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The Factors Driving Vegetable Oil Prices

Presentation to the 2018 Pakistan Edible Oil Conference

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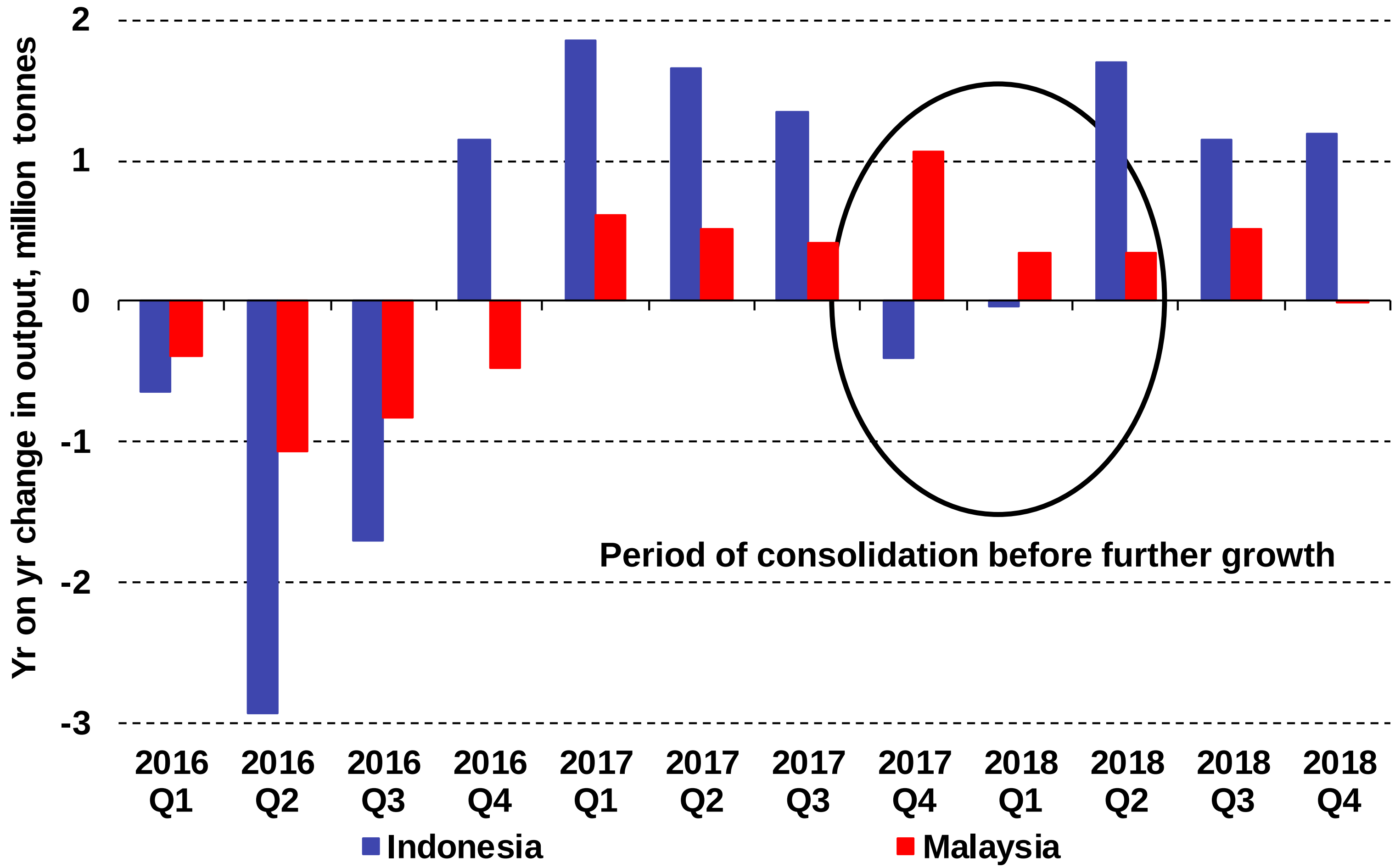
I start with palm oil, the key vegetable oil

