The Changing Dynamics of the Oils and Fats Market Today

Presentation to POTS KL by James Fry, October 2014
LMC International, Oxford,
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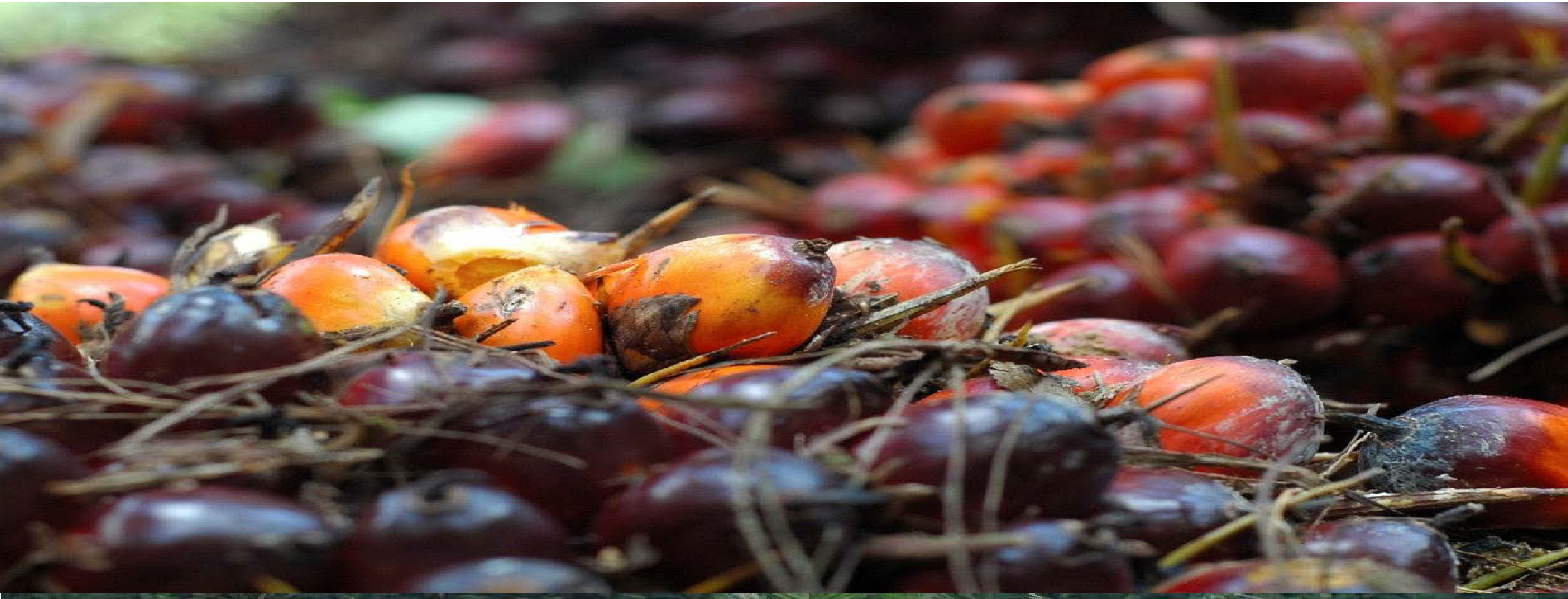
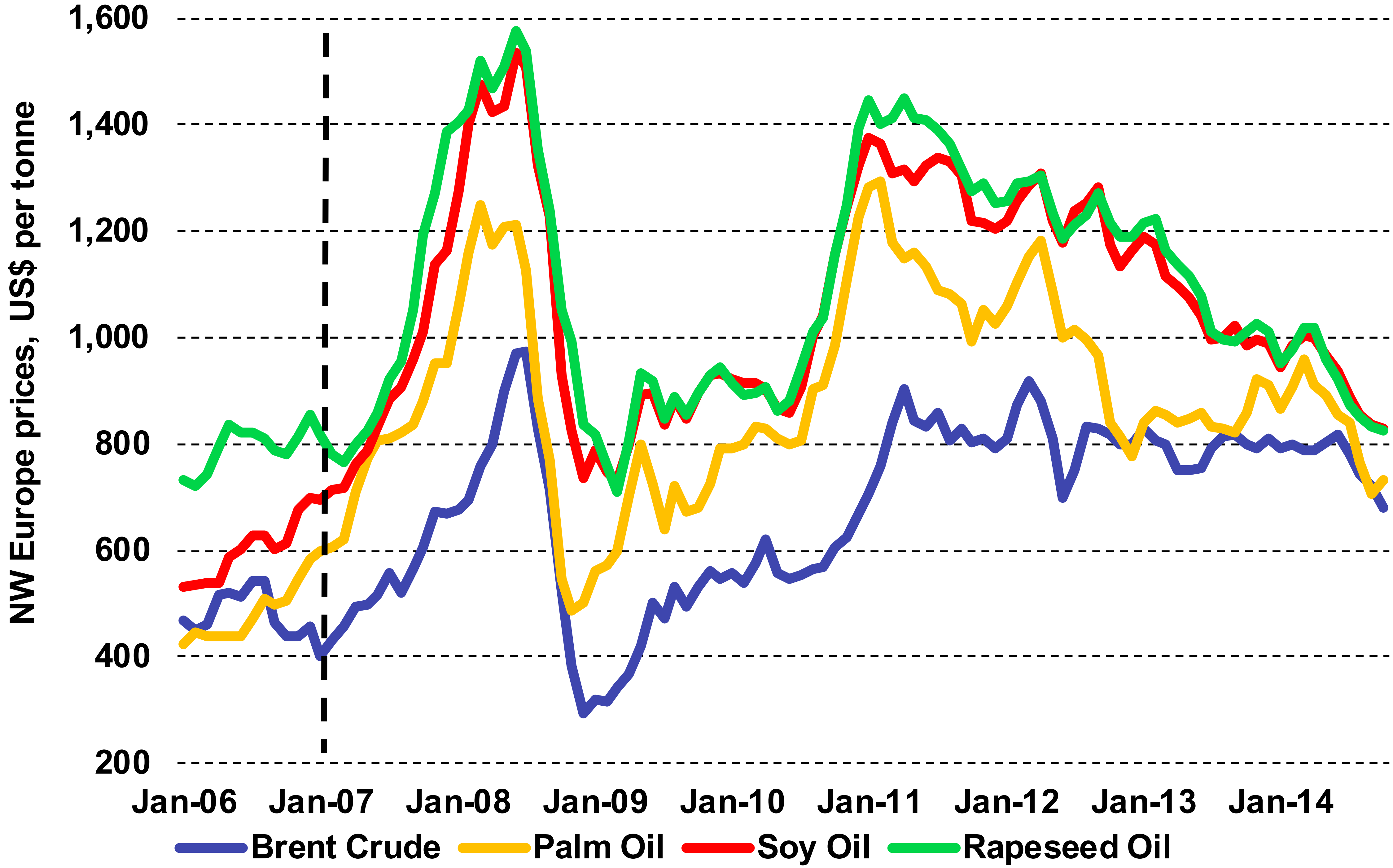
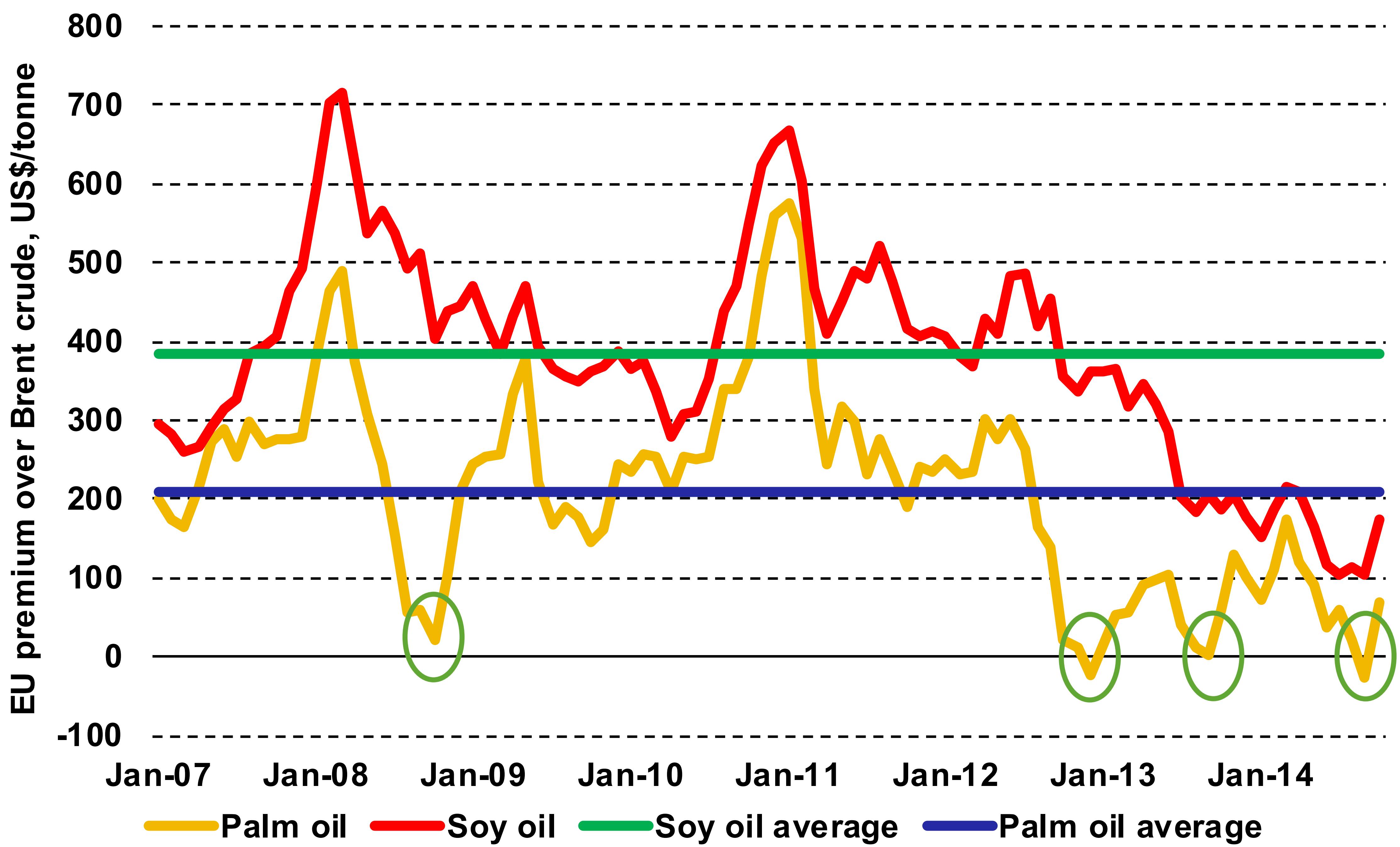


