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The impact of government policies on the behaviour of the CPO market

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Why did I choose this topic for my presentation today?

Government policies have a major impact on vegetable oil markets today. In this context I feel I must start with Mr Trump's unpredictable behaviour.

Among the most significant of his actions in terms of their impact upon vegetable oil prices are (a) his decision to embark upon trade wars with the US' major trading partners, most notably China, and (b) his Administration's measures to water down renewable fuel targets, moves that have undermined the benefits for US soy oil producers from US biodiesel mandates.

I cannot discuss policy without saying something about EU policy towards palm oil, even though it will take quite a long time before the repercussions are felt of the EU's decision to phase out the use of palm biodiesel by 2030.

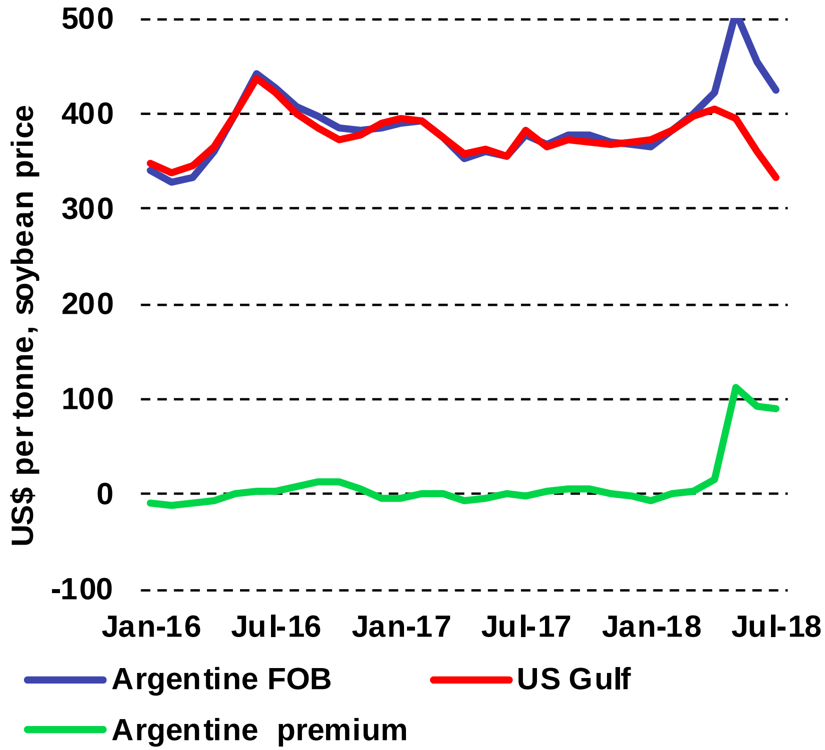
I will also contrast Indonesian and Malaysian biodiesel policies. Their approaches are very different, with Indonesia's use of export levies to fund biodiesel subsidies playing an increasingly vital role in stabilising CPO prices.

I end with a discussion of the latest situation regarding palm oil production and the outlook for CPO prices, including the position of CPO within the now-familiar price band, which links the prices of vegetable oils to that of crude oil.

