Coffee Given A Kick

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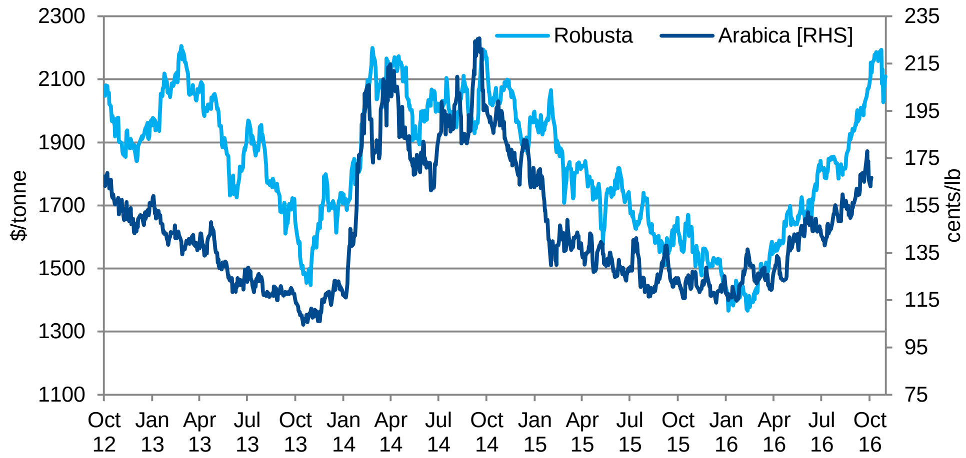
2nd Robusta vs 2nd Arabica: *Both contracts have posted impressive returns*



Source: Bloomberg

Coffee prices have soared this year with front month Arabica contract up 27% year to date and Robusta rising 44.36%. The recent retracement has taken some of the gains off the table; however the front month contract is the 2nd best performer in the Bloomberg Commodity Index, behind zinc

Over the last decade adverse weather conditions in producing regions and a strong rise in coffee consumption have put huge pressure on the industry, culminating in tight a fundamental outlook. In the US, daily coffee demand from millennials has risen 48% in the last 8 years and 60% within the age bracket of 25-39.

The age at which individuals start drinking coffee has fallen. Millennials born after 1995 on average start at an age of 14.7 years compared to millennials born around 1980 who began at 17.1 years.

Global consumption trends have changed with a greater interest in the quality and blend of coffee. Consumption of gourmet coffee among 18-39 year olds has grown 23% since 2008 in America with 81% of the same demographic drinking a wider variety of coffee products.

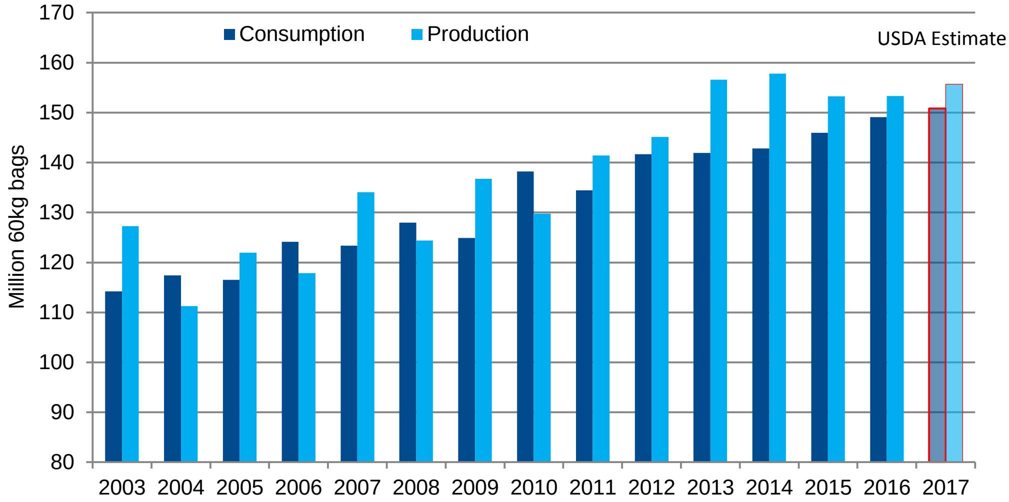
"…global intake of coffee has grown 4.1% over the last 3 years."