The worldwide palm oil output recovery

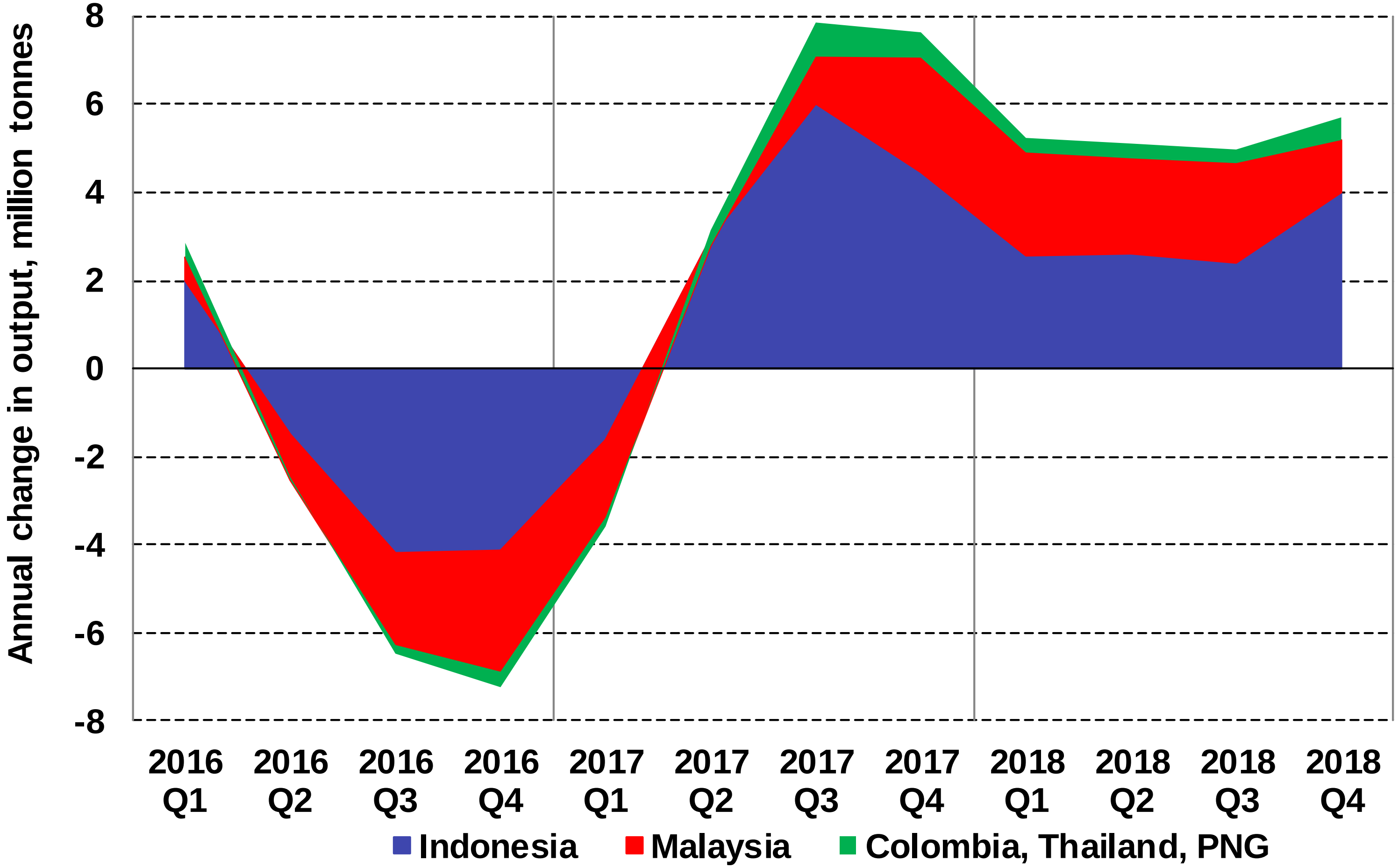
The growth in output after El Niño has not been smooth

This shows year-on-year output growth by quarter, i.e., Q1.2018 on Q1.2017



2017 world CPO output grew over 7 million tonnes after a fall of 7 million in 2016. It should grow 5-6 million in 2018.

This plots rolling annual year-on-year output growth. Thus for Q1.2018 it shows growth between Q2.16-Q1.17 and Q2.17-Q1.18, and so on.



Note: CPO output outside Malaysia and Indonesia grew by 1 million tonnes in 2017.

Much more vegetable oil will be available

Much of 2017 was characterised by the rebuilding of stocks drawn down in 2016. However, as we know, 2017 ended with all-time record year-end stocks in Malaysia.

Where will this extra palm oil be absorbed in 2018?

Some will meet food demand growth, since there is no overall growth in sun and rapeseed oil output in 2017/18.

In the case of soy oil, supply depends on meal demand. Led by China’s insatiable demand, soy meal (and oil) output will grow 4-5%. This means over 2 million tonnes more soy oil.