Changing Dynamics – 1:
The emergence of the oil price band

The EU price band is self-evident. Brent crude (in $/tonne) is the floor and the vegetable oils trade in a recently narrowing band above this floor.



Here I plot spreads over Brent. For a third time in three years, the floor was tested for CPO and the premium rebounded. Soy spreads narrowed too.



What determines the CPO spread over Brent? It moves in the opposite direction to MPOB stocks.

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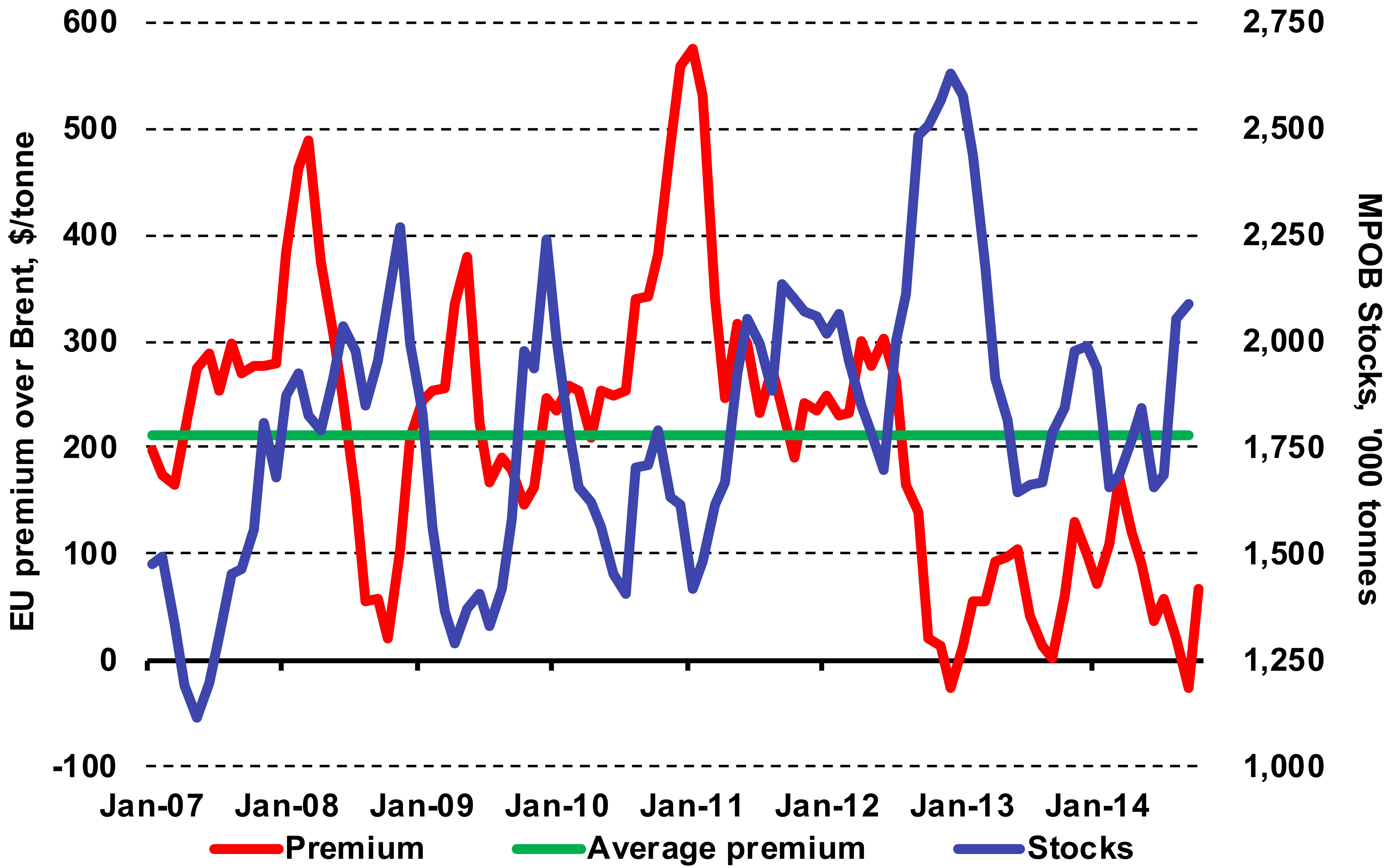
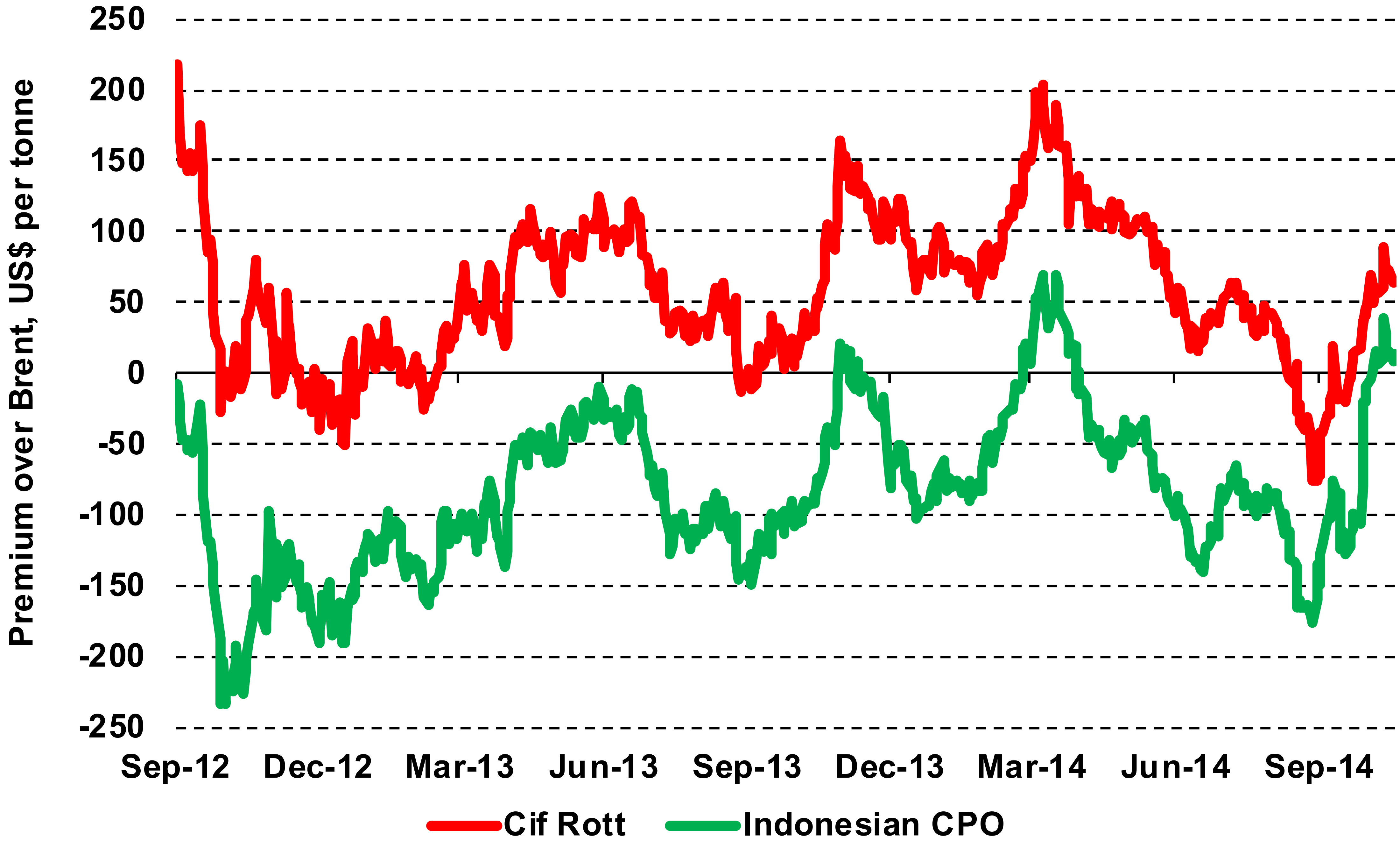


How does the price floor hold firm in the face of the pressure of stocks?

Here I plots daily CPO differentials vs. Brent in Europe and inside Indonesia. Freight and export taxes explain the gap between the two series.



Freight costs and export taxes have defended the floor to the EU price band

We use EU prices to plot the price band but, in practice, the CPO price floor is defended in South East Asia. The shipping costs from S.E. Asia mean that, when EU CPO prices equal Brent crude prices, FOB S.E. Asia CPO prices are at a discount (the cost of freight) to Brent.