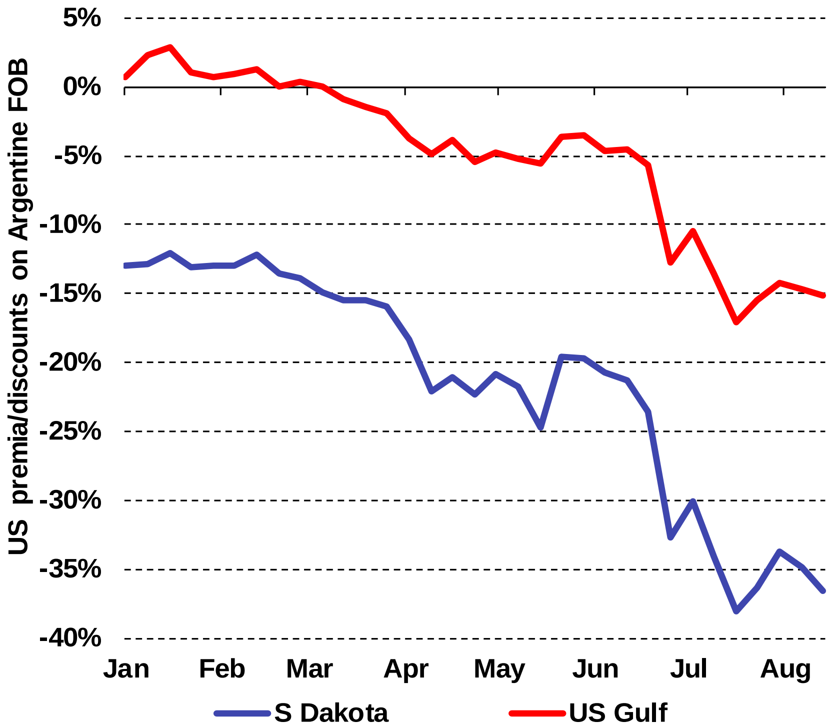
The US trade war with China

The US trade war with China and other countries

Argentine FOB $ premium over US Gulf prices



US soybean differentials vs Argentine FOB prices

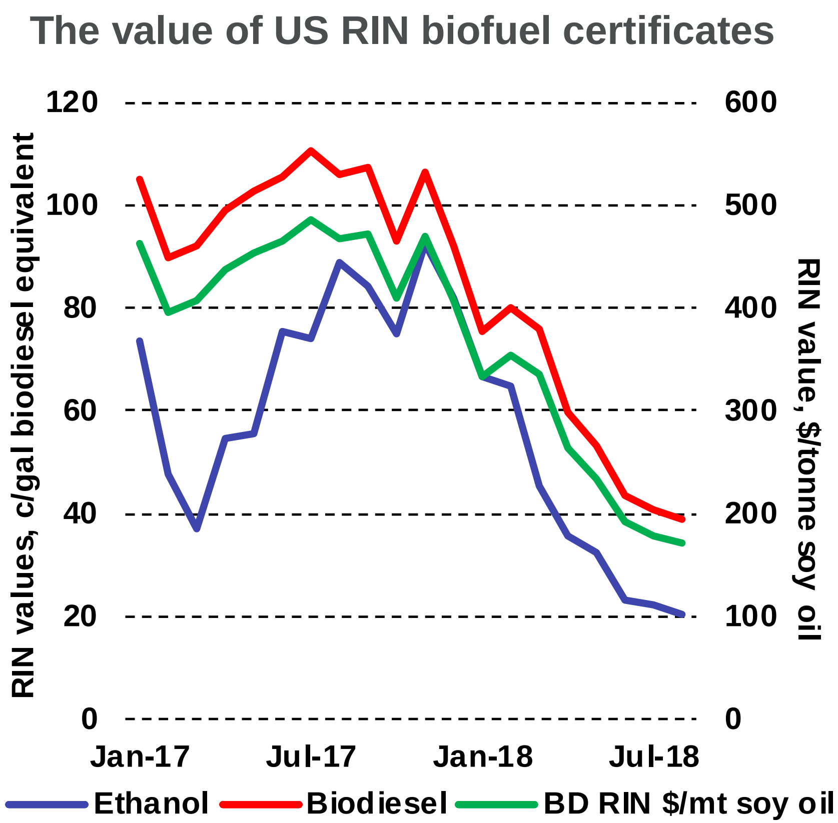


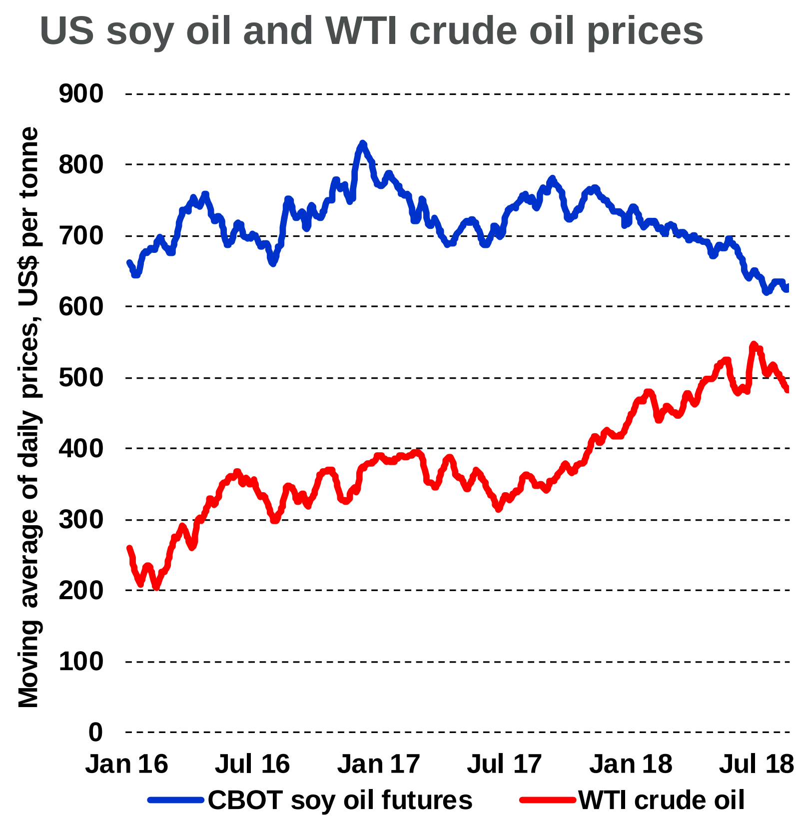
Mr Trump's trade wars have already had a big impact on the oil and oilseed market. One immediate consequence has been China's 25% import tariff on US soybeans. As a result, US bean prices have moved sharply below Argentine FOB values (LH diagram).

This hit US farmers. China's tariff has cut prices sharply in states like S. Dakota (RH diagram) which send most of their beans to the US Pacific North West for export.

