Bittersweet Outlook For Cocoa

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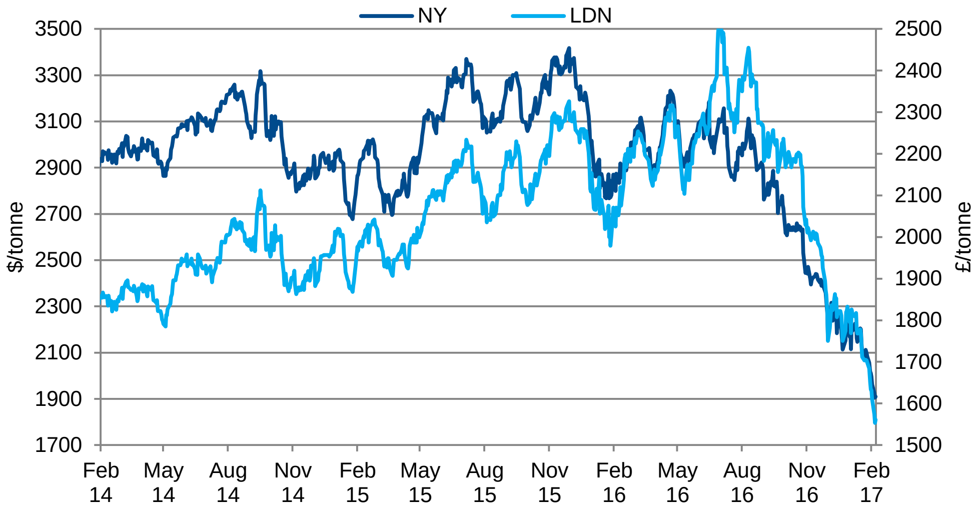
2nd NY Cocoa vs 2nd LDN Cocoa: *The strong downward trend in Q4 2016 has continued in Q1 2017*



Source:Bloomberg

Cocoa futures were one of the worst performers in the commodity complex in 2016 with the New York second month contract closing the year down 34%. The rout in the final quarter of 2016, which saw the price of New York cocoa beans fall 27% to $2,113 per tonne, was to blame. The London contract followed a similar pattern with prices closing out the year at £1,750 per tonne, down 24% in the final quarter of the year. The beginning of this year has seen the bearish run continue with both New York and London listed cocoa futures down as much as 10% year-to-date.

“The rise in output was largely attributed to a strong main crop from West Africa”

Rumours of a surplus this year had been floating around the market for some time, and as evidence of higher global production for the 2016/17 crop emerged, futures were sent into freefall. The rise in output was largely attributed to a strong main crop from West Africa where, according to the International Cocoa Organisation (ICCO) 74% of the world’s cocoa production is grown, as well as signs of increased production from Latin America.

The recent sell off ended 4 years of solid gains and with performance so far this year mirroring last year, cocoa producers are starting to feel the pinch. Transmar Commodity Group is one such casualty, the company filed for bankruptcy at the end of last year citing poor trading conditions with debts totalling $413million, stating that unfavourable forward contracts were the reason for the accumulation of rapid losses.

Aside from Transmar, consumers have become frustrated by the shrinkage in the size of confectionary items and chocolate bars, as recent high bean prices have reduced confectioner’s profit margins, prompting a reduction in size rather than hike in price. Companies such as Mondelez who famously reduced the size of the Toblerone bar last year continue to face increasing costs due to high cocoa prices compounding the impact of currency volatility.

Over the last 12 months spot cocoa butter prices for natural African type cartons have fallen to $5,208 per tonne as of the 6th of February, after peaking at $8,000/tonne in Q4 2016. The current spot price is trading below 10 year average of $5,868 per tonne. However, confectionary groups are still squeezed by price increases for other inputs such as sugar, which had a strong year, up 34%

throughout 2016 to 19.25¢/lb, may go some way to negate the impact of falling spot cocoa butter prices. The declines for cocoa beans and butter suggest that there still could be some benefit accrued to producers from lower input prices however; there will be some lag until these lower prices filter through to end users.

Cocoa Merchants Natural African Cocoa Butter Spot Price: *Remains elevated despite the decline in Q4 '16*

Source:Bloomberg

Stagnant Global Demand

"For the 2016/17 season, demand may rise 1% y/y with a further 1.1% y/y increase projected for the following year"

ICCO data indicates that global consumption growth could remain under pressure for the foreseeable future. For the 2016/17 season, demand may rise 1% y/y with a further 1.1% y/y increase projected for the following year. In comparison to 2013/14 season when consumption increase 3%, these growth rates are lacklustre, and we believe the slower growth to be attributed to the rise in prices as companies attempt to pass on higher costs to the consumer.