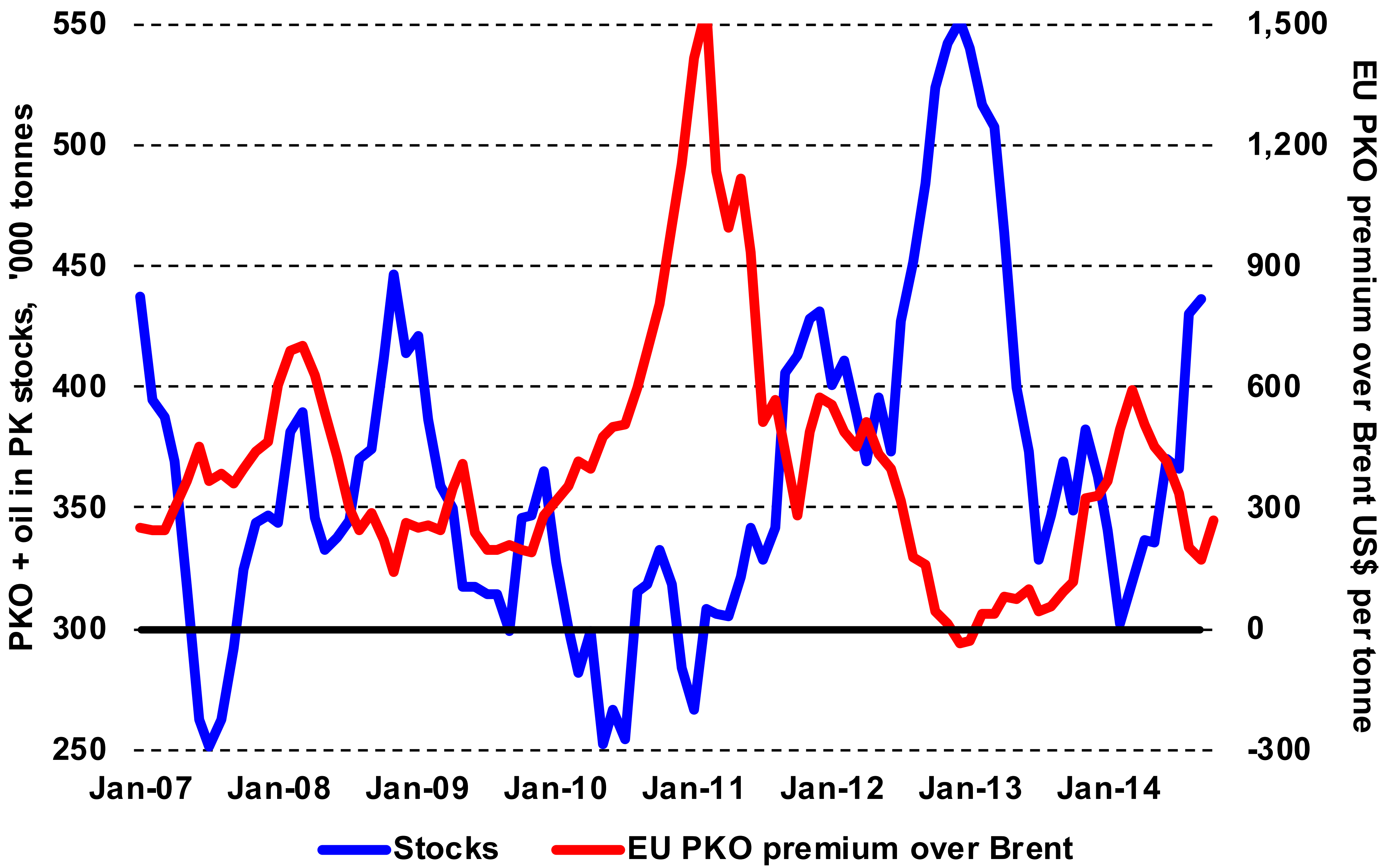
Inside Malaysia and Indonesia, export taxes reinforce CPO's competitiveness against Brent crude as a fuel.

At the low point (4th Oct) in 2012, Indonesian CPO was \$233 (equivalent to \$32/bbl.) below Brent; at the low point in 2013 (6th Sept), its discount was \$149 (\$20/bbl.); this year the low point (on 29th Aug) was \$177 (\$24/bbl.).

The scope for using CPO as cheap fuel protects its price floor. (NB: This is also true of Argentina for soybean oil.)

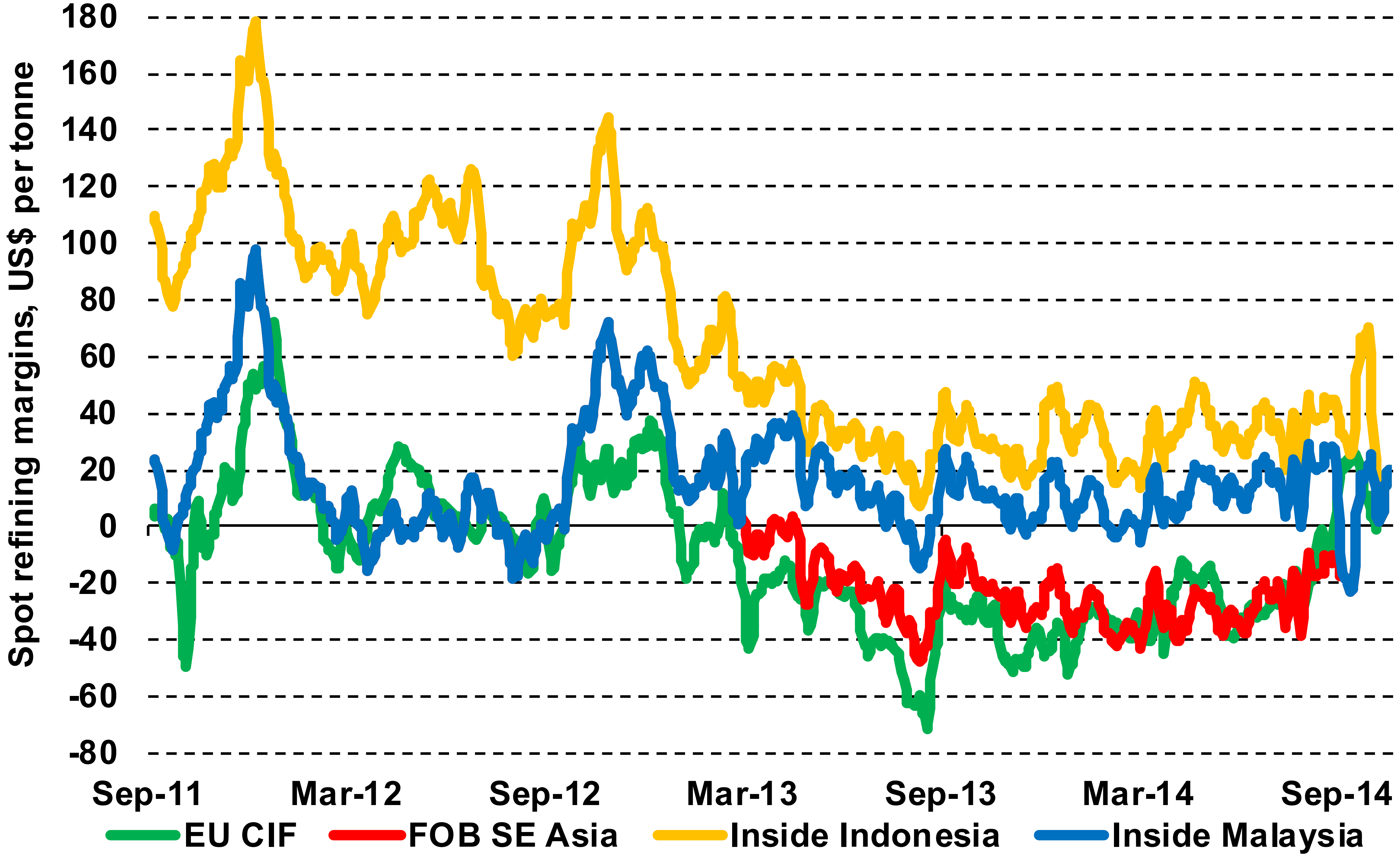
Changing Dynamics – 2:
PKO has its own price band today

Plotting the PKO premium over Brent against PKO stocks, we see that, as with CPO, stocks and the premium move in opposite directions.

