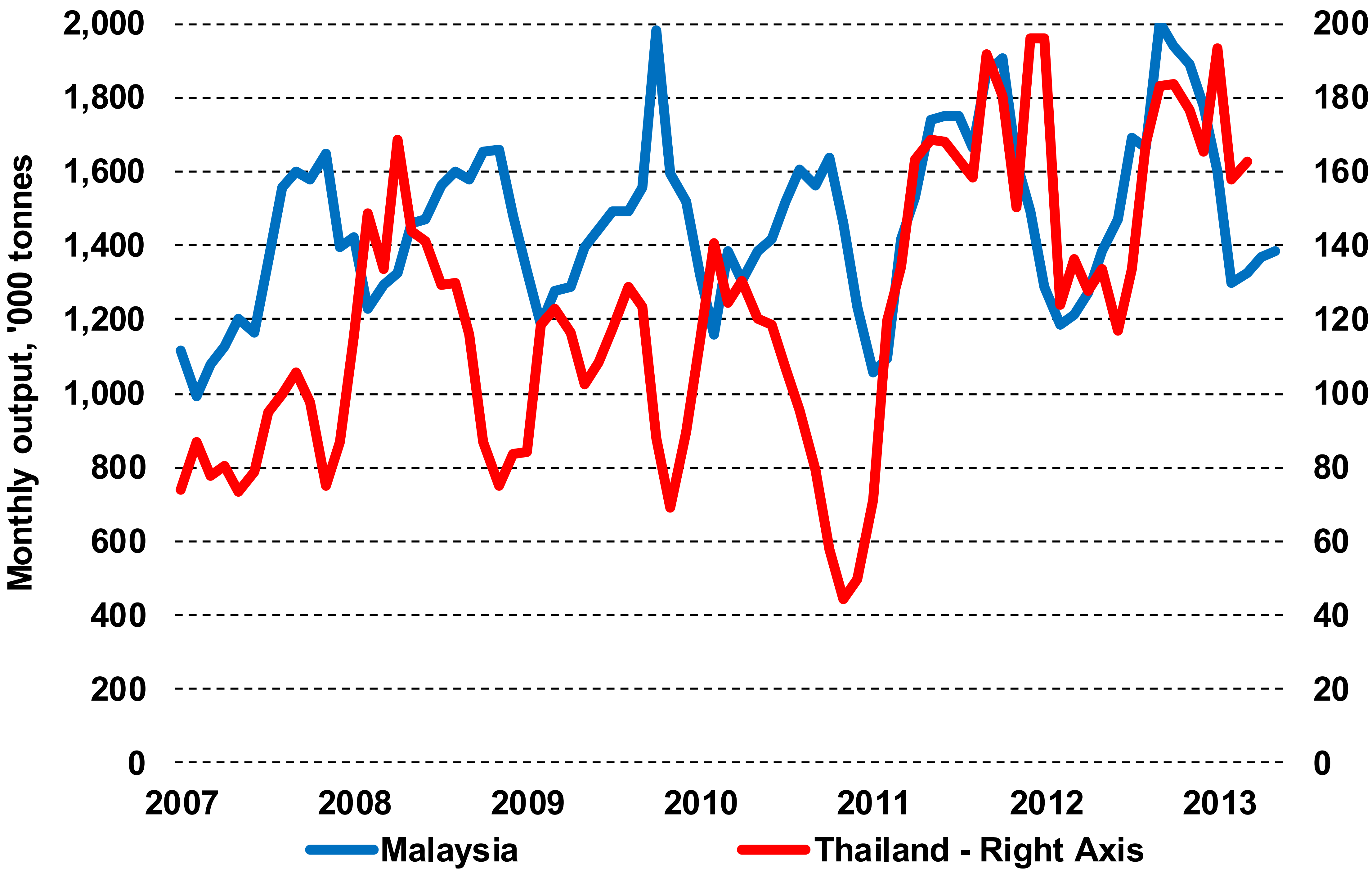
This was because freight costs meant that the floor to the EU price band (where CPO prices equal to those of Brent crude implies a CPO discount in S.E. Asia.

Export taxes reinforce the appeal of turning CPO into biofuel in Indonesia and (to a lesser extent) Malaysia.

