Crude Palm Oil

Three persuasive bearish drivers

29th June 2017

Highlights

- Palm oil futures failed to rally despite the recent Ramadan celebrations, which ended as of 24th June 2017. Statistically, crude palm oil exports from key exporting countries were remarkably stellar, especially seen in Indonesia (April: 60.6%yoy) and Malaysia (May: 10.2%yoy).
- Despite the healthy demand, prices continue to fall as market-watchers were concerned over Malaysia's ballooning palm oil production. Empirically, CPO production saw 6 consecutive months of positive growth, with May's production at its highest since Oct 2015.
- With supply growth likely to accelerate into 2017, while seasonal demand fades after the Ramadan celebrations, we look for CPO prices to see further downside risk into 2H17. Given the weaker prices of late, we downgrade our outlook to MYR2,250/MT at year-end.

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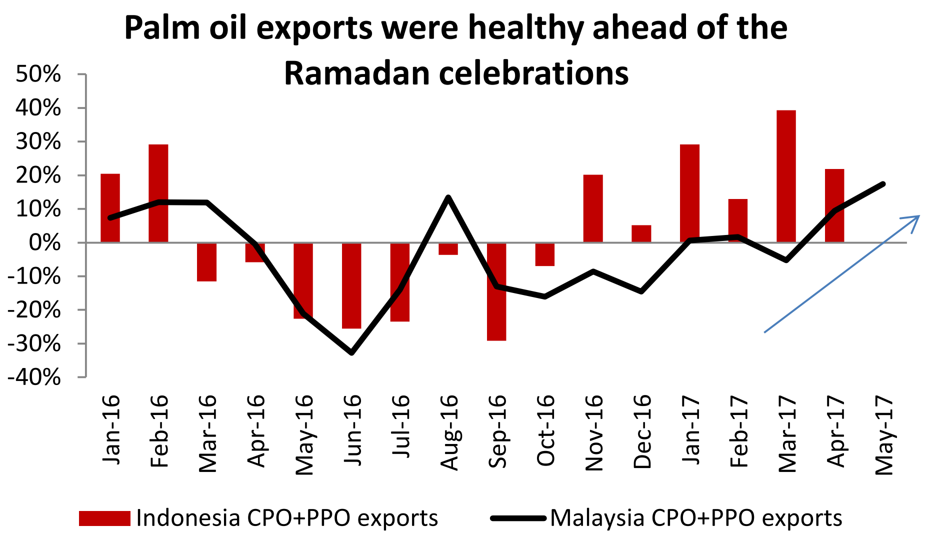
Higher seasonal demand failed to rally prices

As the seasonal period of fasting and feasting ended with the end of a month-long Ramadan, palm oil watchers would also recognise that seasonal higher demand for palm oil would likely fade into July. Should history be of reference, palm oil prices should rise as feasting practices observed by Muslims worldwide during the said festive lifts the demand for cooking oil. In fact, Malaysia's palm oil exports were up 17.4% in May, led by a substantial spike in import demand from destination markets like Bangladesh, India, Pakistan and Egypt.