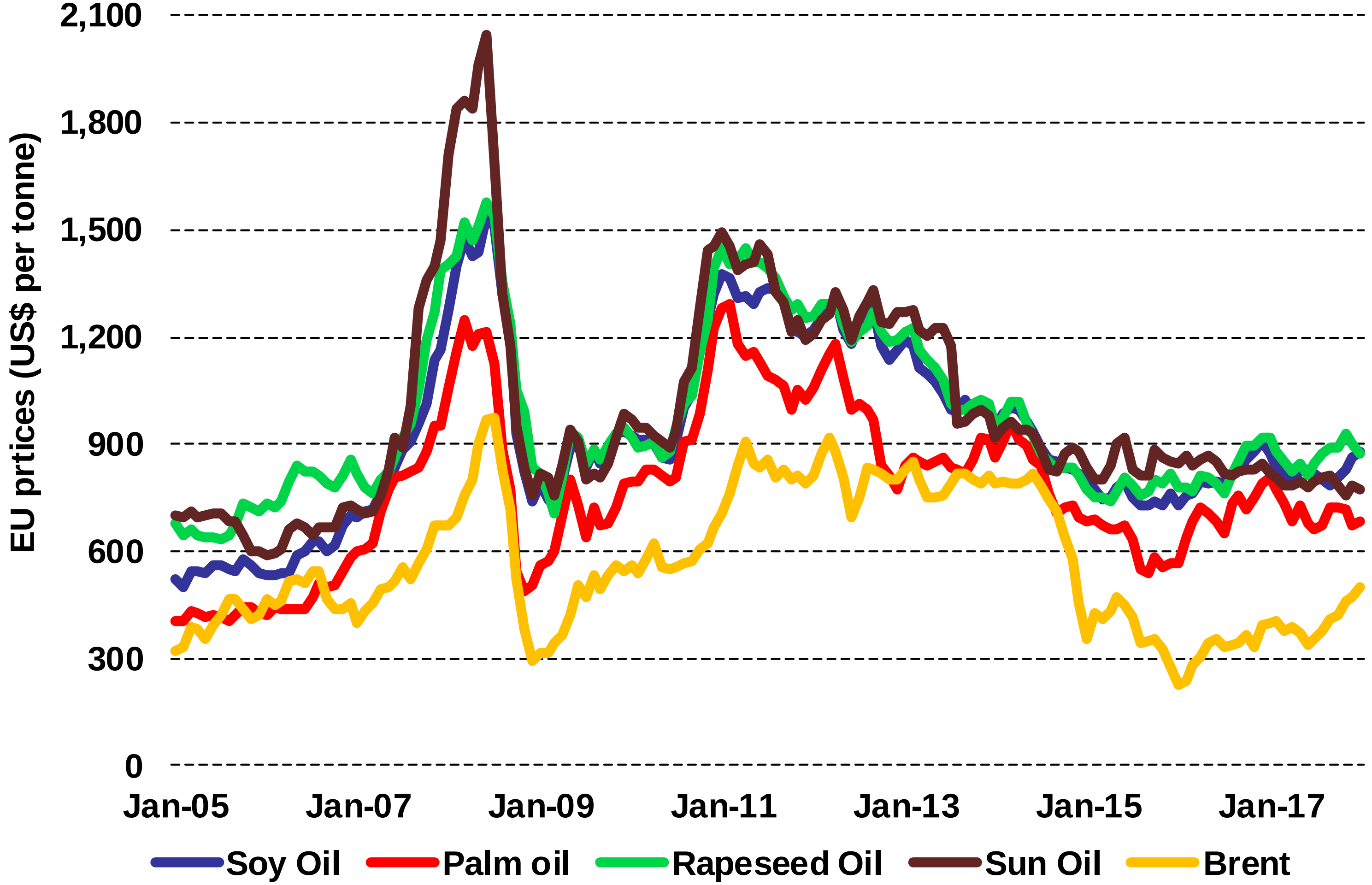
Whether oil demand manages to keep up with all this extra supply depends crucially on the growth in biofuel offtake.

The determinants of vegetable oil prices

The influence of stocks

This updates the price band. Inside the band, EU vegetable oil prices all trade at a premium to Brent crude oil

Whenever, since 2007, EU CPO prices touched Brent crude prices, they bounced back. Brent is now the floor to CPO prices and CPO the floor to other oils prices.