Europe as a continent accounts for 40% of global demand and this market share looks set to remain firm despite changing consumer trends. Sales statistics in the region suggest that consumers in the continent purchase goods less frequently and are favouring more innovative bars. Craft chocolate has increased in popularity in recent years along with consumers preferring products with a higher cocoa content. Moving forward this change in trend towards higher quality items is likely to put a floor on prices and offset any material drop in sales volumes.

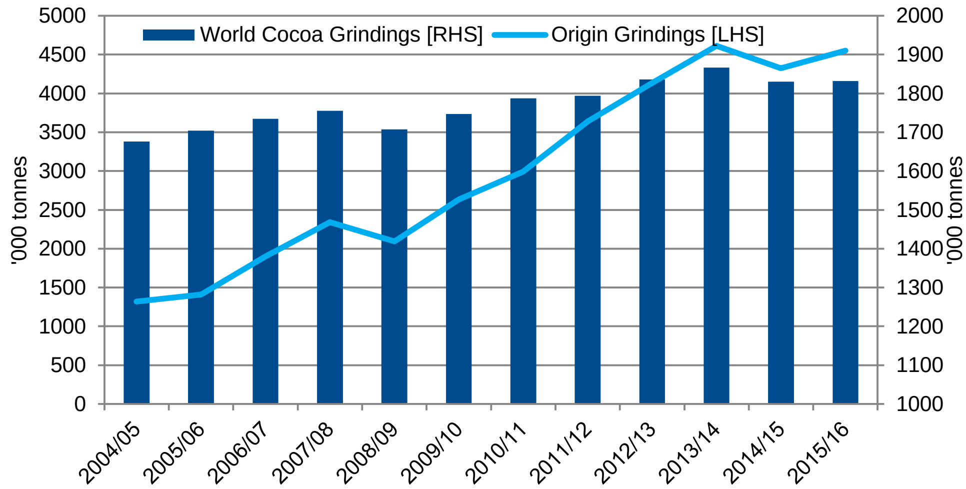
…"this change in trend towards higher quality items is likely to put a floor on prices…"

Despite coming from a very low base, consumption in Asia is a bright spot for the industry amid stagnant growth data elsewhere. ICCO figures suggest annual per-head consumption in China and India is below 100g compared to Germany, France and the UK which consume between 3.5-4.5kg per head. Future demand in Asia has vast potential; however, with demand for cocoa products coming from a low base, economic uncertainty would present a significant headwind to what is seen as a non-essential item in these countries. Subsequently retail volumes of chocolate in China were weak last year and fell 4% y/y to 122,000 tonnes, despite final quarter grinding figures up 16.9% on the previous year.

Brazil, a marginal producer with 140,000 tonnes last season, has seen a sharp fall in cocoa consumption as the country goes through an economic recession. Demand has fallen by a cumulative -12.6% since 2014 due to unfavourable economic conditions however ICCO figures suggest that decline is likely to steady a -2.8% this year with growth returning next year at a rate of 2.2%.

Grinding data released by the ICCO at the end of 2016 shows a rebound in Europe. Grindings, a good indicator of demand, grew 1.5% last season to 1,344,092 tonnes.

Total World Grindings vs Origin Grindings: *Origin Grindings improved dramatically in recent years*



Source:Bloomberg

The Netherlands took the top spot with 520,000 tonnes and was closely followed by the Côte d'Ivoire where grindings fell 48,000 tonnes to 510,000 tonnes. Despite last year's decline, which we attribute to weaker production, Côte d'Ivoire grinding has been growing steadily in recent years. Origin grinding has been an increasing trend across the globe, most notably in Indonesia as investment flows improve the facilities and infrastructure in these areas.

"Origin grinding has been an increasing trend across the globe..."

However, recent unrest in Cameroon and the Ivory Coast has prompted some companies to rethink spending into new and existing factories as concerns of future instability weigh on investment decisions. If the political unrest continues, we expect to see the cocoa industry suffer which would not only impact grinding figures but would prove detrimental to the typically smallholder producers in the region.

The US closed the year on the back foot with grindings down 1.1% from the previous year to 117,588 tonnes. This rounded off a disappointing year for North American grinding as output fell for the second year running to 395,000 tonnes. This equated to growth in the retail market of 0.6% y/y in 2016 which remains poor compared to the previous year's performance, this growth is expected to continue with total consumption in the US forecast to improve to 745,000 tonnes this year.