Source: Bloomberg, OCBC Bank

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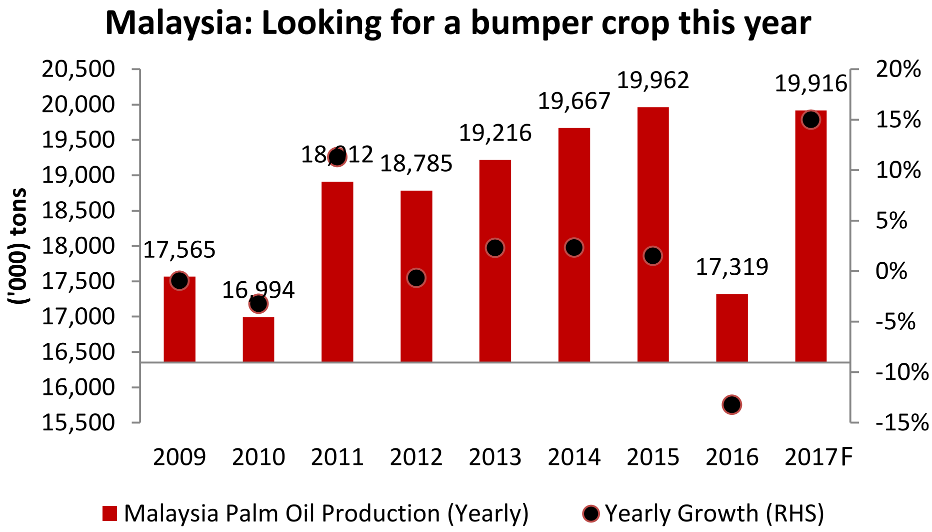
However, unlike previous years where Ramadan celebrations seasonally lifts palm oil prices, this year's palm oil fundamentals are starkly different. In a nutshell, the higher demand in cooking oil seen over April and May are also met with ballooning crude palm oil (CPO) production. Owing to the El Nino phenemonon seen in 2016, palm oil production growth in key producing countries including Indonesia and Malaysia has fallen 13.2% yoy. Given the recovery in palm oil production in the first five months of 2017, coupled with the low base year, market concerns over ballooning production effectively overshadowed the relatively pallid demand gains over two mere months.

Upside risk to fizzle into 2H17

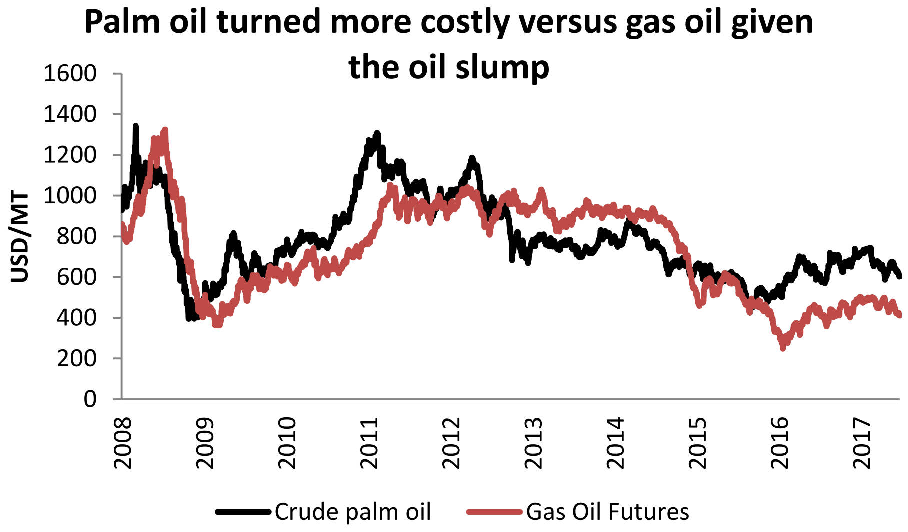
The absence of any significant rally in CPO prices illustrates an important point: market-players remain in close scrutiny over the ballooning palm oil production. However, the higher production into the year is only one of the many reasons to why palm oil prices should decline into the year. On top of (1) strong CPO production into 2017, we recognise two other key reasons to explain our bearish take: (2) sustained low oil prices to-date and (3) healthy alternative oilseed supplies globally.

Strong CPO Production Outlook: Accounting for the low production base in 2016, we expect Asia's CPO production to gain starkly into 2017. Indonesia, the biggest palm oil producer in the world, has cited upside risk in its production to 32 – 33 million tons this year, up from 28.5 million tons in 2016. Elsewhere, the second largest producer, Malaysia, should see CPO production to rise by 15.0% into 2017 according to our estimates. Empirically, Malaysia's CPO production had gained for six consecutive months into May, averaged 18.8% in 5M17 (strongest growth print since 2008 over the same period). Moreover, production is slated to rise further into August 2017 before tapering lower on seasonal patterns, suggesting that more upside risk to production levels can be expected into 2H17. Statistically, we opine that palm oil prices have already peaked in 2016 since the onset of the El Nino weather conditions, and should continue to point south as weather conditions improve.