Biodiesel policy: the US, EU and S.E. Asia

Impact of US biofuel policy on soybean oil prices

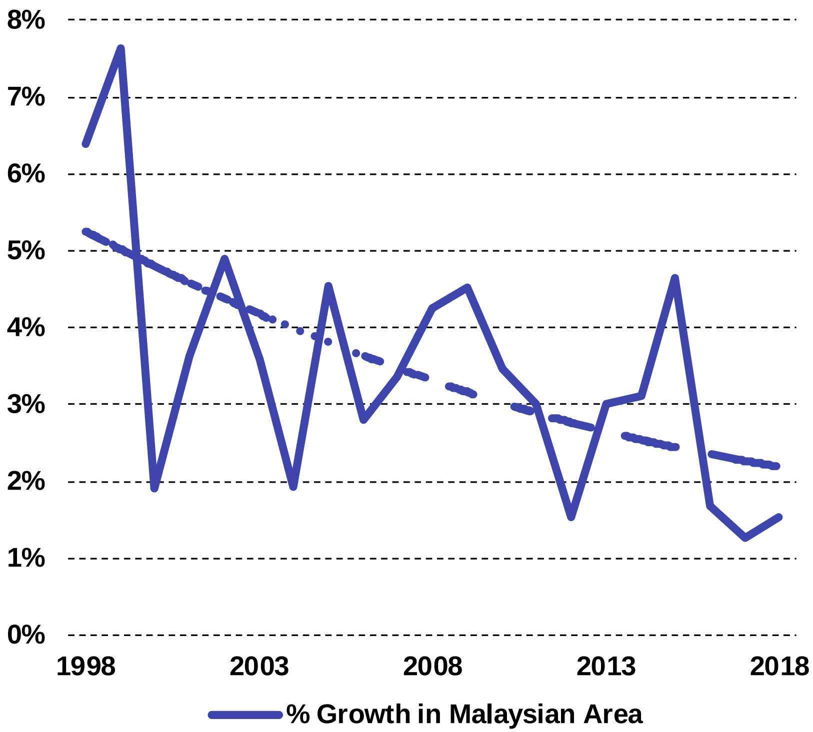




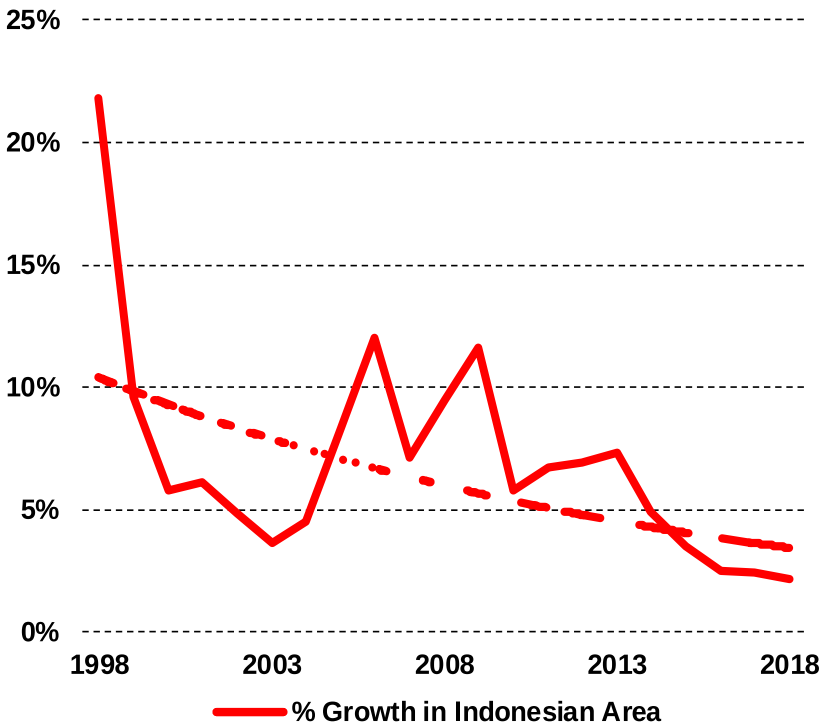
Besides hitting US farmers' incomes through his trade war. Mr Trump's apparent hostility to biofuels has lowered local soy oil and biodiesel prices because the EPA has reduced effective US biofuel mandates. This has slashed prices of RIN tradeable certificates that reflect the market's valuation of the mandates (LH diagram). Biodiesel RINs have fallen $300/tonne in the past year, leaving US soy oil prices at their lowest level since 2016 (RH diagram), despite a $150 rise in crude prices (the floor to oils prices) in the same period.