Coffee consumption has increased considerably in recent years, growing 29.8m 60kg bags from 2009 to 2016, with the International Coffee Organisation (ICO) stating that global intake of coffee has grown 4.1% over the last 3 years. Looking ahead, the ICO estimates that American coffee consumption will grow 2% a year to 2020, with global demand reaching 160m 60kg bags.

"…1% fall in GDP would see a 0.3% fall in coffee demand"

Sluggish economic growth could hinder consumption growth; however coffee is relatively insensitive to economic slumps. Euromonitor research has suggested that a 1% fall in GDP would see a 0.3% fall in coffee demand.

Global Consumption vs Production: *Fundamentals point to a tighter outlook*



Source: USDA,Bloomberg

Developed countries are the major source of coffee demand with the US and Europe consuming the most this year at 25.2m bags and 44.5m bags respectively. Unlike most commodities China has little impact on coffee demand. This releases pressure on the industry, as it is not solely reliant on one large demand centre, however with the fundamentals in already tight, down the line, an increase in coffee consumption in China is likely to be bullish on prices.

Even though the industry has a strong demand side outlook, this year supply side shocks have added further tailwinds to prices. Bullish fundamentals has led to a promising price outlook; further tightness is to be expected going forward.

The United States Department of Agriculture (USDA) forecasts world production to rise again next year to 155.7m bags, up 2.4m bags from this year's numbers. The data suggests we could see a surplus of 4.9m bags. Arabica output is set to grow to 60% of the global crop and due to favourable conditions in key Brazilian growing regions some producers are starting to plan for next year's planting.

"Arabica output is set to grow to 60% of the global crop …"

Supply shocks hit Robusta

Due to lower than average rainfall in Espirito Santo, Robusta production has been weak this year. USDA suggests next year Brazil's Robusta output will fall again by 1.2m bags to a 7 year low of 12.1m as water shortages limit irrigation.

The combination of poor yields and strong domestic demand has led to a surge in the local price of Robusta. However since July, Brazilian coffee exports have made a recovery in the second half of the year up from 1.96m bags in July to 3.22m bags at the end of October. Although seasonal this year's move seems exaggerated. Exports for the coffee year 2015/16 fell to 111.83m bags from 112.65m the previous year.

ICE Arabica warehouse stocks fell to their lowest level since 2000 in October with just three days of global consumption stored. ICE daily Arabica stocks have depleted to 1.27m bags, which is considerably below the 10 year average of 2.65m bags. The USDA revised down their global ending stocks by 1.3m bags to 35.4m in their latest bi-annual report.

"ICE daily Arabica stocks have depleted to 1.27m bags…"

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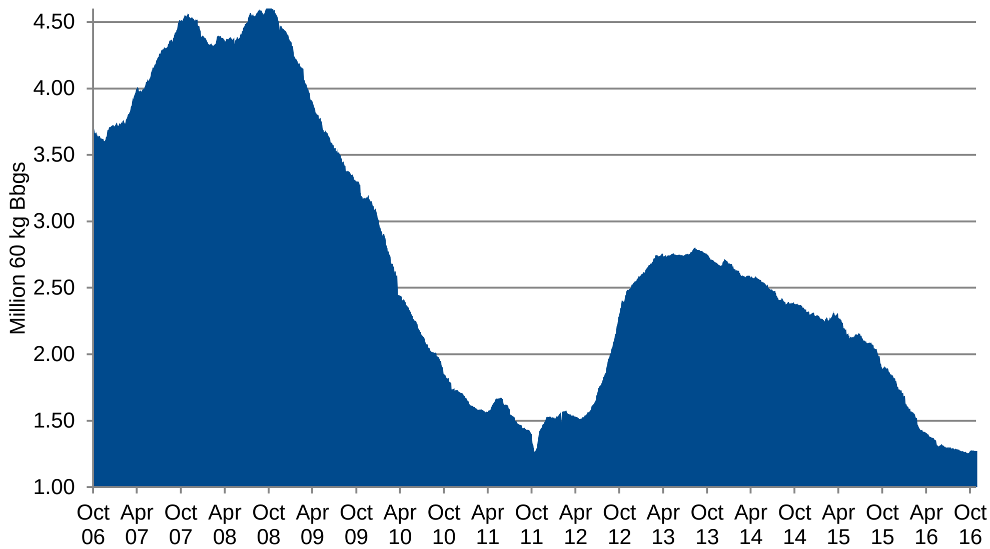
Daily ICE Arabica Inventories: *Stocks of Arabica are at their lowest since 2010*