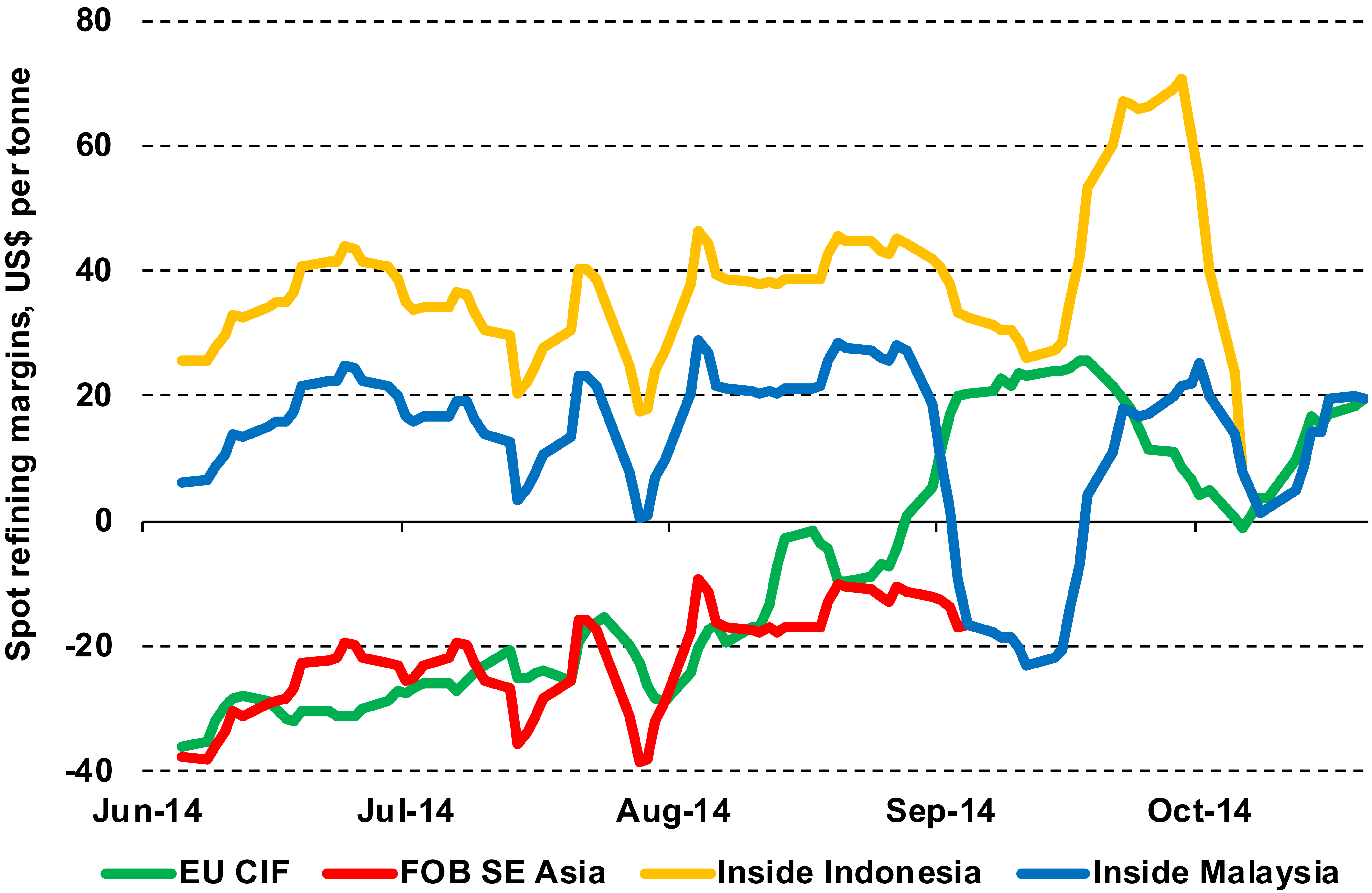


Changing Dynamics – 3: Export taxes have also had a major impact on the refining industry

Indonesia's export taxes boosted investment in refineries. Competition among them drove down refining margins in Indonesia and elsewhere.



If we focus on the past five months, we see that with zero export taxes today in South East Asia, refining margins have converged in all regions.



One effect of the arrival of zero Indonesian export taxes has been to pull FOB S.E. Asian RBD olein above CPO prices for the first time in over a year.