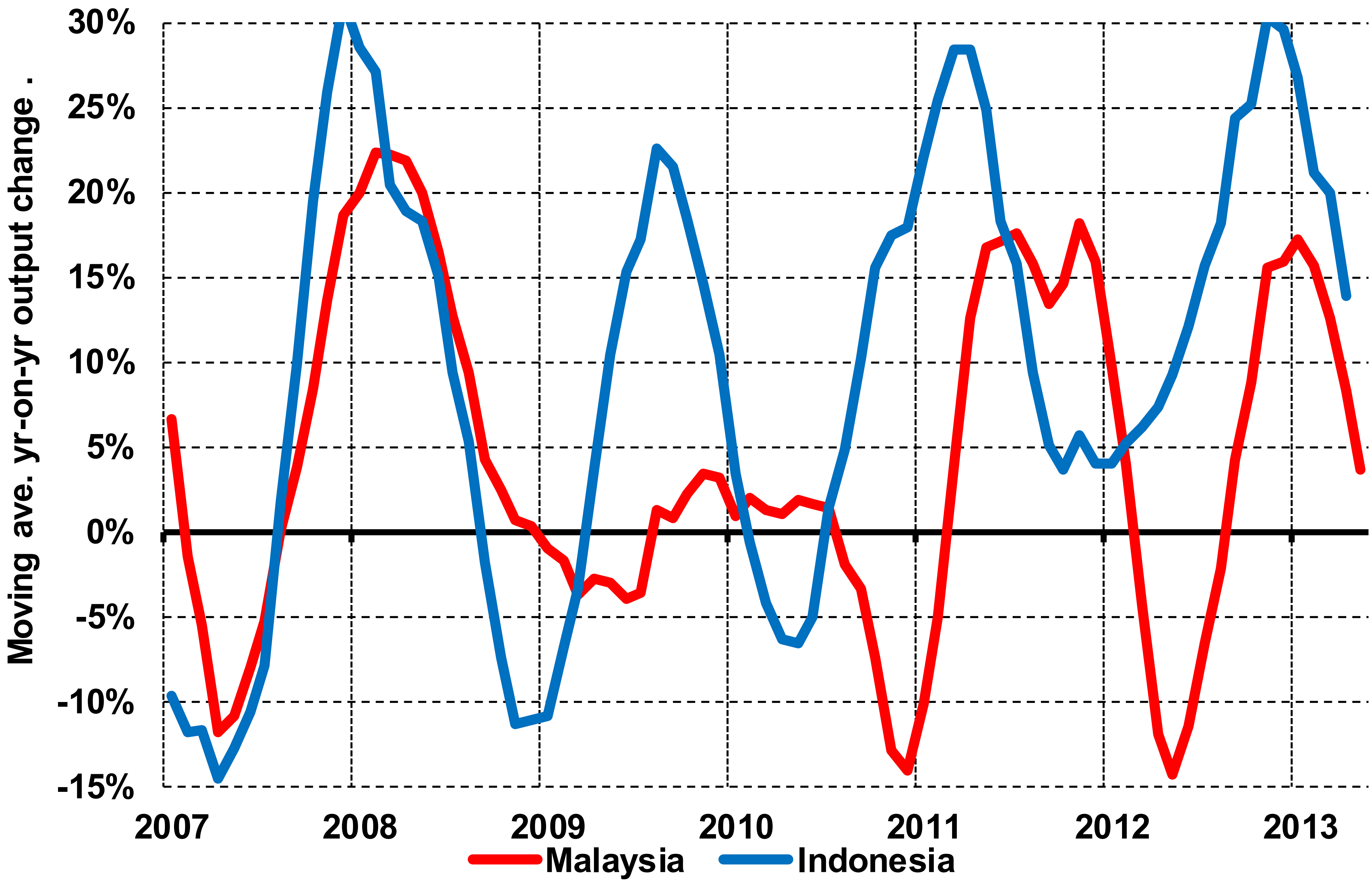
This is because a local CPO seller cannot avoid the impact of the export tax. Competition between traders selling for export and to the local market ensures that local sales earn producers the same value as sales for export, i.e., the f.o.b. export price *minus* the export tax.