EU biodiesel policy: the law of unintended consequences

The growth in Malaysian oil palm areas

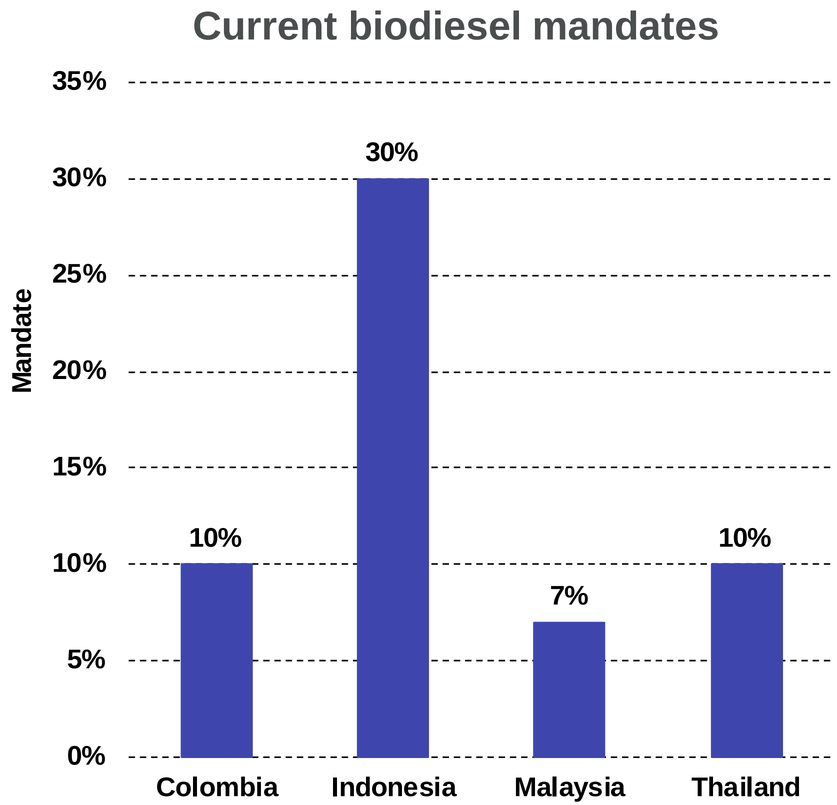


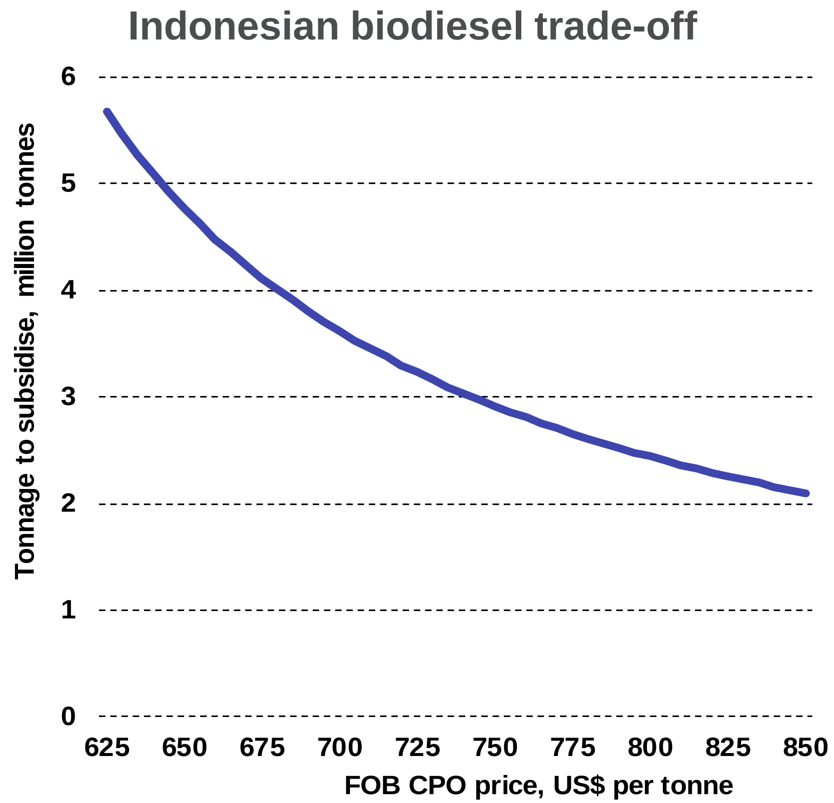
The growth in Indonesian oil palm areas



The NGO pressures that lay behind the EU decision to ban palm use in biofuels in 2030 have led to a sharp slowdown in SE Asian oil palm area growth. CPO supplies will soon struggle to keep up with demand for food, let alone biofuels. Soybeans will have to meet a larger share of oil demand growth; but they yield over four times as much meal as oil. Therefore, faster growth in soy output will hit meal prices. Logically this must raise soy oil prices to generate the higher bean prices needed to boost supply, benefiting CPO, too.

Biodiesel policy differs among palm producing countries





Thailand and Colombia apply B10 mandates and Malaysia a modest B7, while Indonesia's mandate is variable in practice. Its formula to subsidise PME mandates from export levies can fund high PME sales at low CPO-gasoil spreads (the RH diagram depicts the trade-offs if the Brent price is $65/bbl, assuming that $750 mn/year is spent on subsidies) . We see that after high PME sales have cut stocks and raised FOB CPO prices, the amount of PME that can be funded from export levies will fall, moderating upward pressure on prices.