Geopolitical Highlights

Political stability in the Côte d'Ivoire continues to strengthen as President Alassane Ouattara galvanizes his government's positions during the second 5-year term of his presidency. Since his victory over Laurent Gbagbo in 2010 which sparked widespread unrest, leaving thousands dead and many more displaced, stability has returned as the former IMF economist has attempted to bring about sweeping reforms in an effort to develop and modernise the West African nation.

"…stability has returned as the former IMF economist has attempted to bring about sweeping reform"

Such reforms will no doubt take some time to be drafted and passed and as such the nature of the Ivorian economy has changed little since the 1980's – as a market-based, agricultural cash crop economy reliant on smallholder farms.

Threats from Islamist militant groups remain a key concern for the ongoing stability not only in West Africa but the continent as a whole. Last year's attack by the North

African branch of al Qaeda in Grand Bassam was the third attack in West Africa in four months and while the security forces have taken extensive measures to bring peace to the region, attacks have continued in West African neighbours Mali, Nigeria and Niger.

A potential flashpoint for unrest in West Africa is Cameroon, where a government crackdown on civil unrest is underway. While the Côte D'Ivoire leads West Africa and indeed the world in cocoa production, Cameroon is forecast to produce 250,000 tonnes in the 2015/16 season making it responsible for just over 6% of the world's gross cocoa production.

Internet access to English speaking parts of the country have been cut in recent weeks, prompting concerns from the UN who called it an "appalling violation" of the right to freedom. Civil unrest and street protests against the government have been ongoing since mid-January and while currently localised to Anglophone regions there are real concerns that public sentiment may radically swing against the government, presenting some risks to cocoa exports over the year ahead.

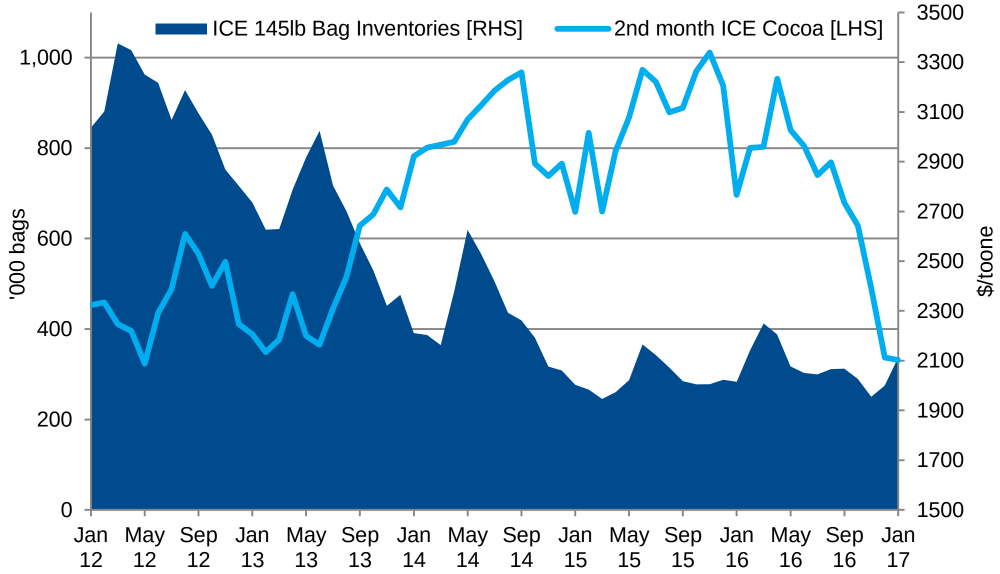
"...presenting some risks to cocoa exports over the year ahead."

Stronger Supply Outlook…For Now

With the 2015/16 season ending in a 212,000 deficit we expected to see a greater draw down in global cocoa bean stocks. In contrast, year ending stocks remain elevated at 1.447m tonnes down from 1.597m. The weak demand outlook explains the stubbornly high stocks however the current figure is still below the 20 year average of 1,549,000 tonnes. With global demand under pressure and expectations for this year's production to return a surplus, albeit a small one, stocks could remain at high levels keeping a lid on prices.

"…year ending stocks remain elevated at 1.447m tonnes down from 1.597m."

ICE Cocoa Stocks vs 2nd Month Cocoa Price*: Stocks increased slightly after last year's deficit*



Source:Bloomberg

The 2015/16 season in Africa was hampered by supply side shocks as the combination of El Niño and strong Harmattan winds hit West African supply, particularly impacting the Côte d'Ivoire which fell 15.9% from the 2014/15 season due to a weak mid-crop. Although some of this shortfall was offset by Ghana's improved output by 6.1% y/y and Cameroon's by 16% y/y as the world's leading producer accounting for some 40% of global production, any downward revision for production in the Côte d'Ivoire is likely to have a bigger impact on price volatility.

