Blue Skies Ahead for Soybeans

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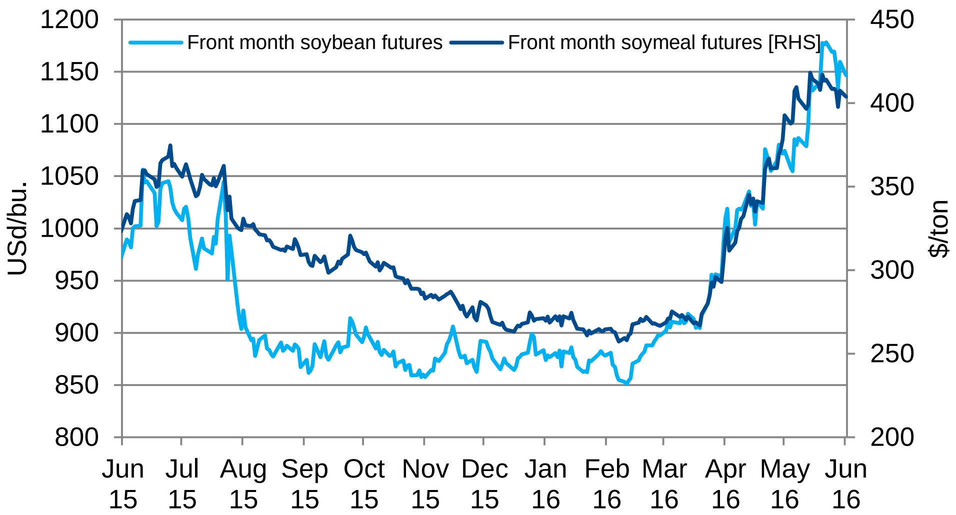
Over half a century of explosive population growth in China has brought with it a voracious appetite. Roughly 1.35 billion mouths to feed present a significant challenge not only for the ruling party but for exporters hoping to ride the cresting wave which will see the world's second largest economy transition from predominantly export led manufacturing growth to a more services and consumption led economy.

With headlines dominated by the BREXIT vote, the upcoming US Presidential election and the ongoing volatility in crude oil prices many market participants may have overlooked what has been one of the year's best performing assets. Prices for soybeans and soymeal, which together with soybean oil is end result after the crushing process, have rallied substantially since the start of the year. Front month soybean futures adding 30% year-to-date while front month soymeal futures steam ahead with almost 54% year-to-date gains, easily the best performing commodity so far in 2016.

Front Month Soybean and Soymeal Futures: *After a relatively subdued end to 2015, futures for both bean and meal have risen sharply this year.*



Source: Bloomberg

"A perfect storm of contributing factors has seen demand for soybean and meal increase at an alarming rate…"

A perfect storm of contributing factors has seen demand for soybean and meal increase at an alarming rate, especially in the last month or so which has seen significant interest from speculators as hedge funds look to get in on the trade. This is confirmed by the open interest which according to the CME hit a high of 387,000 on the 20th of May. Incidentally the previous high was 412,000 in September 2014 when prices were tumbling amidst strong yields. Two main factors underpin the almost meteoric rise in soybean and soymeal futures; adverse weather conditions in Argentina and the US which are key growing regions, and China's appetite for animal protein.

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"…75% of the oilseeds production is used for animal feed."

Soybeans have numerous uses, most notably a key source of protein in livestock feed. The CME group denotes that 1 unit of soybean produces 80% meal with the remaining 20% made up of waste and soybean oil. The latter is predominantly used for human consumption but 75% of the oilseeds production is used for animal feed.

USDA figures shows that Argentina production fell from 59.5m tonnes in June last year to 57m June this year. The fall in output is due to heavy rainfall in Argentina in key growing areas. The Buenos Aires Grain Exchange estimated that 1.6m ha has been lost due to flooding out of a total 20.5m ha. Poor yields in the badly affected areas such as Cordoba Buenos Aires, Santa Fe and Entre Rios, were fortunately offset by bumper yields in areas that benefitted from favourable conditions.