Source: ICE, Bloomberg

Weather patterns are important to the commodity complex and with the probability of last year's El Niño turning in to La Niña increasing, further disruptions to supply could be on the horizon. Sea temperatures in the equatorial Pacific Ocean are now -0.5 degrees Celsius below normal, enough to be labelled a La Niña.

Other key growing areas may not be so lucky; the pattern could threaten the yields in Vietnam as heavy rainfall after a period of extreme dryness can negatively impact the coffee trees. Heavy rainfall may slow the ripening of the coffee cherries and delay the harvest, further impacting this year's yield.

"Vietnam's production may decline in the 2016/17 season by 2m bags…"

Vietnam's production may decline in the 2016/17 season by 2m bags as coffee trees are unable to cope with the transition to heavy rainfall after a period of hot and dry weather. As a result, stocks in Vietnam, the main producer of Robusta, are expected to fall by 2.2m bags next year to 3.5m bags.

A perfect storm heading towards producers

Unease in the coffee industry is not just affecting Brazilian production; a truck driver strike disrupted operations in the port of San Antonio last month, Colombian exports slumped in September by 17% month-on-month. However, the stored volumes have now been released and exports have resumed. Positive yields in Colombia could persist as output continues to be buoyed by the tree plantation drive earlier this decade.

"…farmers only receive 7-10% of the final retail price"

Despite the high prices, coffee growers have had a torrid time and are suffering from reduced revenues. Fairtrade International suggests that farmers only receive 7-10% of the final retail price, often not enough to afford a sustainable living. The nature of the industry is fragmented with 80% of the sector supplied by 25 million small producers. The market could move toward focusing on a few regions as small producers consolidate and larger groups emerge.

The growth of the coffee industry has understandably put pressure on the farmers; these issues may become more prominent. Recent ICO research notes a large variation in operating profits as a consequence, on average farmers were not able to cover their variable costs of production.

“Crop intensification may not be the answer due to sustainability issues having a negative impact on yields in the long term.”

“Leaf rust has led to losses on average of 181USD/ha”

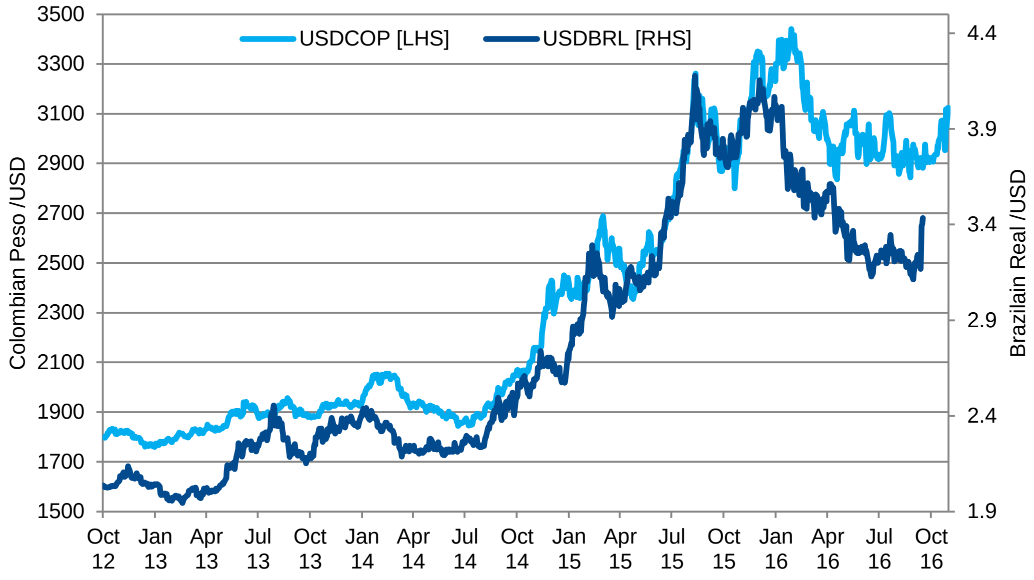
This is a direct result of the yield changes and fees received by farmers. Persistently low prices may cause production to intensify in areas with advanced systems and favourable cost structure. In the long run, if this pulls through we may see greater volatility as supply side shocks having a greater impact on annual yields. Crop intensification may not be the answer due to sustainability issues having a negative impact on yields in the long term.