The outlook for CPO prices today

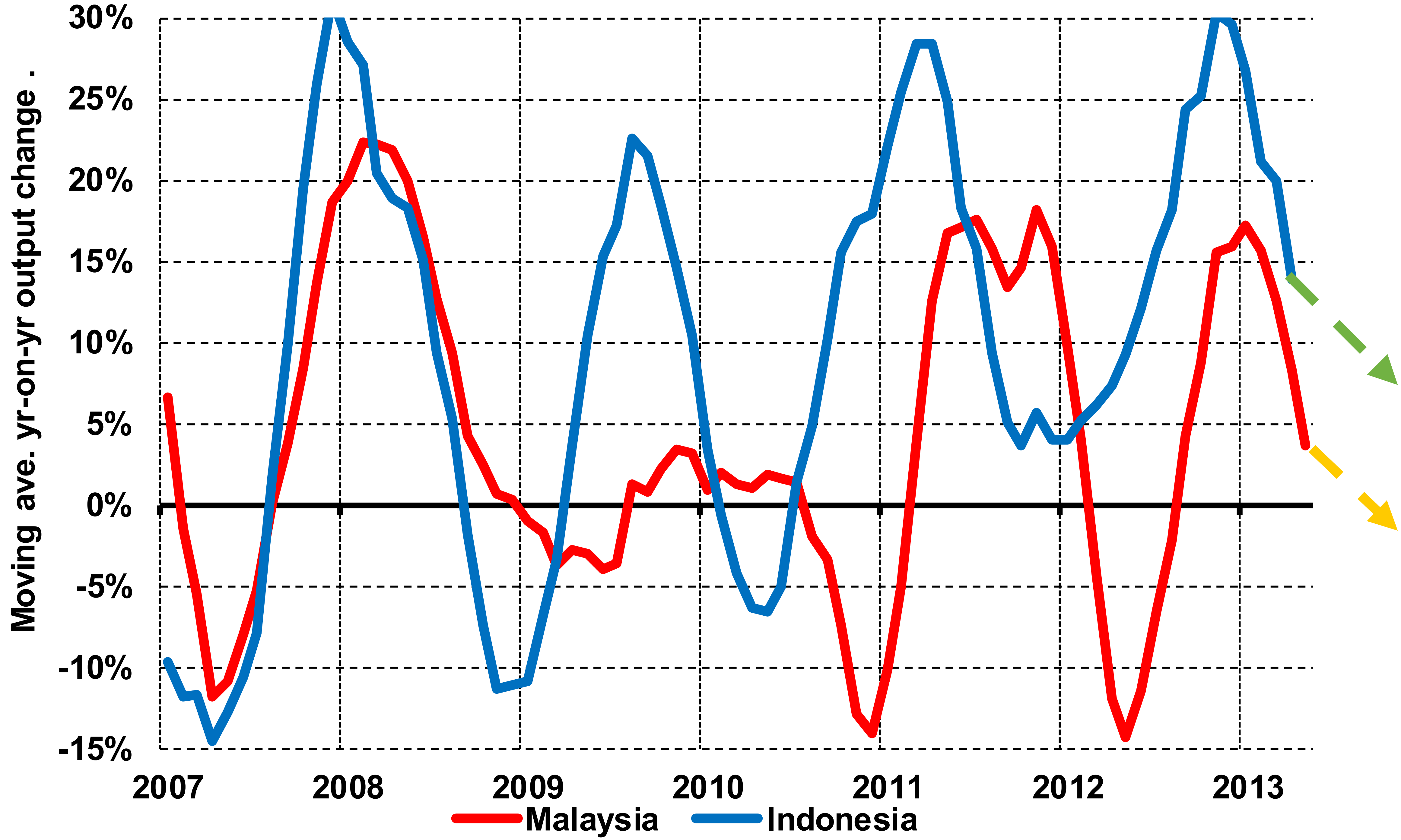
There is always a seasonality to palm oil output. You can see how monthly production fluctuates in Malaysia and Thailand (with a drier climate)



There is also a biological cycle as trees rest after a period of very good output. Underlying growth is stronger in Indonesia than in Malaysia.



The year-on-year rate of growth in output (i.e., July 2013 on July 2012; August 2013 on August 2012; etc.) is slowing after its early 2013 peak.



High CPO prices triggered a major increase in Indonesian palm areas. Although prices have fallen back, they still encourage large plantings.