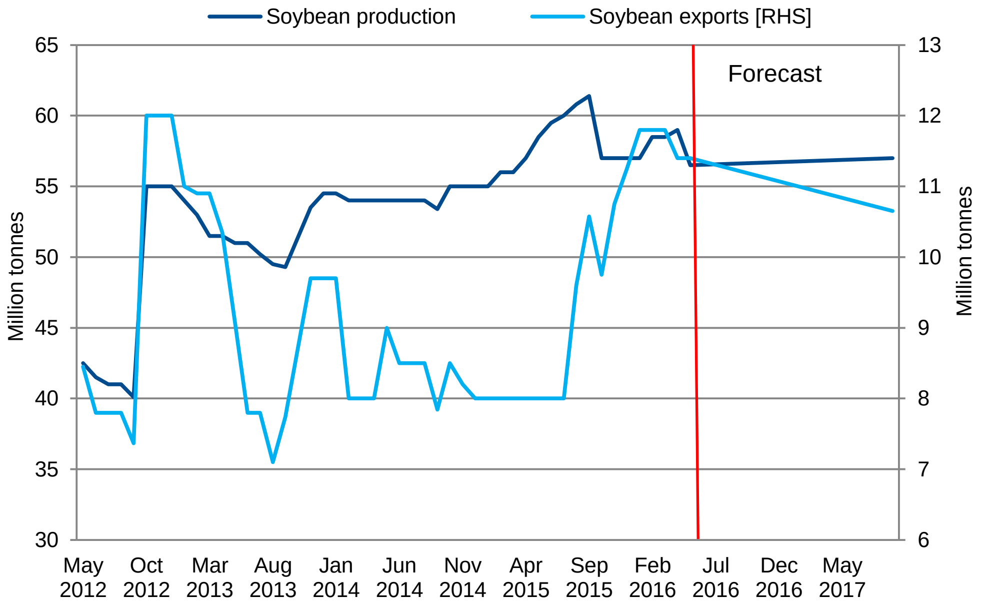
Dr Michael Cordonnier of the Soybean and Corn Advisor outlines that some of these growing regions, notably Buenos Aires and La Pampa provinces soybean yields were as high as 4,000 kg/ha. We believe there is still some downside risk for total soybean production in Argentina with some early estimates as low as 54m tonnes. Soybean yields for the country as a whole could be as low as 46.1 bushels per acre.

In addition to the low yields and production figures, the tough times continued when farmers came to assessing the quality of the beans. Argentina is unable to export beans which do not meet a certain grade, forcing them to sell stock onto processors. The processors placing a greater focus on crop quality and along with crushers have resorted to mixing and blending lower quality beans with high quality beans, however producing a meal of good quality is still problematic.

"High quality soymeal will have a benchmark protein content of 48% and this is the grade which is priced on the futures market."

High quality soymeal will have a benchmark protein content of 48% and this is the grade which is priced on the futures market. Any meal below 47.5% is automatically rejected. The cash market allows protein content to dip as low as 46.5% however crushers are unlikely to produce meal if it does not meet the 47.5% cash market level.

Has Argentina's Soybean Market Peaked? *Soybean production is forecast to come under pressure well into 2017 with exports significantly impacted.*



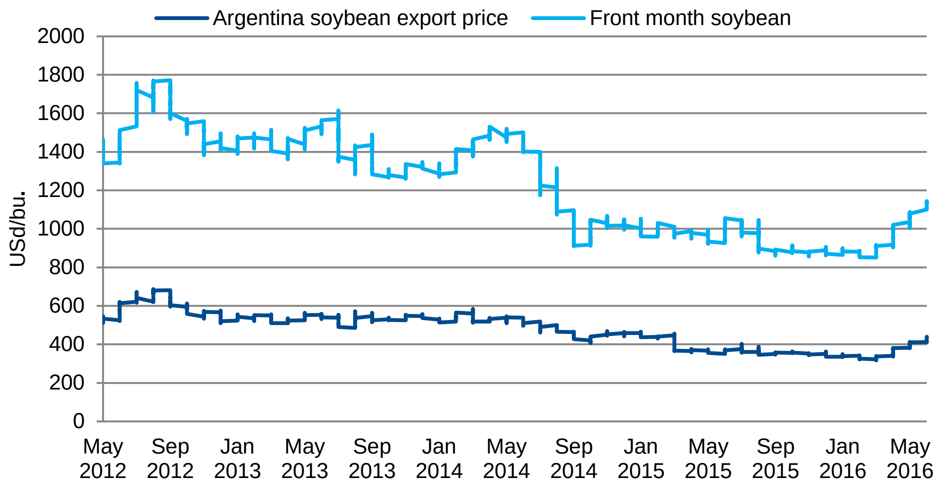
Source: USDA

Accordingly, as a result of the poor harvest in Argentina processors are struggling with a limited supply of high quality soybean, and therefore meal. This can go some way to explain the exponential price increases in the futures market, with prices up 53% year to date, which have so far dominated activity this year.

"…the issue of having a low crop yield has been compounded by the poor quality of what they have managed to produce."

Given that Argentina is the largest exporter of soymeal in the world due its domestically strong crushing industry the issue of having a low crop yield has been compounded by the poor quality of what they have managed to produce. Customers may have to obtain more of the crop in order to receive the same protein count as other years. This has been mirrored in the global markets by soaring prices.