"…prospects of a late Harmattan wind ruining their crop for a second year running."

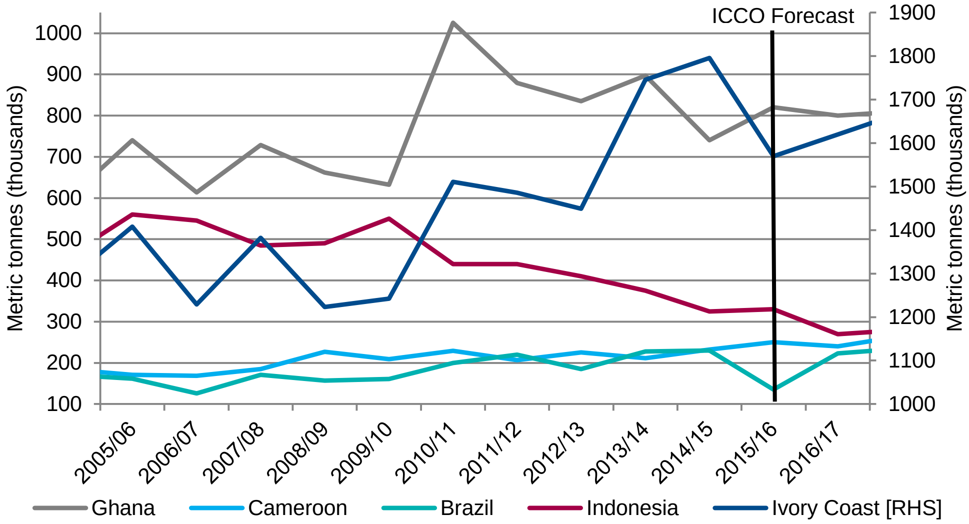
With West Africa accounting for 74% of world cocoa output any adverse weather conditions could have a material impact on cocoa markets. Farmers are growing increasingly concerned about prospects of a late Harmattan wind ruining their crop for a second year running. The strong dry winds typically fall between December and March; and producers have already experienced a short spell of unfavourable weather in January. The dry conditions hit late last year and there are fears this could be reciprocated in the coming weeks lowering bean quality and yields.

Looking ahead, the prospect of La Niña whet the appetite of market participants as cocoa production was expected to improve owing to the weather phenomenon. While recent data from the National Oceanic and Atmospheric Administration indicates La Niña conditions are present, their presence is weak at best and is likely to transfer to neutral in the coming weeks. Subsequently any negative impact from a particularly dry Harmattan season on cocoa crops will likely be limited, owing to a modest La Niña, strengthening the case for a strong production year.

"…the main crop forecast at 1.4m tonnes and mid-crop 500,000 tonnes."

The Côte d'Ivoire has shown signs of robust output this season with the main crop forecast at 1.4m tonnes and mid-crop 500,000 tonnes. Reports from Cocobod have suggested that Ghanaian output may have to be written down closer to 800,000 tonnes. Swollen shoot disease which limits the yield of cacao trees has destroyed 17% of tree stock and market participants are wary of any further downward revision. The main crop in these areas reaching maturity towards the end of this month the industry will have a better idea of this year's yields.

Top Cocoa Producers: *Favourable conditions could see production booosted*



Source:Bloomberg

The recent price slump has been catastrophic for exporters who are unable to honour contracts; reports suggest as much as 80% of contracts bought cannot be fulfilled as speculators are caught off guard by the aggressive price swings. Le Conseil du Café-Cacao (CCC), the industry regulator, has been told by exporters that they can only ship as much as 50,000 tonnes of cocoa with 350,000 tonnes unable to be honoured. Since December, trucks loaded with cocoa have been parked at ports with reports in major newswires also suggesting farmers are stocking cocoa as they are unable to sell it.

The CCC is looking for compensation to the tune of $162 million due to losses on bean prices, which may result in the stabilisation fund being used. The regulator

"…exports for the first 3 months of the season have fallen 15% y/y for the Côte d'Ivoire"

has attempted to assure market participants that they have sufficient funds which have not yet been used to support cocoa sales. Subsequently, exports for the first 3 months of the season have fallen 15% y/y for the Côte d'Ivoire to 305,125 tonnes. The arrivals of beans at ports through to the end of January were also down albeit only by 1,000 tonnes to 1.1m tonnes. Ghanaian figures were again poor with Cocobod reporting bean purchases up until January 19th down for the current season to 611,763 tonnes from 621,661 tonnes.