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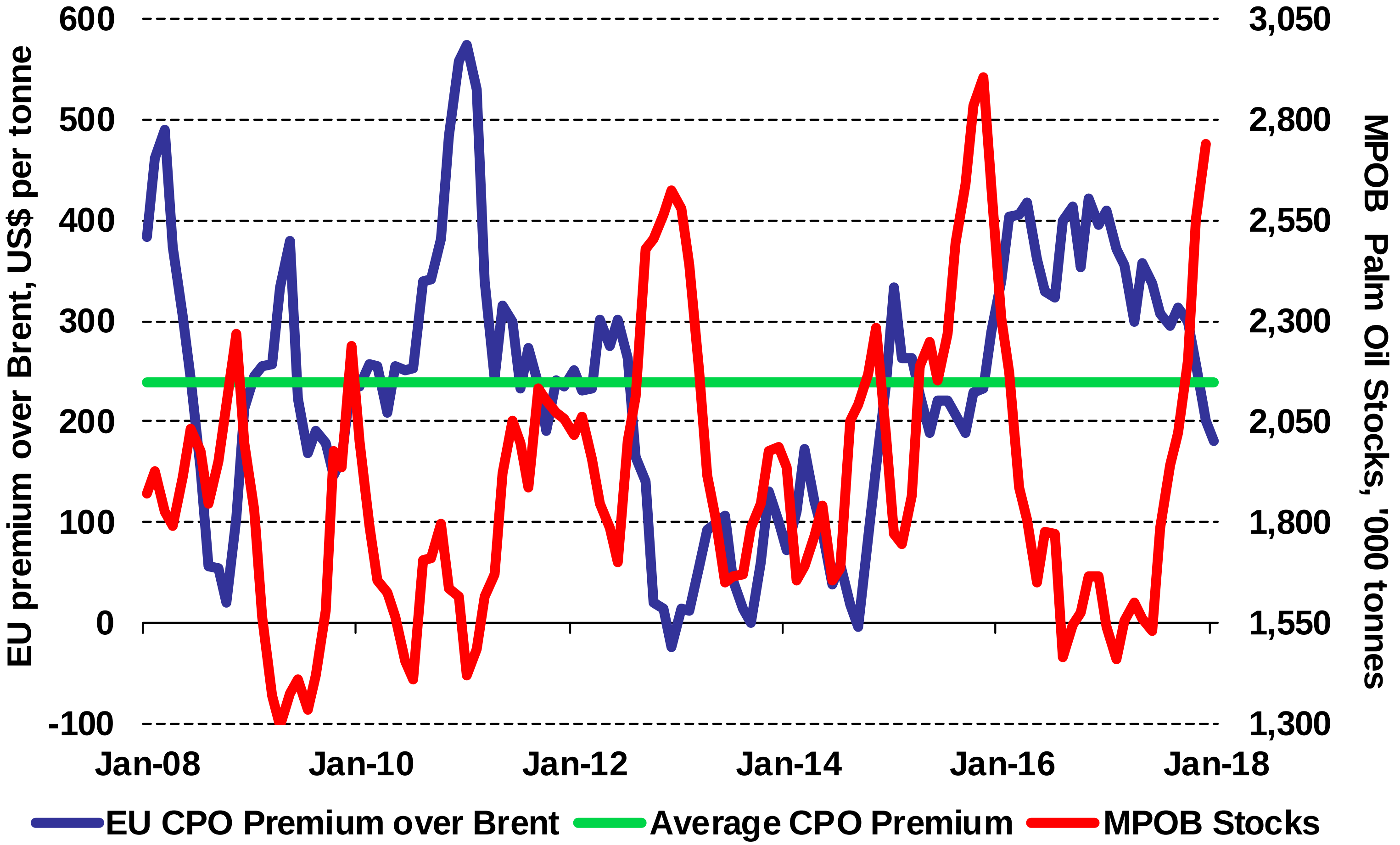
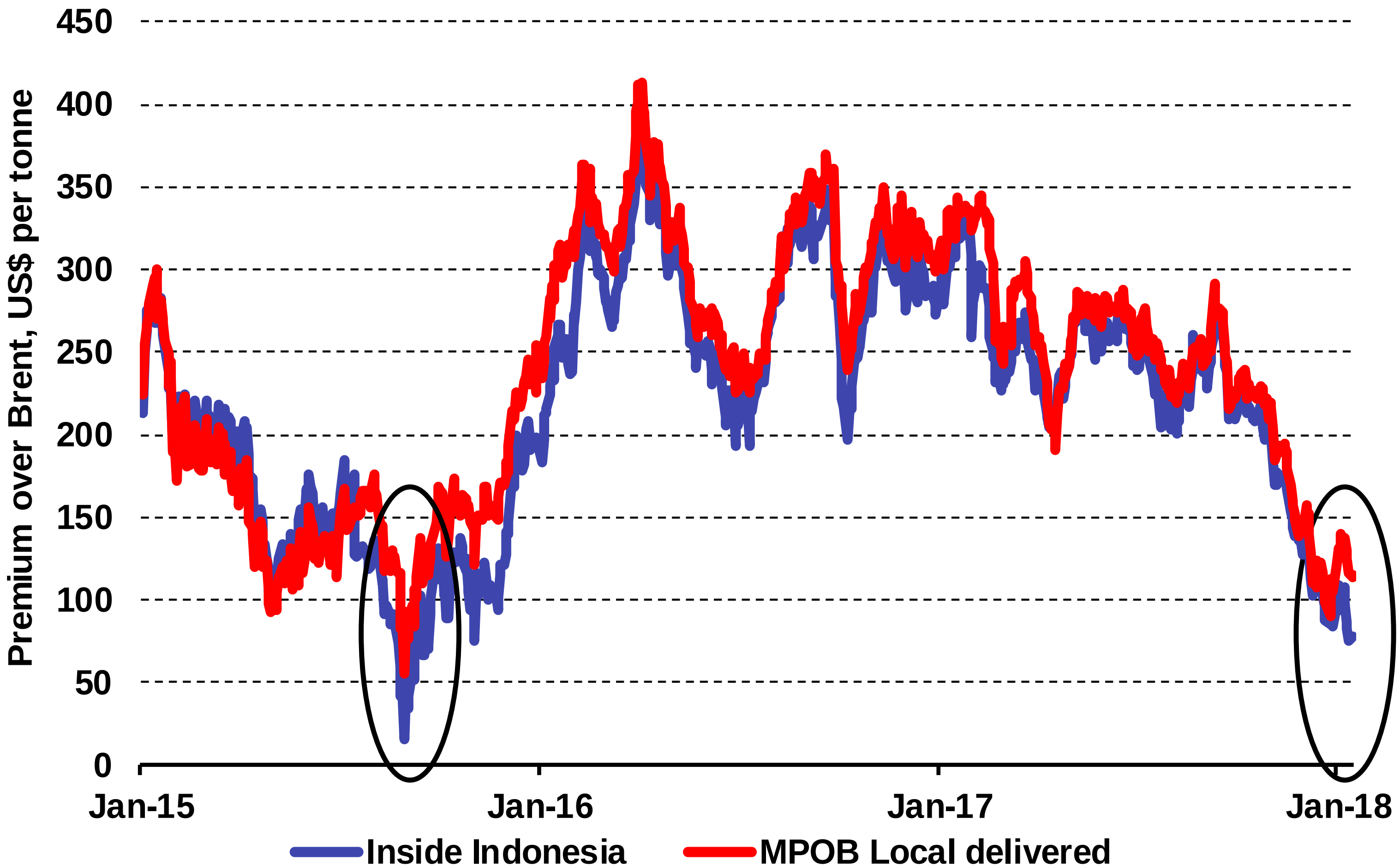
The link between stocks and CPO-Brent spreads is working