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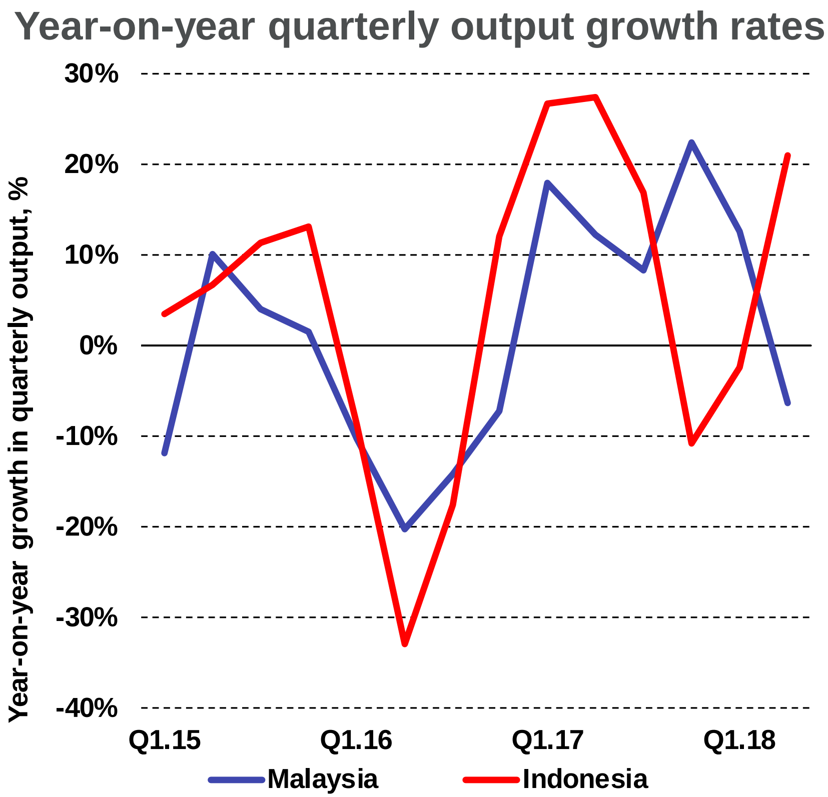
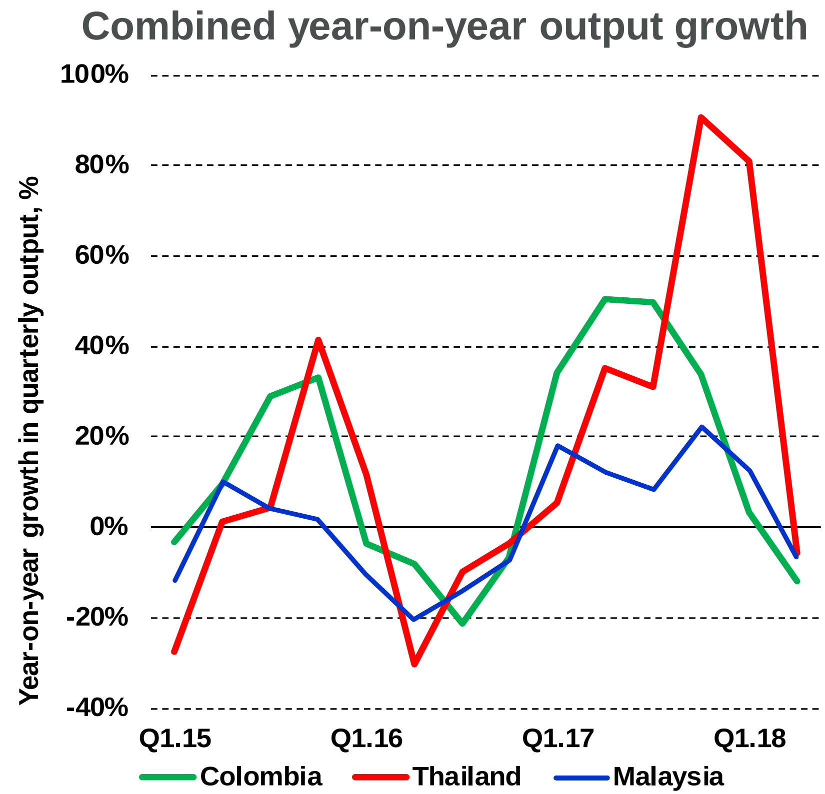
The outlook for CPO today