Costa Rica and El Salvador are among the biggest losers. Costa Rica saw the cost of production increase by 58% to approximately 3,617 USD/ha between 2006/07-2011/12. Farmers have put up with negative profits since 2012 with revenues not sufficient enough to cover increasing production costs.

In El Salvador farmers have been less fortunate with negative operating profits for the last 4 years. Leaf rust has led to losses on average of 181USD/ha. Some farmers have started to produce more economically viable products, such as cocoa, with only the more resilient producers able to prevail, resulting in an overall loss of production.

Since 2000 the ICO composite benchmark has traded in a range of 41 US cents/lb in September 2001 and 231 in April 2011 but the January 2016 figure was below the 10 year average of 137cents/lb at 132cents/lb. This has been driven by a phase of low coffee prices but given this year’s pricing activity we could see the benchmark trade above this 10 year average.

USD vs COP & BRL: *A stronger dollar has put pressure on producers.*



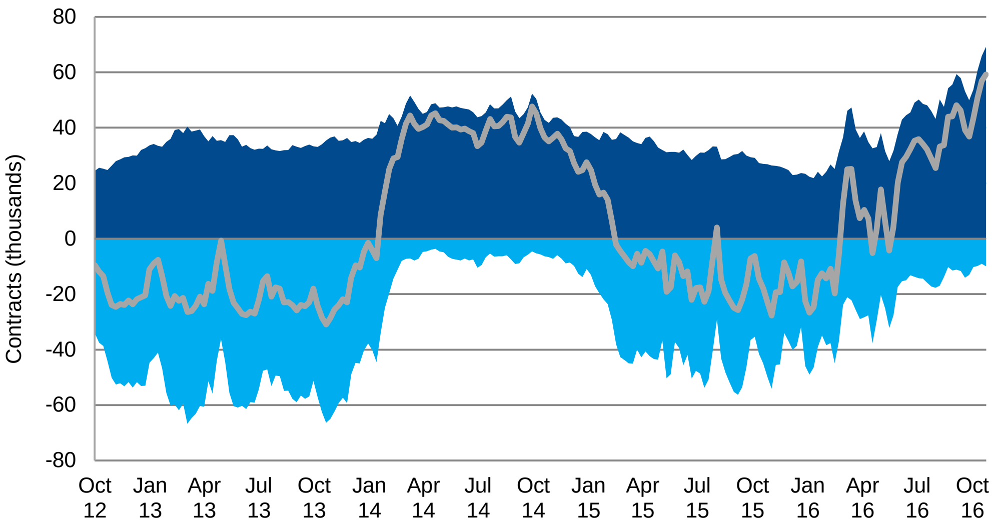
Source: Bloomberg

The dollar has strengthened against LATAM currencies since the US election; while the strength in the greenback has improved the prospects of exports growers have seen an increase in costs, which are rising at a faster rate as imports of fertilizers and pesticides become more expensive. These rising costs make coffee production in these loss making areas unsustainable

“Recent volatility is likely to prevail in the near term …”

As mentioned above, currency moves have contributed significantly to volatility in prices, the DXY index hit 100 on the 14th of November, reinforcing the dollar’s strength on global commodity markets. Persistent strength in the dollar could act as a significant headwind to coffee prices going into 2017. Recent volatility is likely to prevail in the near term as President Elect Donald Trump sets out his government.