If Malaysian stocks are high, downward pressure on prices cuts the EU CPO premium over Brent. If stocks are low, the premium rises to ration demand.



Daily S.E. Asian CPO-Brent spreads are below 2016-17 lows

The slump in spreads has been overlooked because of the rise in Brent prices. Note the very recent widening of the gap between Malaysia and Indonesia.



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CPO-Brent spreads play a key role in the market

The surge in Brent prices has made absolutely no difference to the close link between stocks and the CPO-Brent spread.

With its export taxes, local Indonesian CPO prices today are only $75 above Brent. This means that Indonesia's CPO Fund can finance a much larger tonnage of biodiesel. If it does, it would help to absorb 2018's oil supply surpluses.

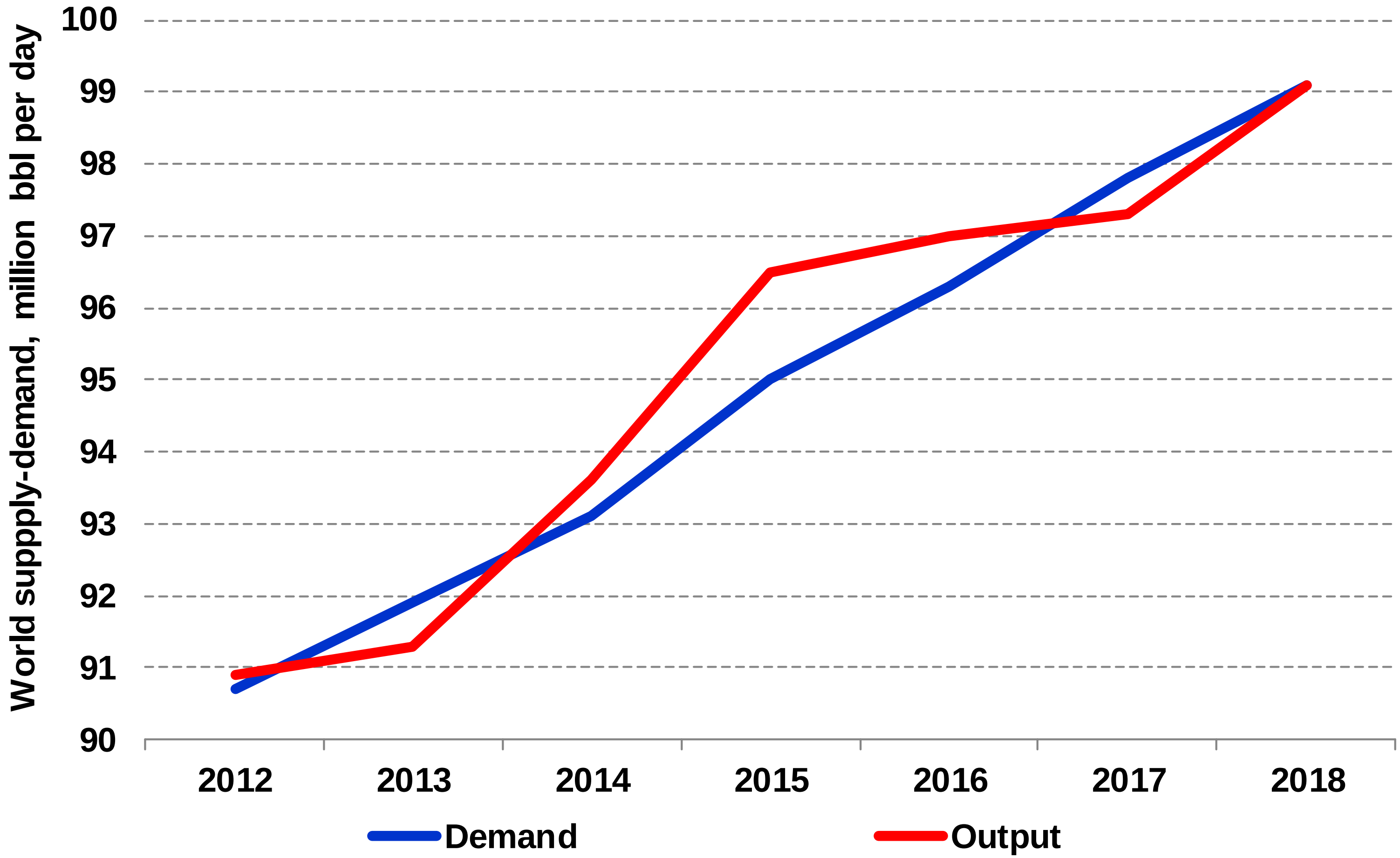
Note: Malaysia suspended its CPO export taxes this month, making its CPO exports more competitive, but undermining its refining margins, which were higher than Indonesia's in 2017. This lifted its refined export market share in 2017.