Output trends diverge among the main palm producers

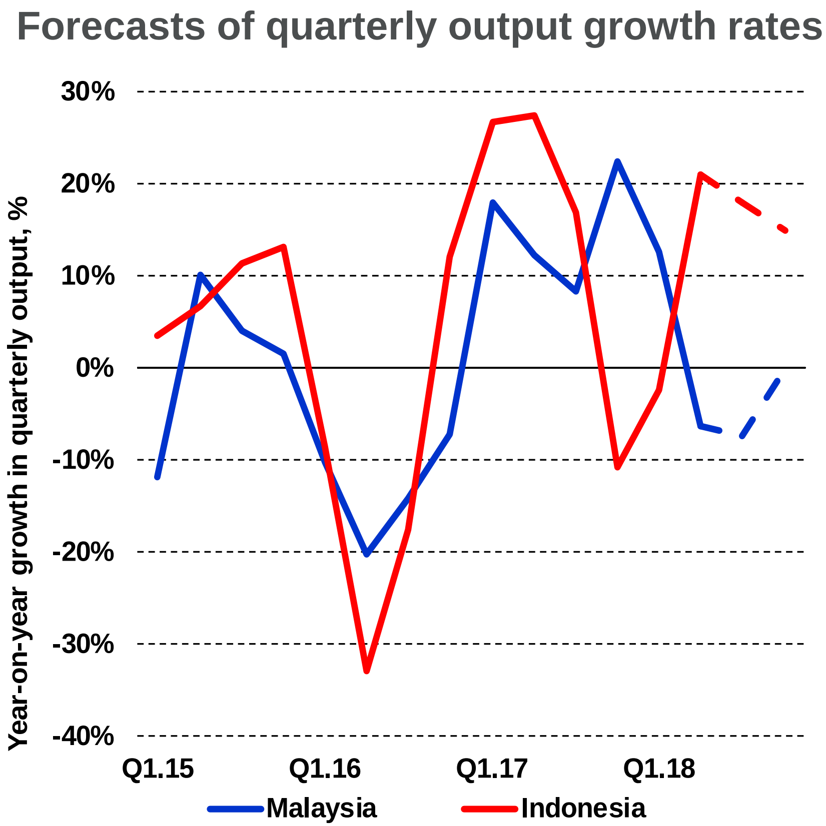


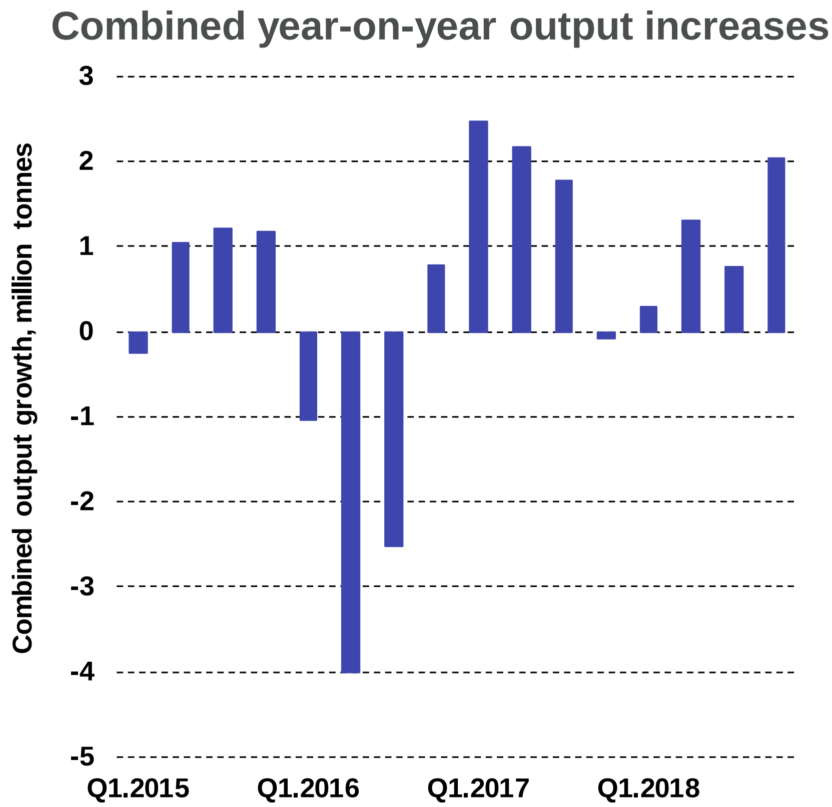


Despite similar weather, the last three quarters saw remarkably different growth patterns in Malaysia and Indonesia. Indonesian quarterly output fell year-on-year in both Q4.2017 and Q1.2018 but then leapt in Q2.2018; Malaysia did exactly the opposite (LH diagram).

Indonesia is the odd one out in the world of palm. Output growth in both Thailand and Colombia followed Malaysia's recent cycle, but with stronger fluctuations (RH diagram).