Soybean Export Prices: *Argentina's export price for soybean has been slow to respond to the rapid rally in futures markets.*



Source: Bloomberg

Other Latin American countries have also had their crop yield revised lower; with the situation particularly dire in Brazil which has seen soybean plantations infested with pests. This season's crop is estimated to be down 1.27m tonnes from last year and as a result of this lower estimate, October to September exports and stocks are expected to be down both this year and the next. The shortage has impacted the global market on such a scale that according to industry forecasts, total stocks will be drawn down to 66.3m tonnes. However, in spite of the fact stocks have fallen sharply in 2016, the current figure is still well above the 20 year average of 49.8 million tonnes according to the USDA.

In the northern hemisphere, North American production is well underway but there are fears that excessive weather conditions could damage crop yields. As it stands reports suggest that 73% of the crop is rated good to excellent, according to Dr Michael Cordonnier. In the US, the soybean crop can look weak come the end of June but if favourable conditions persist throughout July and August we could still see a good crop produced. Estimates for this year's planting stand at 84.5 million acres with yields of 46.7 bushels an acre which if accurate would be down 0.2 bushels per acre from last year.

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"The weather worries may not stop there, as soybean crops could be further impacted by the adverse effects of La Niña."

The weather worries may not stop there, as soybean crops could be further impacted by the adverse effects of La Niña. Data suggests a 75% chance of La Niña, with half the indicators suggesting the necessary weather conditions could hit by winter 2016/17 (Climate Prediction Centre 2016). If La Niña does surface this year, scientists see a moderate to strong cycle.

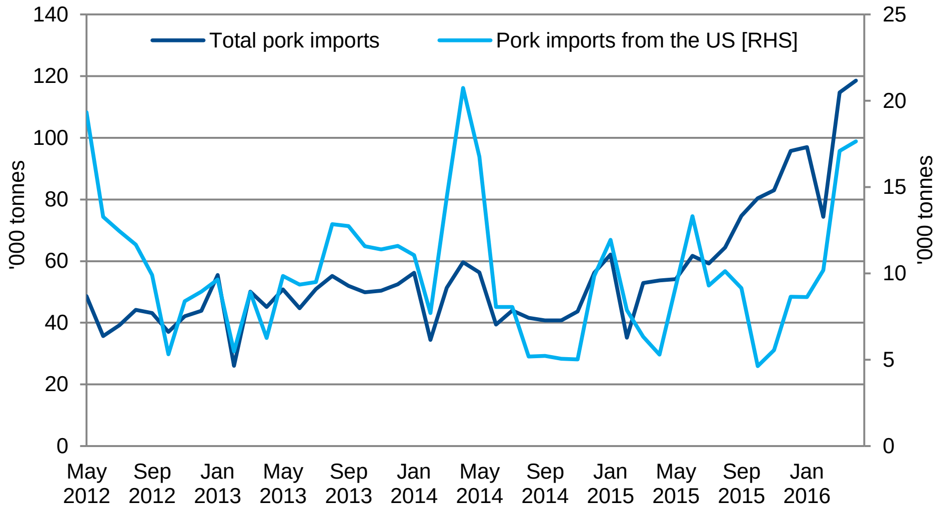
La Niña is associated with cooler than average sea surface temperatures in the central and eastern tropical Pacific Ocean. In land, the weather cycle brings hot and dry conditions which can impact crop production in the "Corn Belt" to Brazil thus soybean yields could be hit heavily.

Research suggests that the adverse weather conditions of the potential La Niña can negatively impact parts of Brazil and Argentina soybean growing areas. The most affected areas in these countries are those which rely solely on rainfall. On a global scale the conditions can negatively impact 9-13% of the harvested area. In contrast to this the positively impacted area is rather limited to 2-4%, globally.

This year's poor production from exporters such as Brazil and Argentina has seen the Chicago Board of Trade (CBOT) soybean price up 31% year to date as the market tightened acutely. Brazil's production looks set to fall this year from 98.16m tonnes to 97m (USDA). A tough year ahead for soybean farmers, especially in North America could see more draw on stocks next year as supply remains low.

Producers in the United States may face further troubles as the potential for drier than normal conditions negatively affect crops. Chinese demand is set to ramp up at a steady pace; accordingly hopes for a balance and stable market are limited.

Chinese Pork Demand: *China's appetite for animal proteins, particularly pork, has seen an upswing in imports driven from the US.*



Source: Bloomberg

"…farmers incentivised by higher prices could increase the plantation area for soybeans."