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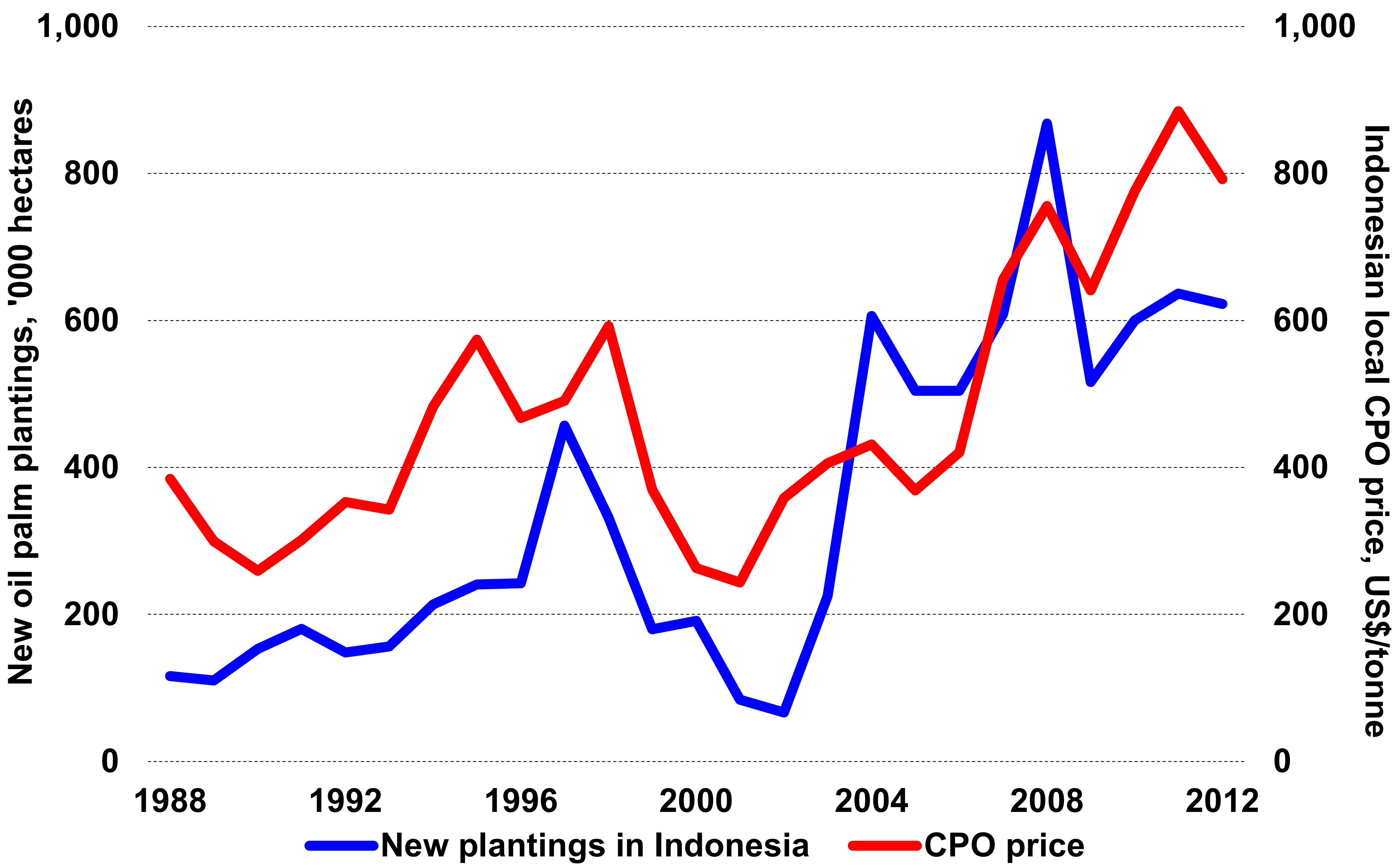

Monthly CPO output will rise, as is usual in the second half of the year, but year-on-year output growth is slowing.

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After mid-year, monthly palm oil output rises, and it will do so this year, helped by good rains in most areas.

The underlying year-on-year percentage growth rate in output is slowing, after being very strong early this year.

In the background, Indonesia and Thailand are seeing output boosted by the growing maturity of the oil palms planted in response to high CPO prices after 2006.

These plantings will underpin world palm oil output growth for the next few years.

This means that palm oil stocks will start rising again from July, which will put downward pressure on the premium for CPO prices over Brent crude oil prices.