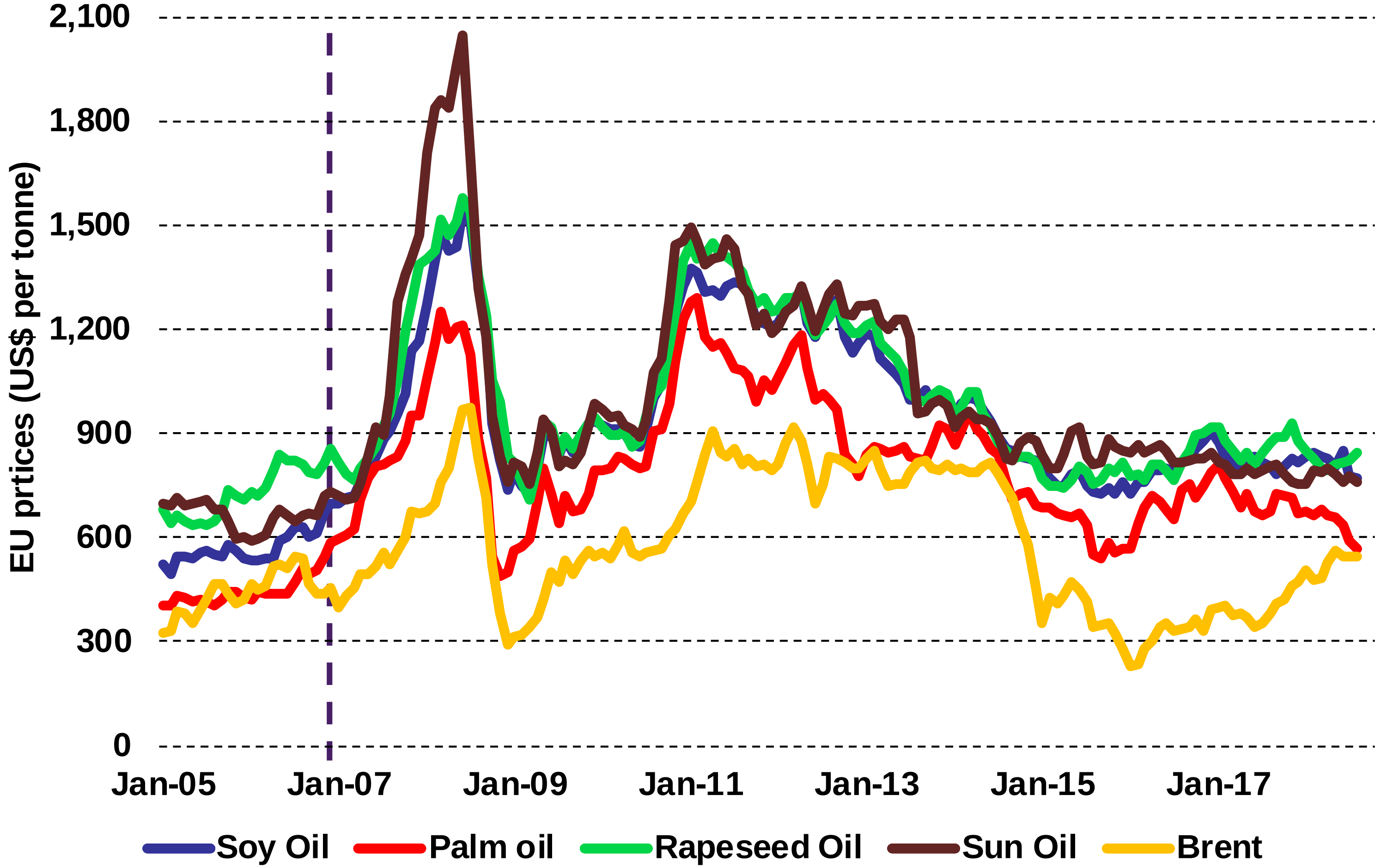
Projections of Malaysian and Indonesian output





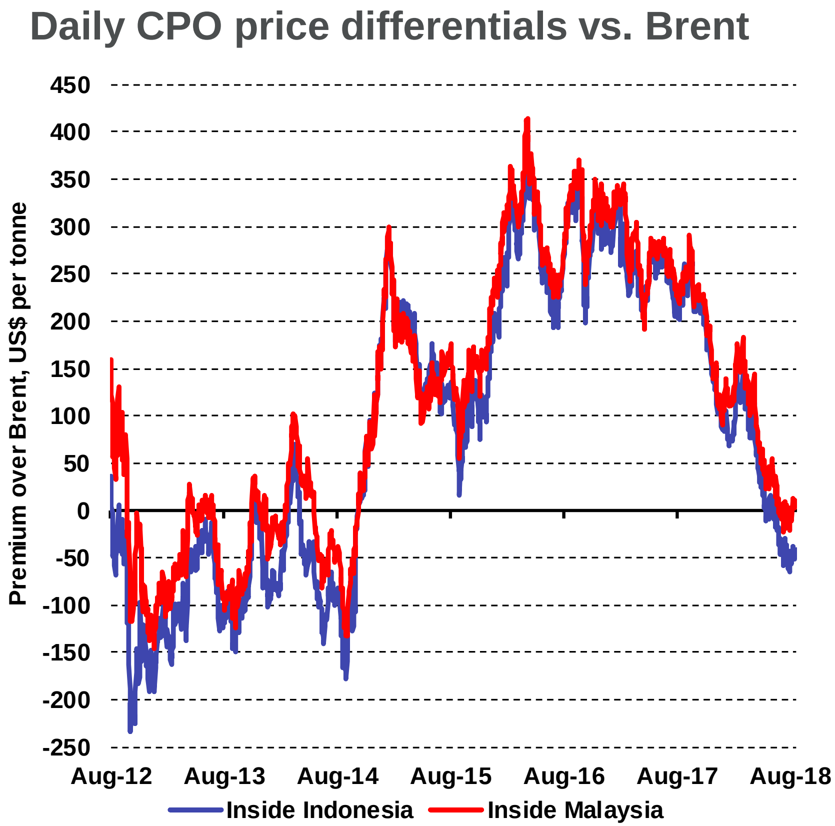
We are currently forecasting that the recent contrast in production growth trends in these two giants of the palm oil world will continue (LH diagram). When we add them together, we see that their combined year-on-year output growth stalled in Q4.2017 and Q1.2018 (RH diagram), but, thanks entirely to strong Indonesian production this year (since we believe that Malaysia is now set to end 2018 producing 0.2 million tonnes less than the 2017 total), we expect that their joint output will grow over 4 million tonnes in 2018.