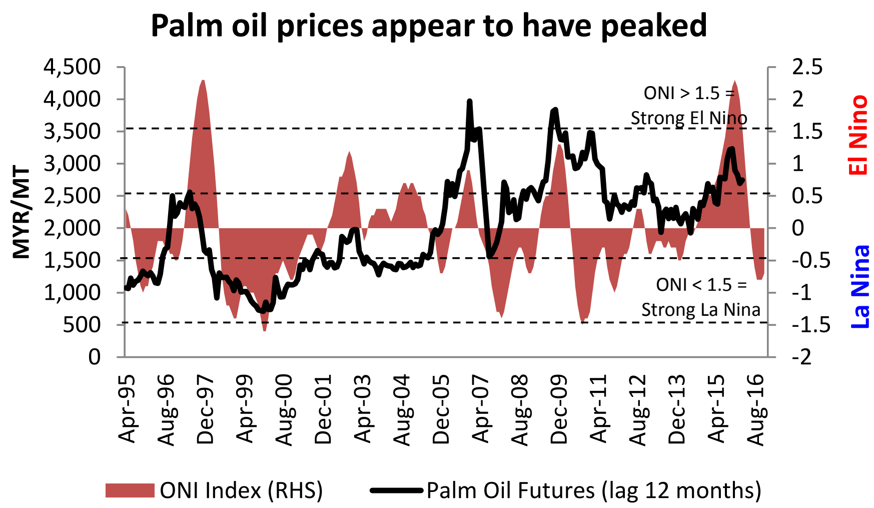
Source: MPOB, Bloomberg, OCBC Bank

Sustained Low Oil Prices: The low oil prices seen of late have also contributed to weak palm oil prices. Aside from palm oil being the world's most consumed cooking oil, the red oil is also a key input product to produce biodiesel. However, with the falling oil prices over the last years, gasoline prices have fallen starkly in tandem and left the rather expensive alternative biodiesel on the shelf. According to the Malaysian Biodiesel Association, biodiesel plants in Malaysia had been unable to make profits given the low oil price, and utilisation capacity is merely under 25%. Statistically, gasoil futures are already 31% cheaper compared to unrefined palm oil, thus making CPO as a biodiesel not only expensive, but also enormously unviable. Globally, we opine that biodiesel demand will likely taper into 2018, driven not only by the low oil prices, but also due to the recent withdrawal of the United States from the Paris Climate Accord, which in essence has the potential to limit the adoption of clean energy in the US while promoting coal and crude oil as key energy sources instead.



Source: Bloomberg, OCBC Bank

Healthy Alternative Oilseed Supplies Globally: Unfortunately for palm oil producers, the relatively healthier outlook for alternative oilseed production globally may continue to weigh on overall oilseed prices. According to the United States Department of Agriculture (USDA), global oilseed production grew into 2016/7, underpinned by higher soybean production in Brazil and Argentina, which rose global stocks by 3.1 million tons to 93.2 million over the same period. Into 2017/8, the USDA continues to expect higher global production and stock build-up for global oilseeds – cottonseed and sunflowerseed production is expected to gain further, though rapeseed production may decline on lower projected yields in Germany given the dry & sub-freezing seasons into the year. Soybean crop, a key substitute to palm oil, is projected to grow higher given strong yields in recently harvested areas particularly in Rio Grande, Brazil.[1]



Source: Bloomberg, OCBC Bank

[1] United States Department of Agriculture, *"World Agricultural Supply and Demand Estimates"*, 9th June 2017.

Price Outlook & Caveats

Given the above-mentioned factors that will likely drag palm oil futures lower into the year, we downgrade our Crude Palm Oil price outlook to MYR2,200/MT at year-end. More importantly, prices are set to decline further from now on, as indicated by the leading indicators especially seen from the Oceanic Nino Index.

Still, weather conditions are very unpredictable, though highly significant in influencing palm oil prices. Though weather experts agreed that there are no active El Nino or La Nina patterns as of June 2017, the chance for another weather extremity event (El Nino) remains elevated between 35% and 50% for the year. Even so, should it come to pass, the dry weathers would only be seen in late 2017. Still, prices could react sharply especially when more confirmation over any weather extremity is seen into 2H17, which could provide some upside risk to our price outlook. However for now, with the likely absence of a weather extremity condition, on top of very persuasive drivers for lower palm oil prices, the path of least resistance would likely be one of a bearish palm oil case.