This year, with no export tax, Malaysia will sell more CPO, letting Indonesia supply more of the refined export market.

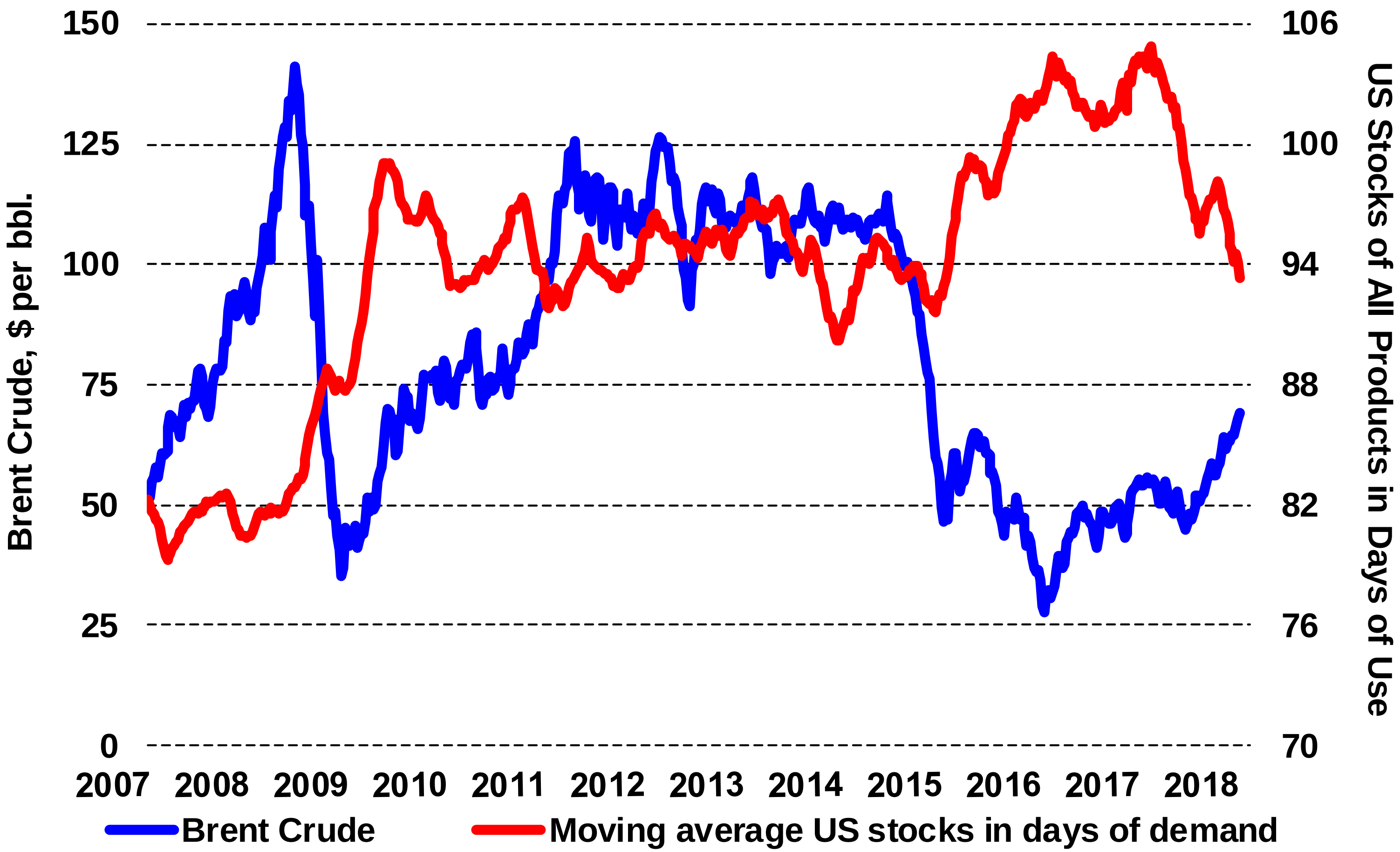
The crude oil market

OPEC slowed oil supply growth, but US shale is filling the gap

The IEA says the world had a deficit in 2017, but should be in balance in 2018.



