Crude Palm Oil

More rally into year-end

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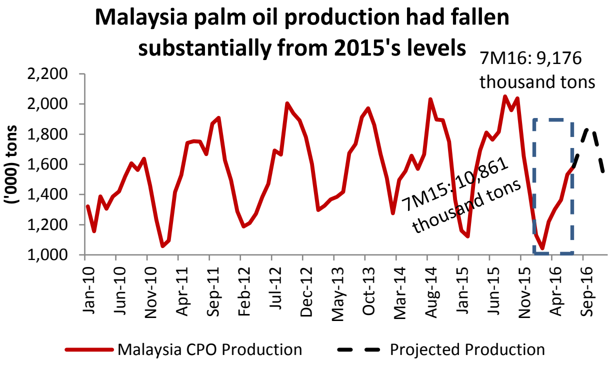
Highlights

- The rally in palm oil prices is largely due to lower production levels seen in the first seven months of this year. Empirically, weather extremities owing to the El Nino phenomenon has left Malaysia crude palm oil production growth to contract for seven months straight.
- On the other hand, demand has been robust (except for prints seen in June & July), led by double-digit growth in Malaysia's CPO exports and Indonesia's PPO exports.
- We are approaching the fourth quarter of the year, where palm oil production is expected to decline seasonally. With the already negative growth in overall production levels seen year-to-date, the further fall in production may lift CPO to exceed our initial call at MYR2,800/MT at year-end.

Let's talk pleasantries – the weather

"She's to keep to two subjects – the weather and everybody's health." That was what Professor Higgins advised to an uncouth flower street-seller in a famous 1964 play starring Audrey Hepburn. Despite it being pleasantries, for the palm oil market, weather is indeed crucial for overall production and its cues on prices. As for health, there is debate if palm oil is beneficial for one's well-being, but that is a discussion for a later time perhaps.

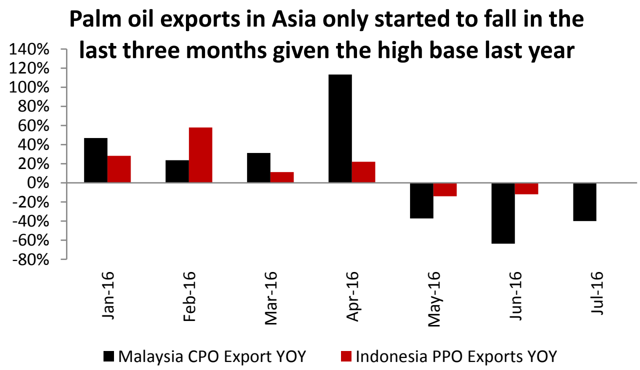
Empirically, the palm trees home to Asia (Asia produces more than 90% of global crude palm oil) has been struggling to keep up with historical production levels given weather extremities known as the El Nino which occurred late last year. In Malaysia alone, crude palm oil production growth has fell for seven months straight since the start of this year, and have been contracting at double-digit prints since March. Alone, Malaysia's crude palm oil production has fallen by 1.68 million tons this year, a level which equated to an average month of production in 2015.



Source: MPOB, Bloomberg, OCBC Bank

Barnabas Gan
Tel: 6530-1778
BarnabasGan@ocbc.com

With the significant decline in palm oil production, market-watchers were right to shrug off the relative weakness in palm oil export prints in the three months leading to July 2016 (given the relative high production base seen in 2015). In-all, should we compare against the fall in Malaysian crude palm oil production (-1.68 million tons in 7M16), the fall in exports in absolute terms was only a mere 345 thousand tons over the same period, thus underscoring a supply crunch instead.



Source: GAPKI, MPOB, OCBC Bank

More rally may occur into year-end

As for the rest of this year, higher palm oil prices may continue to persist on two reasons: (1) the effects from weather extremities may have not been fully digested just yet, and (2) seasonally lower production in 4Q16 is expected to occur in the coming months.

Focusing on weather extremities, while the El Nino have peaked and gone away in the last months, it is a known fact that palm oil production will still be adversely affected given the time needed to recover and produce new fruits. Elsewhere, the risk of the La Nina (55 – 60% chance of it happening in 2H16), may well add further upside risk to crude palm oil prices should it occur. With these peculiar weather patterns, the downside to production levels into end-year may be prolonged and even magnified compared to previous years.

All-in-all, lower palm oil production seen in the first seven months of this year was dominantly enough to pressure prices higher. The fall in absolute production levels in the coming months should be closely watched then, given that production levels have been a key factor at play in determining price trends of late. Weather extremities may also persist in the form of a La Nina later this year (if not 2017). On this, we raise our crude palm oil futures to MYR3,000/MT (previous MYR2,800/MT) at year-end.

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