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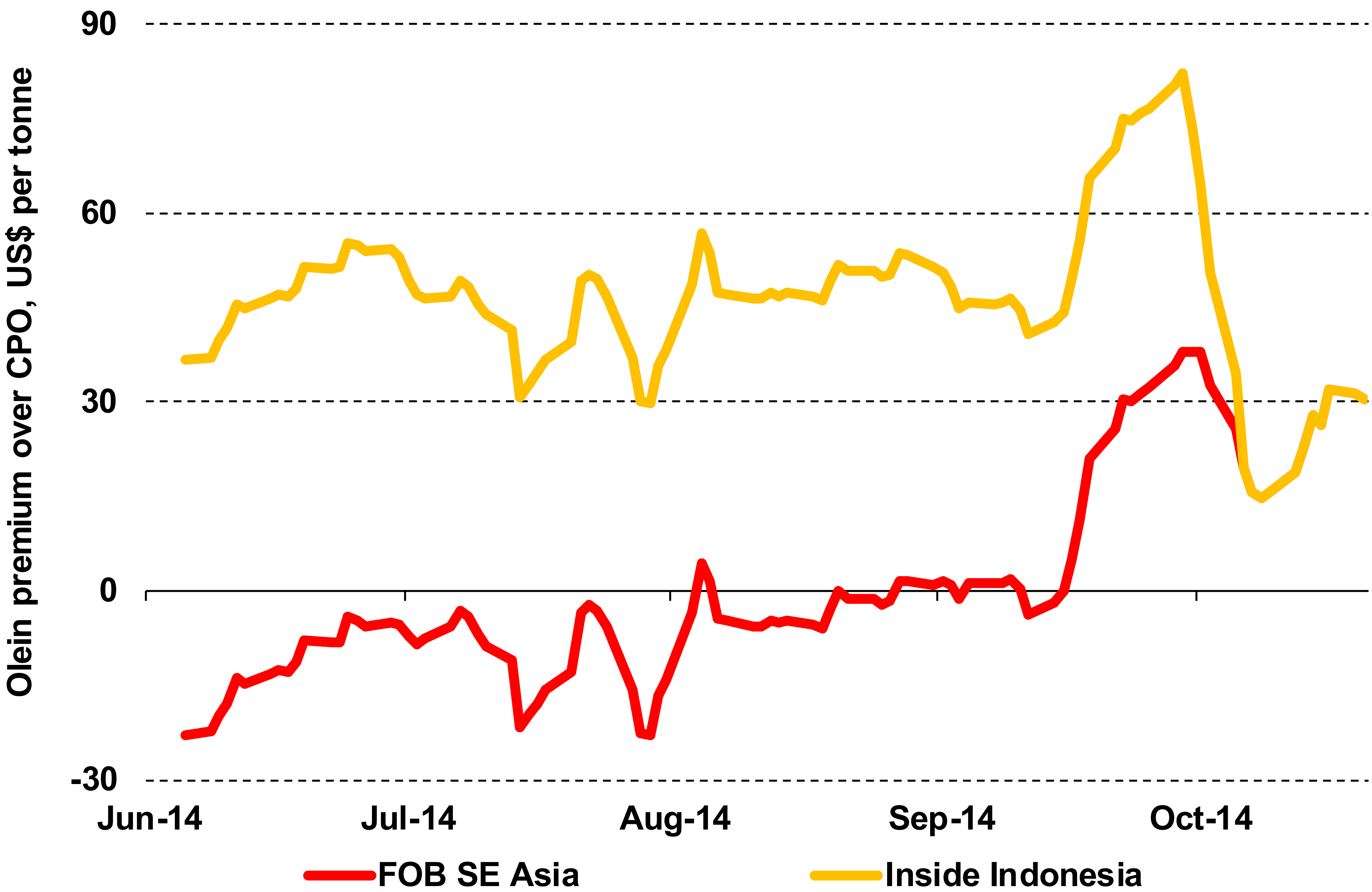