After years of very high US stocks-use, the ratio is falling



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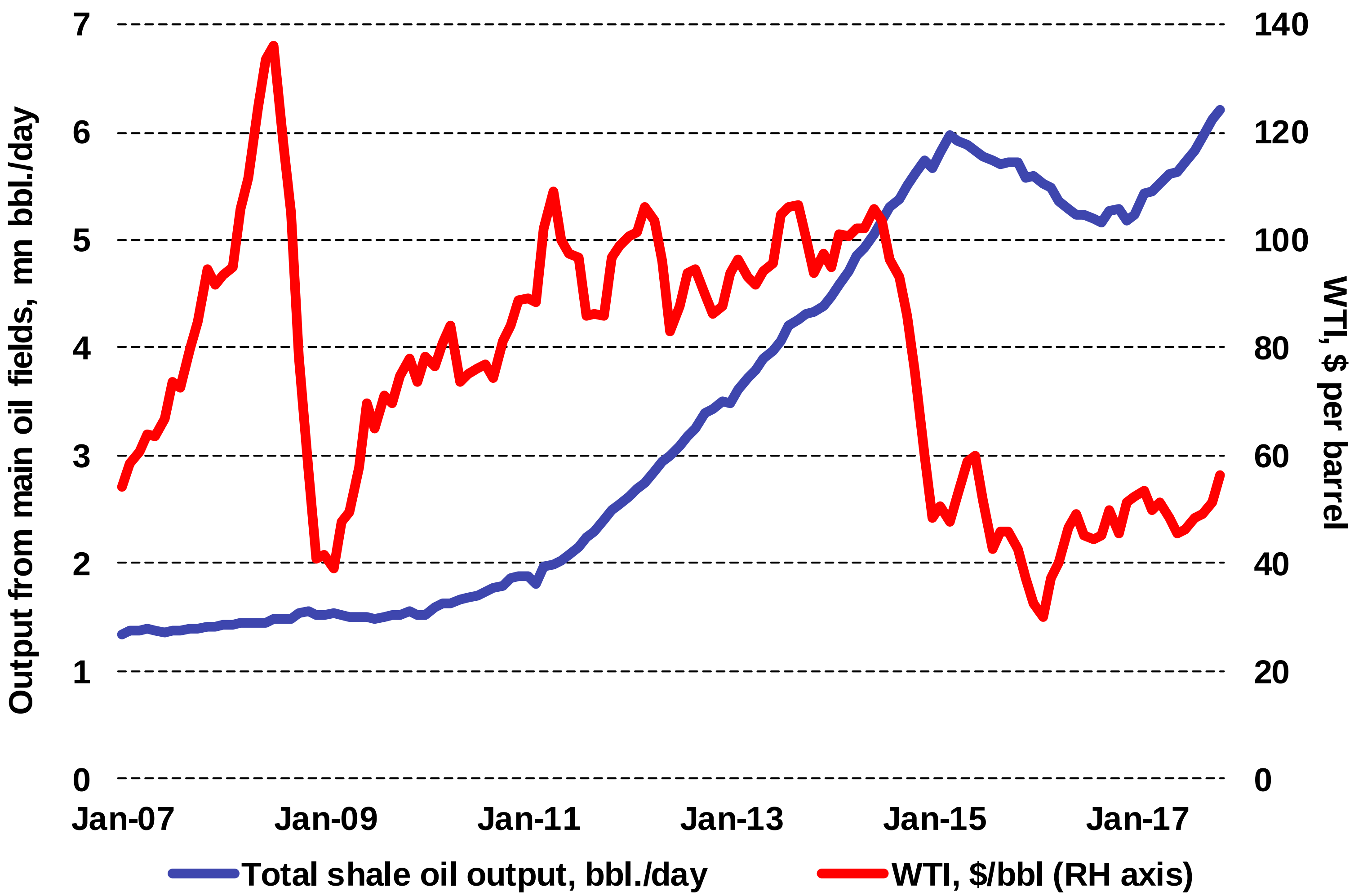
US shale oil provided 4 million bbl/day out of the total 7.5 million bbl world output increase between 2012 and 2017



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Implications for crude oil prices

The balance in the crude market has finally switched towards a global deficit, after a long period of very high stocks.

Credit for this goes to the Saudi government and its need to get the best possible price for Aramco at its IPO this year.

I expect OPEC cuts to last till Aramco has had its IPO. After that, you can expect output cuts to end, primarily because traditional oil exporters can see the US shale oil industry taking advantage of higher prices to ramp up their output.

As long as Brent prices are supported at $65-$70 by OPEC, the floor to the EU price band will be near $500, and so oils will trade in a range above that, with the CPO premium over Brent determined by stock levels.

Other factors influencing oils prices

Biofuels will be the most important

Biofuels: "the tail will wag the dog"

At first sight it is paradoxically that the biofuel sector, using 15% of the world's oils, should, after crude oil, be the next most important influence on the short term price outlook.

This is because, unlike food, biofuel use can change sharply from month to month, without far-reaching impacts upon human well-being. There are three big biofuel issues now.