If the cycle does not move into La Niña and conditions remain neutral, farmers incentivised by higher prices could increase the plantation area for soybeans. This being the case, we could see the market normalise however a bumper crop next year may see stocks replenished and prices retreat towards $370 per tonne.

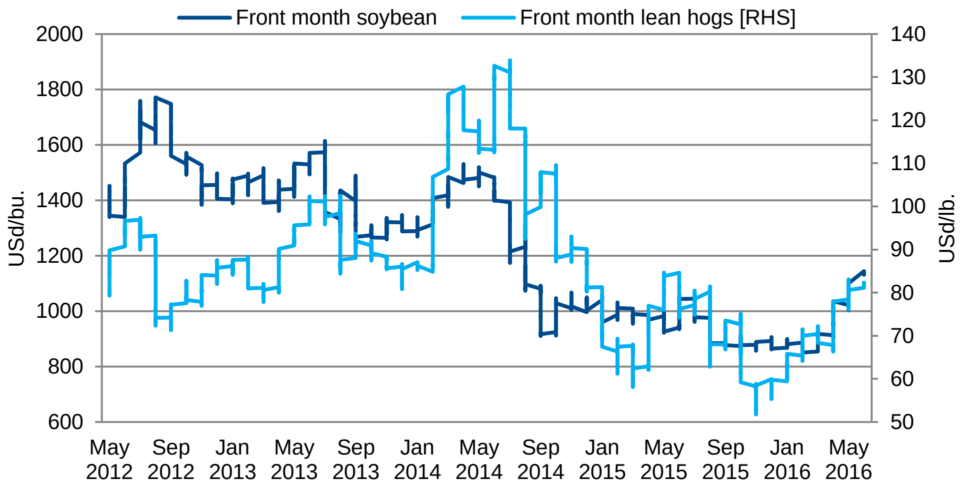
This retracement is likely to be mirrored by soybean meal however if Chinese demand for livestock feed continues to be strengthen, prices could remain above the 10 year average of $371.10 per tonne. Soybean meal's retracement may not be in proportion to that of soybeans. Soybean meal trading volumes for the 14th of June on the Dalian commodity exchange were more than the US consumes in a whole year, dwarfing trade on CBOT. With a strong first half of the year, Chinese speculators wanted some of the action, although we are wary of surges in volumes, there is substance to China's increased demand for meal.

Looking ahead, farmers could be incentivised by the current price of soybeans, which hit a 22-month high at the beginning of the month. Increased planting could lead to a bumper crop in 2017/18, which may bring some stability to the market and restrain any additional impulsive price appreciation. Global production in 2016/17 is forecast at 324.2 million tons and while this expectation is up a modest 8 million tonnes year-on-year, it hinges on optimal weather conditions in Brazil, Argentina, India and Ukraine (USDA).

"…consumption growth to the tune of an additional 3.8 million tonnes in China alone…"

With a modest improvement in crop yields expected this year, crushing activity is expected to remain buoyant with soybean meal expected to increase by 3.2 million tonnes next year. However, this increase is forecast by the USDA to be met with consumption growth to the tune of an additional 3.8 million tonnes in China alone, no surprise then that China is the largest consumer.

Soybean vs. Lean Hogs: *Front month lean hog futures have tracked soybean futures prices closely in recent months.*



Source: Bloomberg

"Growth in Chinese demand coupled with a smaller than expected crop yield this year suggests in our view a buoyant outlook until at least Q2 2017."

This forms the second part of our reasoning for a well-supported soybean and soymeal futures market as well as the consensus forecasts for stable price appreciation next year. Growth in Chinese demand coupled with a smaller than expected crop yield this year suggests in our view a buoyant outlook until at least Q2 2017. Quality concerns in Brazil and Argentina will also be reflected in the futures market providing underlying support to soybean throughout the remainder of the year.

Growing demand for animal protein in the world's most populous country will, in our view, continue to drive the fundamental engine supporting soybean prices higher. According to the USDA, China's soybean imports are expected to reach over 70% of the global market by 2023/24, they already account for the lions share now but this trend is set to continue at a steady pace as an increasingly prosperous urban population drive demand for livestock. USDA projections predict Chinese soybean imports will rise from approximately 80m tonnes in 2015 to roughly 110m tonnes in 2023/24, rising at a steady rate year-on-year over the interim decade.

China's per capita meat consumption is expected to increase from approximately 55kg per person in 2015 to over 65kg per person by 2023/24 according to USDA estimates. This 10kg increase per capita may not seem like much but given the population is expected to increase to by over half a billion people over the next ten years according to United Nations projections, that's a lot of mouths to feed.

In today's volatile markets the bullish underlying fundamentals presented here for soybean and soymeal can offer at least some comfort at a time when fortunes can be won and lost in a matter of days.

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