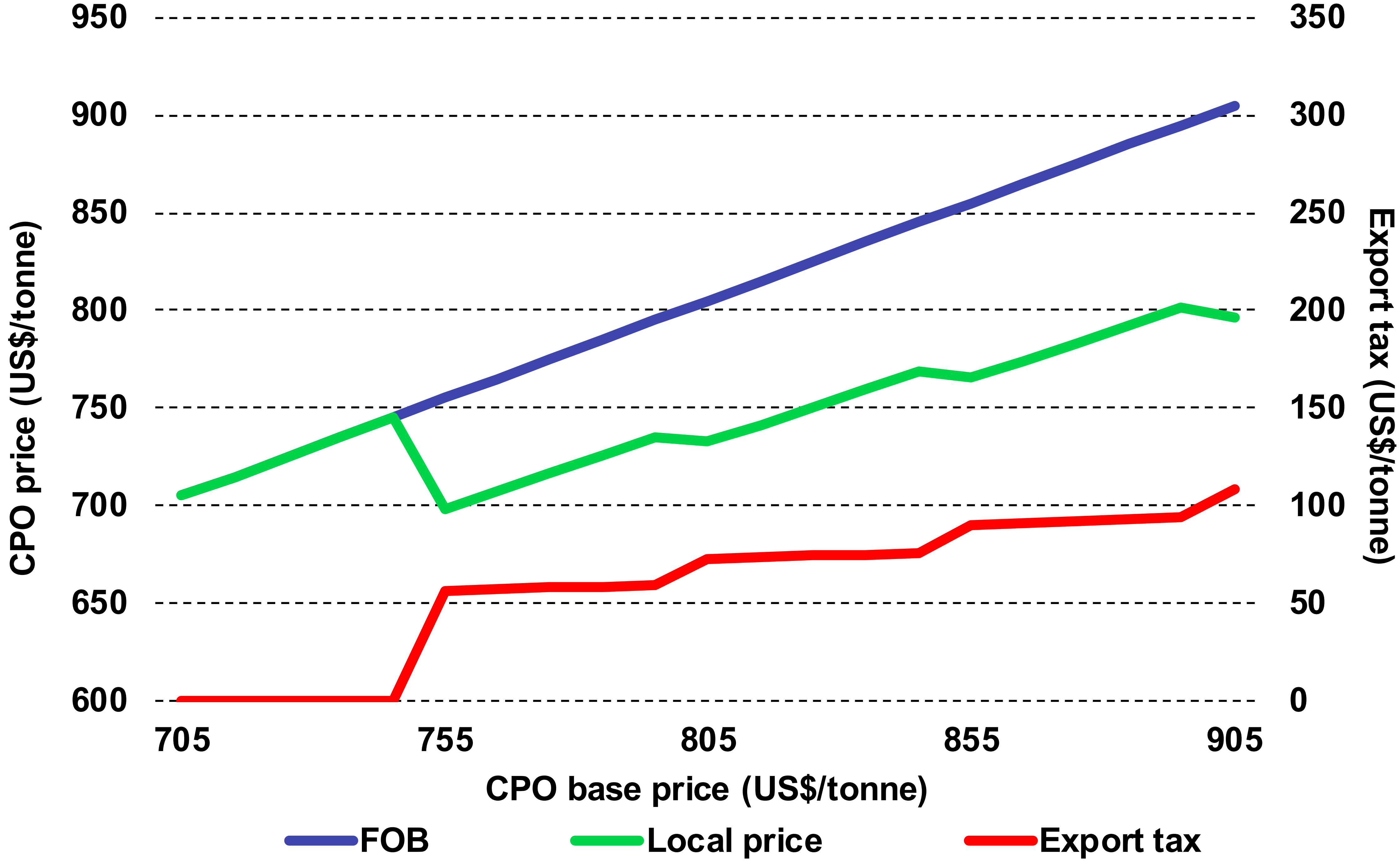
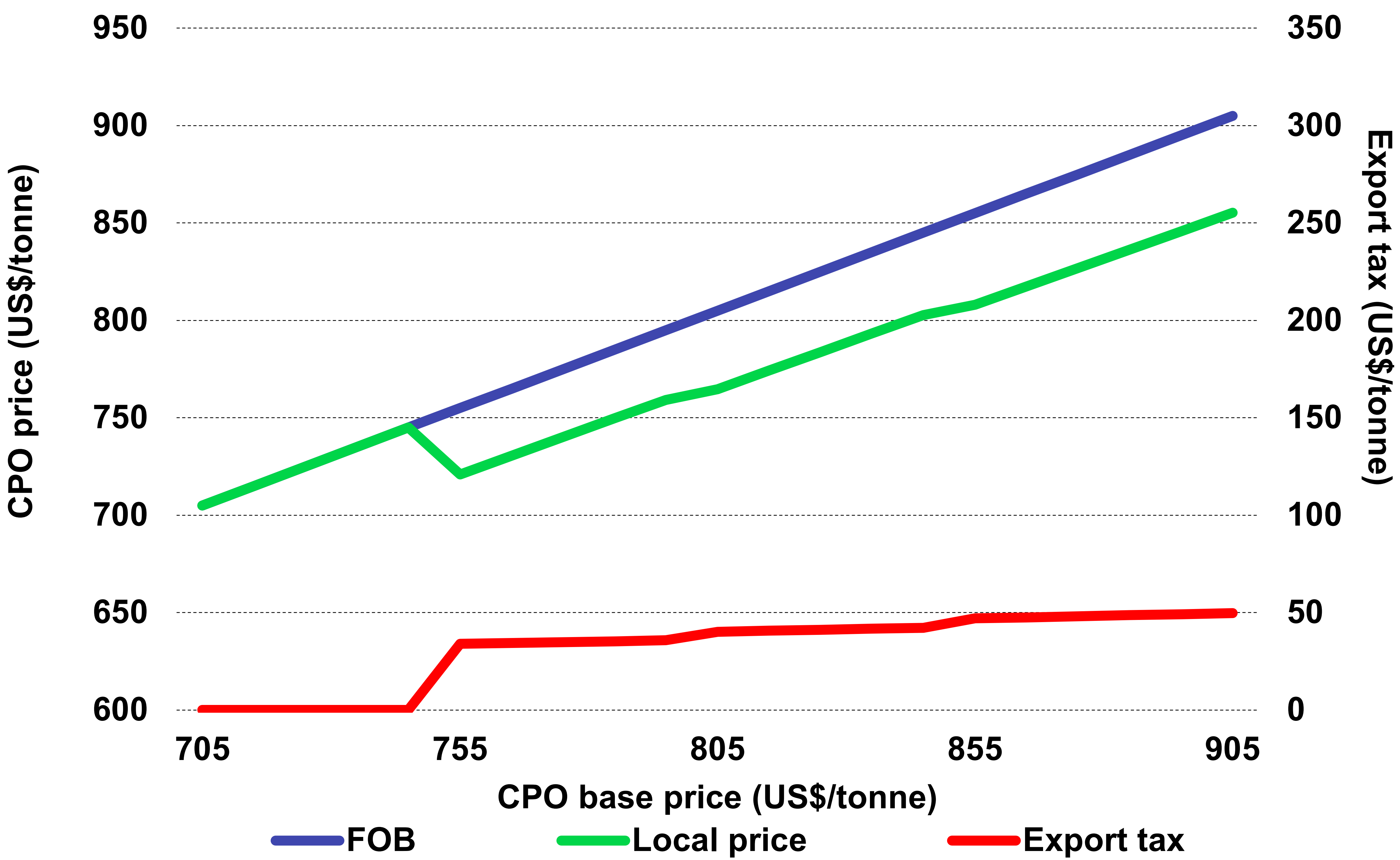