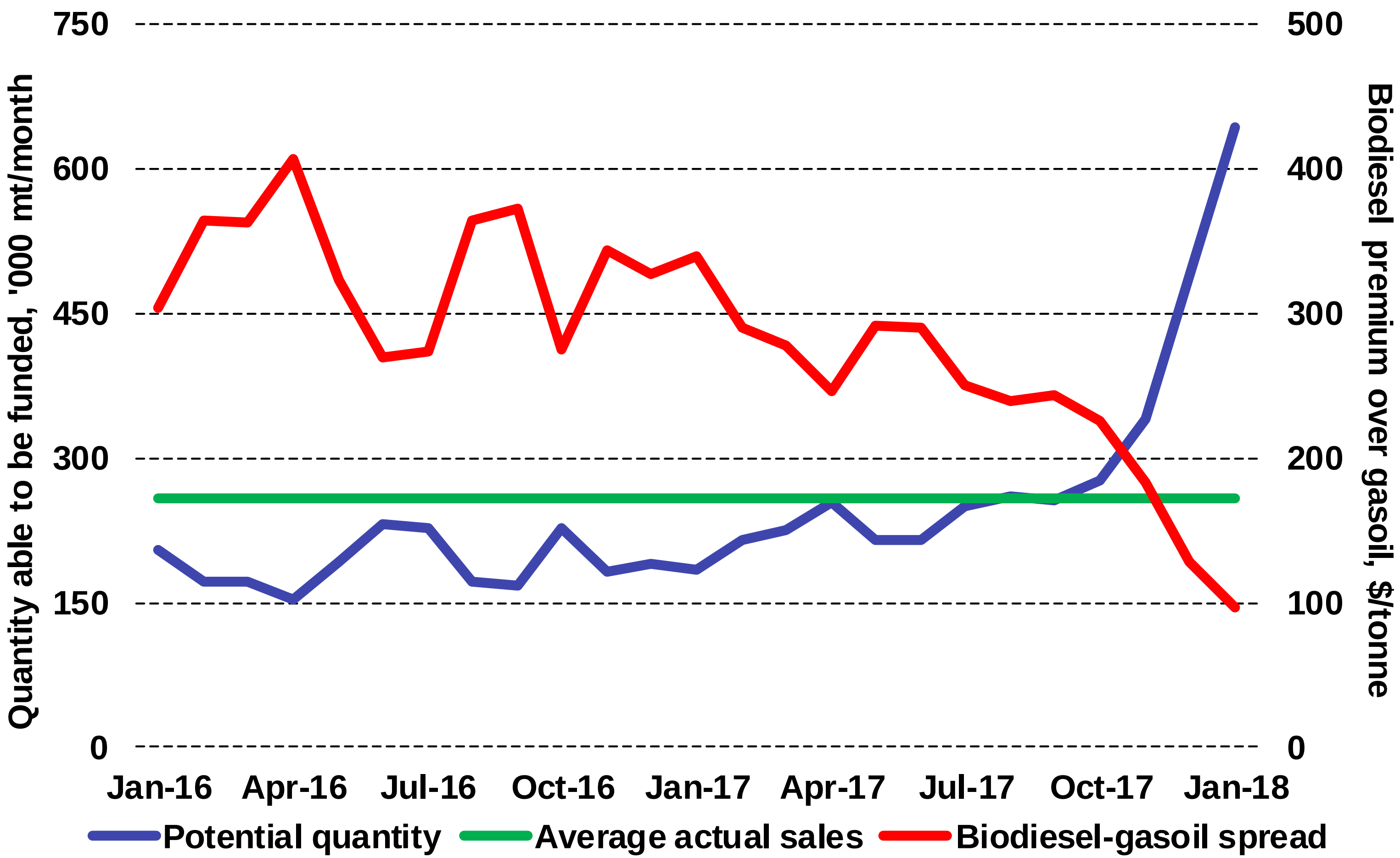
The US will soon revive its $300/tonne subsidy to biodiesel (foreign and local). This would stop oil prices falling further.

EU policy has become very anti-oil palm, even though the palm used in EU meets the EU's own sustainability criteria.

Indonesia's biodiesel mandate, funded from palm export taxes has much flexibility, as I will now demonstrate.

Indonesian biodiesel use is funded from export levies. If the CPO-gasoil spread is low, large tonnages can be funded

This plots how much could be financed from outlays of $750 million/year. The slump in CPO-Brent spreads means that much more biodiesel could be funded.



What does this mean for prices?

With OPEC holding Brent near $70 till Q4, the key factors are:

1. Revived $300 US tax credits supporting vegetable oil prices
2. If Indonesia's CPO Fund supports biodiesel production as intended, local use will expand greatly, lifting CPO prices.
3. CPO stocks will fall till May and then rise rapidly. This will underpin CPO-Brent spreads for 4 months, before they fall.
4. EU anti-palm policies affect sentiment, not prices, this year
5. Malaysia will continue to suspend CPO export taxes till its elections. This has lifted BMD prices by RM145, and was also welcome news to Indonesian exporters of refined oils.
6. I assume that the Ringgit is stable (tracking a weaker US$)

Price forecasts

BMD futures should move towards RM2,700 in the next three months, while FOB CPO moves towards $690 by May.

Key triggers, in chronological order, will be (1) US tax credits (within weeks); (2) MPOB stocks falling; and (3) Indonesia increasing its mandate, with an announcement by April.

From May, stocks will rise. The speed of the rise depends on the willingness of Indonesia's CPO Fund to raise the mandate.

In Q3, FOB CPO prices will fall back to $630-640. BMD futures in Ringgits will drop more, as the export tax is reinstated.

In Q4, prices will fall further, as the Aramco IPO removes the need for OPEC cuts, and OPEC worries about US shale oil.

Soy oil will be the closest price competitor for CPO.

Thank you for your attention

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