Commitment of Traders: *Managed Money Hits record net long*



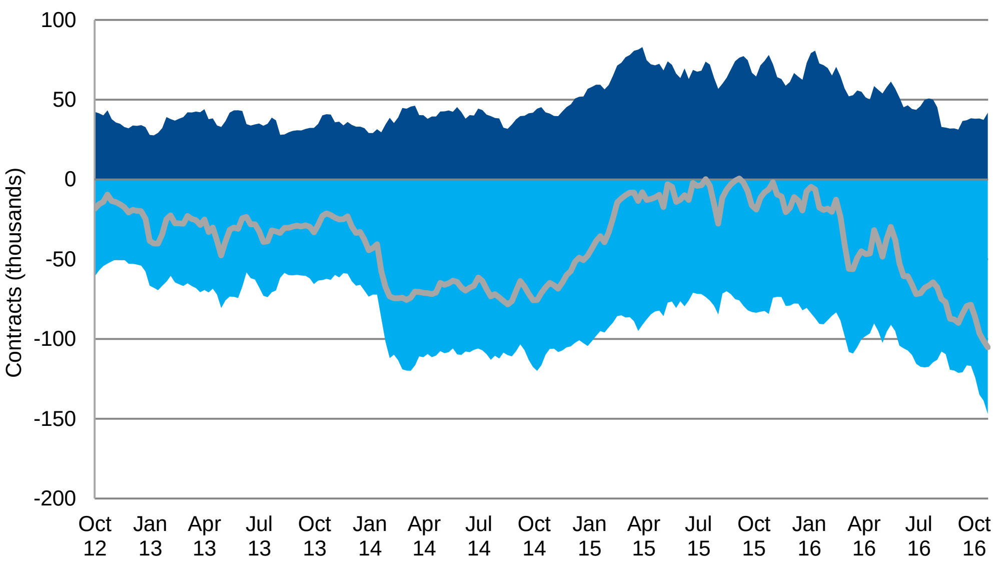
Source: Bloomberg

"…appetite remained subdued, owing to geopolitical tensions and a broadly lacklustre macro outlook."

The Commitment of Traders report nicely illustrates the underlying market conditions. Managed money positions spent the majority of 2015 net short as risk appetite remained subdued, owing to geopolitical tensions and a broadly lacklustre macro outlook.

Second month Arabica futures declined throughout the first half of 2015 but abating macro headwinds, notably a tightening of monetary policy from the US Federal Reserve and EM stability, we have seen second month Arabica futures rally strongly in 2016. US dollar strength and BRL volatility coupled with bullish fundamentals have made for an interesting year so far; managed money net spec length swung from a -22,500 short position at the beginning of the year to over 59,000 contracts net long for the week ending 8th November, a record high.

Commitment of Traders: *Producers and Merchants extend their short positions*



Source: Bloomberg

Producer/Merchants have seen an increasing short net position build this year as they've tracked coffee futures higher in BRL terms; the underlying fundamentals suggest this outlook may persist for some time, but given the pace of positions building on the long side we could easily see sharp swings on profit taking from speculative traders as markets become more impulsive.

In summary, the demand outlook for coffee continues to strengthen with greater concentration on quality, thus boosting Arabica consumption. The Robusta market has been peppered by supply side shocks and we could see this continue through next year. Further down the line persistently negative profits for farmers may see a change in the structure of coffee producers as we know it.

"…Arabica stocks replenished back towards the 10 year average level at 2.6m bags"

The tight fundamental outlook could ease as we move through 2017 as production returns an excess of 4.9m bags. According to USDA figures the rise in production will come predominantly from Brazil's Arabica crop forecast to jump 7.8m bags. This could see Arabica stocks replenished back towards the 10 year average level at 2.6m bags. The Robusta yields forecasts are weak which could see the bullish trend continue however we cannot ignore the impact a stronger dollar on upside potential.

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