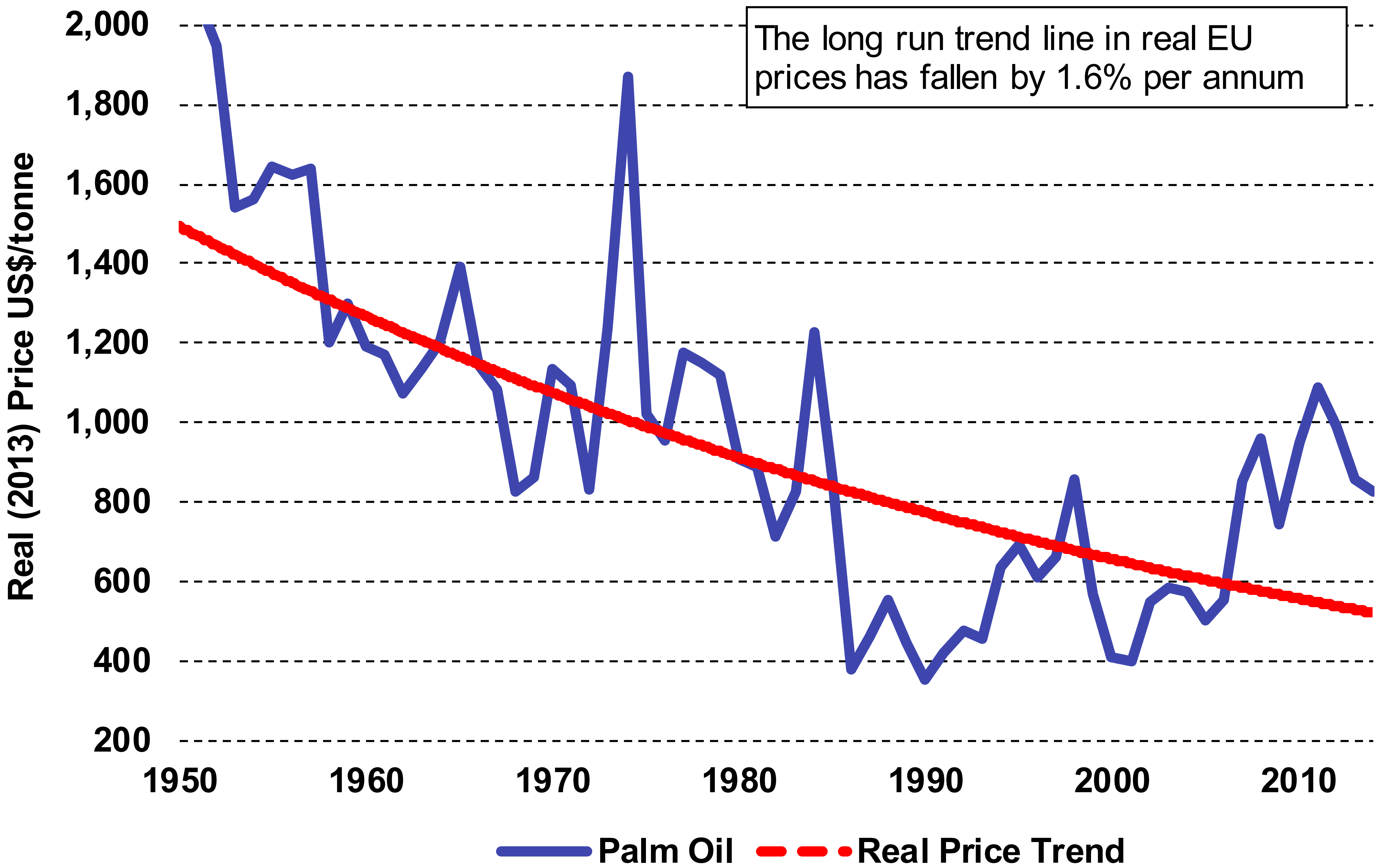
$750 is a key number. Indonesia's export tax leaps from 0% to 7.5% at $750 FOB. Thus, its producers actually prefer a $700 FOB price over one of $750!



Lower Malaysian export tax rates mean that local prices near US$750 (this is at M$3/US$) display less perverse behaviour than we saw in Indonesia.



We should ask if US$750 is a normal CPO price today. In fact, $800 CIF EU (i.e., $750 FOB) is well above its real (inflation-adjusted) price trend.