Lessons for price forecasters

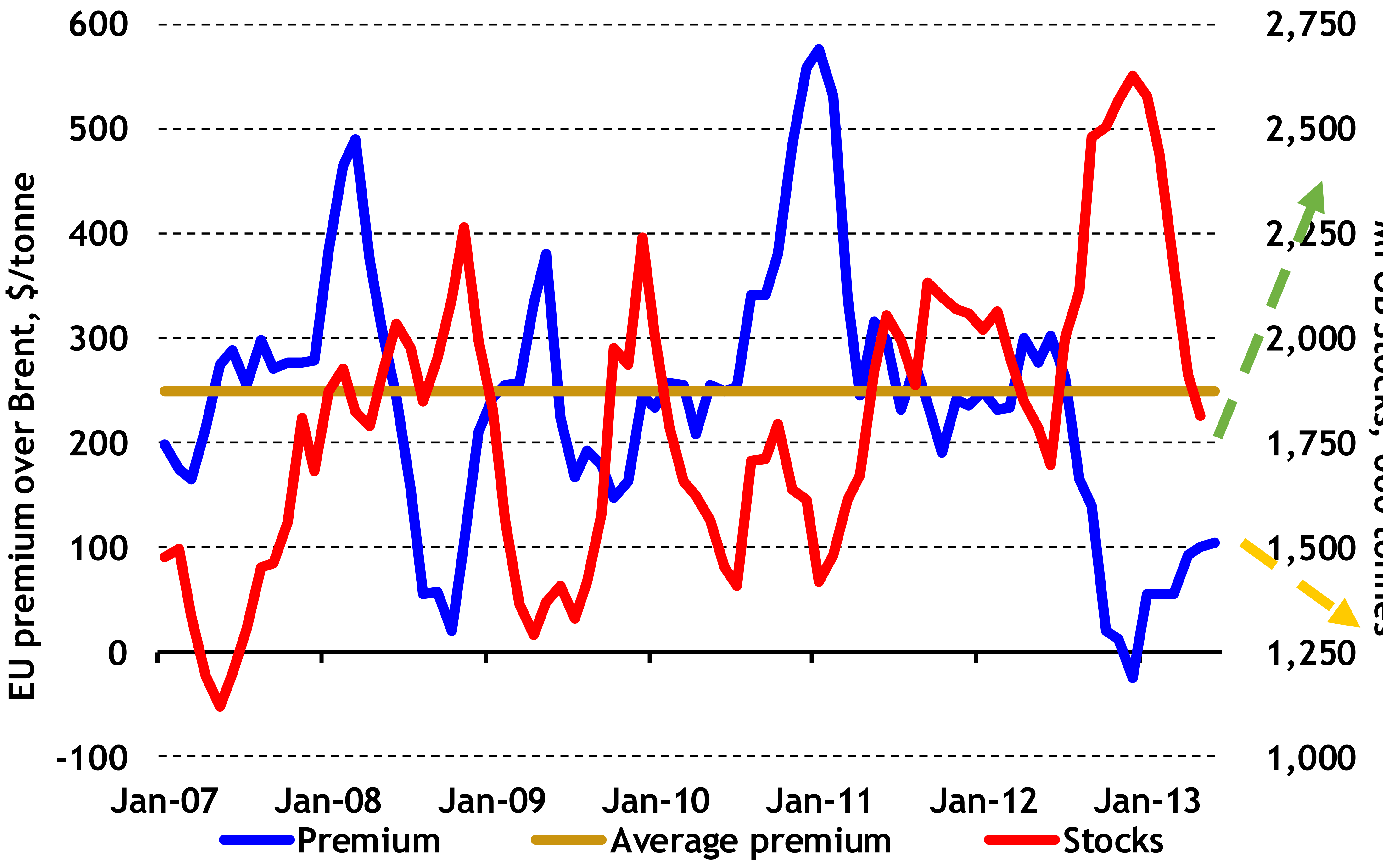
There are three main lessons

Lesson 1: Work hard to understand what it is that is driving crude petroleum prices. Since 2007, they have set the floor to the CPO price.

Lesson 2: Monitor the pace of plantings of oil palm in Indonesia. That country is now the main driver of the growth in global palm oil output, and will remain so, as the most recently planted areas, particularly in Kalimantan, start to mature and increase yields.

Lesson 3: Keep a very close eye on the seasonal shifts in palm oil output and stocks. It is the level of stocks that determines the size of the premium for CPO over crude oil prices.

When Malaysian Palm Oil Board stocks start to move up in July, the EU premium for CPO over crude oil will fall back again..



Thank You

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