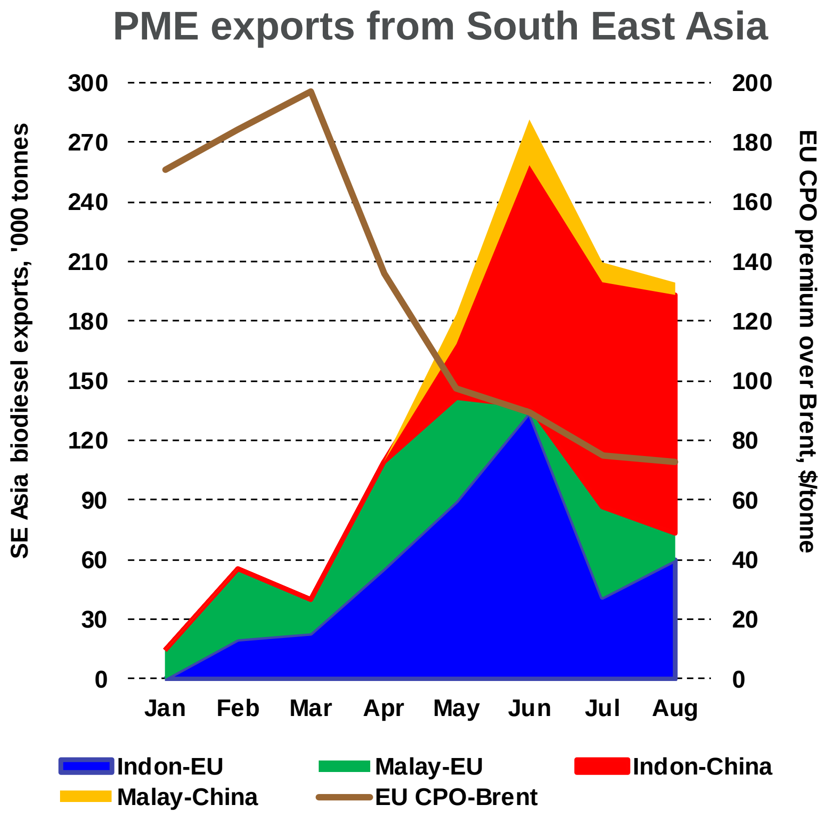
The price band sees EU CPO back at its Brent price floor



The strong Indonesian output growth and expectations of higher MPOB stocks have pulled EU CPO down to the price floor. Higher Indian CPO import tariffs and then the Rupee's fall have hit India's palm oil imports, widening CPO's discount on soft oils, for whom rapeseed oil prices have been the strongest, with its supplies suffering from unusually poor weather.

The main determinants of the short run price outlook





One determinant is crude oil prices, with US shale oil pulling one way and OPEC the other. Another is CPO demand, for which we are back in a world with discretionary biofuel use, as we were back in 2012-2014, with local CPO prices in SE Asia below Brent (LH diagram).

Flexible CPO demand has two key elements: Indonesia's mandate; and price-sensitive PME exports (RH diagram). Unlike 2012-2014, it seems that CPO discounts on Brent do not have to get much bigger to clear the market, as PME exports have responded rapidly this time.

Conclusions and the outlook for CPO prices

This quick review of government policies reveals remarkable diversity. The US is pursuing today policies that have damaged the interests of its own soybean farmers: as its trade war with China has cut local soybean prices; and the EPA's eagerness to grant waivers on biofuel mandates has reduced soybean oil prices, which have been one of the factors depressing CPO prices.

Paradoxically, EU opposition to palm biofuels, by reinforcing the slowdown in oil palm area growth, will eventually have the effect of raising CPO prices.

Malaysia lags behind other major palm producers with a B7 mandate, while Indonesia has a variable mandate which can react to CPO-gasoil spreads. A high spread implies a low mandate and a low spread supports a big mandate.

Indonesia's price sensitivity in its mandate and similar price sensitivity in PME exports are crucial in defending the floor to the price band from pressure from rising output in Indonesia, whose growth is now out of phase with Malaysia.

What about prices? Today Malaysian export taxes are zero. If Brent is steady at $75, BMD futures should trade in a range near RM2,200 till December, with Indonesia's mandate holding Malaysia's peak stocks below 2.8 million tonnes. In January, falling stocks will lift CPO to RM2,400, and $640 in Rotterdam

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