Export taxes have had a profound impact

Just as biofuel policy unexpectedly tied CPO prices to Brent crude, so export tax policies prove to be another example of the law of unintended consequences.

At first, export taxes yielded nice profits for Indonesian processors. These profits attracted investors, but excess capacity and low utilisation rates have been the result.

$750 (Indonesia) and M$2,250 (Malaysia) may be seen to be historically <u>high</u> price triggers for export taxes. So, it is unclear whether export taxes above zero should be considered normal or to be a short-lived phenomenon.

To deduce whether export taxes are likely to apply for a sustained period, we must return to the price band and ask ourselves: What is the outlook for crude oil prices?

Changing Dynamics – 4:
What can we say about crude oil?

Growing imbalance in the crude oil market

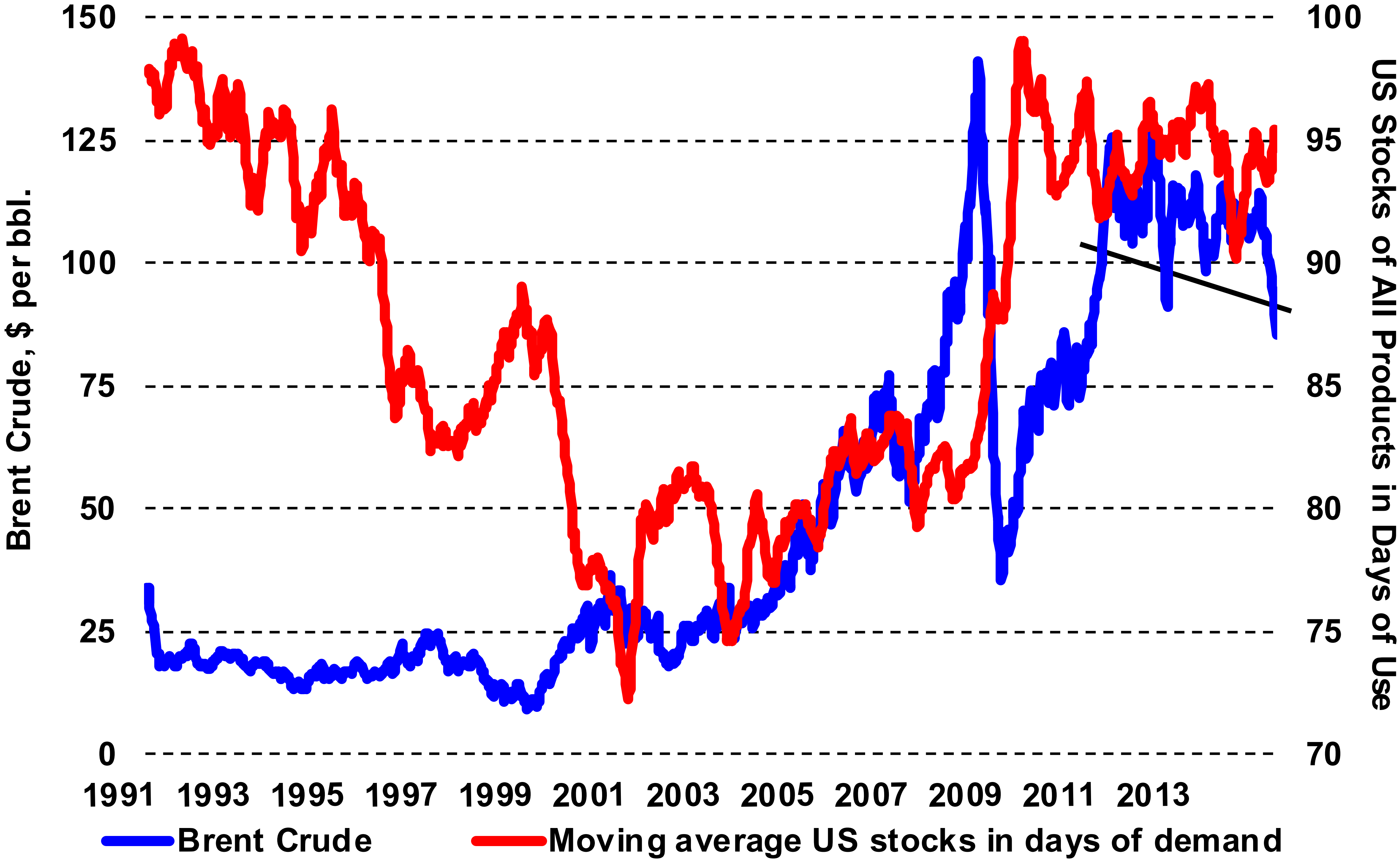
Spurred on by high crude prices, the US is adding 1.40 mn bbl/day to its annual output in 2014 according to OPEC. Canada is adding 0.25 mn bbl/day. Global output growth is forecast to be 1.7 mn bbl/day in 2014 and 1.45 mn in 2015.

OPEC puts 2014 world demand growth at 1.05 mn bbl/day and 1.2 mn in 2015, with shale gas making steady inroads.

Looking ahead, on the principle that "my enemy's enemy is my friend", we can expect Western sanctions on Iran to be eased, and huge offshore oil fields will start soon in Brazil.

Facing these surpluses, why doesn't OPEC cut its output? The answer: many of its members need high prices to cover their budgets. So, lower crude prices induce them to <u>raise</u> output to maintain revenues, making over-supply bigger.

US stock-use levels for petroleum products are high. As supply and demand react more strongly to high crude prices, Brent prices should fall.



Changing Dynamics – 5: The new world of vegetable oils

The new vegetable oil price realities

Since 2007, the new price dynamics of EU vegetable oil prices have seen Brent crude oil providing a price floor.

Freight costs and export taxes mean that when EU CPO is at this floor, S.E. Asian CPO is highly competitive as a source of fuel, and this very flexible form of CPO demand removes stocks. Lower stocks lift prices above the floor.

As we have seen recently, export taxes disappear when CPO prices fall are pulled down by weak Brent prices.

Hence, the Brent price is doubly important today for the vegetable oil market. Not only does it set the CPO price floor; it also, via the price band, sets the range in which oils trade and thus indirectly it helps to set export taxes, too, with a big impact on S.E. Asian downstream profits.

Price implications : short and long run

If we look ahead six months, declining MPOB stocks should support the CPO premium over Brent.

The recent strength of CPO prices has taken its EU premium over Brent to $100 and in S.E. Asia to $40, making unsubsidised biodiesel unprofitable. If Brent settles at $85, M$2,300 is the upside to local prices.

When stocks start to rise, the Bursa price will fall back.

In the background, we must have a view on Brent prices. Crude oil supply surpluses will not shrink unless its price falls back; but as crude prices fall, we can expect OPEC exporters to boost output to maintain revenues, putting Brent prices (and hence CPO too) under more pressure.

Thank You

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Acknowledgements: EIA, IMF, Jacobsen, LMC reports, MPOB, Public Ledger, TNS, USDA, World Bank

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