Fragmented Supply Chain

Falling prices could impact next year's outlook as farmers divert planting to more profitable crops. In Peru the government is particularly worried that farmers will return to illicit plantings. Even though farm gate prices have risen in recent years, the percentage of the final price that farmers receive has fallen due to increasing input costs as well as cost inflation further down the supply chain. Attempts have been made by regulators to make sure the livelihoods of farmers are protected. The minimum price for cocoa this coming season has been set by the CCC at 1,100 Central African Francs per kg (CFA Franc) $1.77/kg.

"Younger farmers are opting for other crops which are more profitable or have moved to cities."

Fairtrade reported that farmers in the two main producers, Ghana and Côte d'Ivoire, live on less than $1 a day. Subsequently the industry continues to struggle in its efforts to attract new farmers, especially those of a young age. Younger farmers are opting for other crops which are more profitable or have moved to cities. The introduction of the minimum price received by farmers is a step in the right direction and has boosted confidence amongst farmers; however, longevity under the current smallholding format threatens the longevity of the farming industry without radical reforms.

The World Cocoa Foundation reports that there are 5-6 million cocoa farmers around the world however approximately 45 million people depend on the industry for their livelihood. The majority of these farms (approximately 80%) are only 2-5 hectares and often run with outdated techniques magnifying inefficiency in the industry.

"The geographical location of cocoa farms is also a threat to future price action."

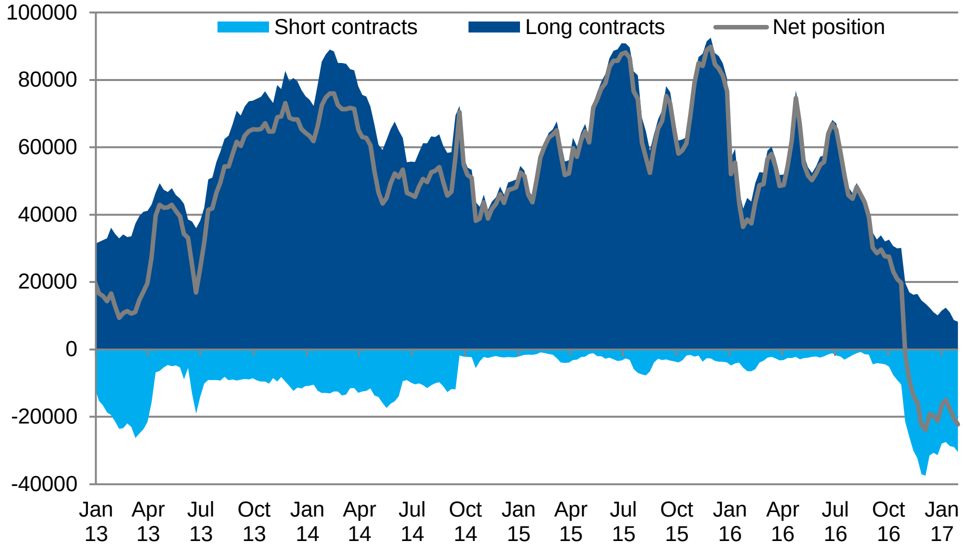
The geographical location of cocoa farms is also a threat to future price action. With a significant proportion of production originating in West Africa the increasing volatility of weather patterns will have a greater impact on traded contracts. Persistent reliance on West Africa to produce the bulk of the world's cocoa is likely to result in land degradation and cultivation of land not suitable for cocoa planting. We have started to see this in the Côte d'Ivoire, increasing the risk to supply in the long term which in turn may lead to increased price volatility.

However, there is growth potential in some Latin American countries which have ideal climates for cocoa. So far though, little has been done by regulators in these areas to incentivise production. The World Cocoa Foundation and Fairtrade have set out programs in an attempt to address these issues within the Industry. Educating farmers has shown positive result in Africa with Fairtrade implementing a process whereby farmers are taught about financial management, agricultural practices, governance and gender and child labour. Cargill have also taken steps to insure child labour is prevented in West Africa.

"…remains key that investment into new technology and techniques is at the foreground of this movement"

Although there in an increasing awareness in the industry of what needs to be done to ensure the safety of future cocoa supply, it remains key that investment into new technology and techniques is at the foreground of this movement. Investment could be impacted by adverse weather and price volatility which may see investment flows into the cocoa industry wane. Ghana has recently attempted to rekindle their relationship with China after the China Development Bank agreed to a $3bn loan facility in 2011 however, so far only $1bn has been received.

LIFFE Commitment of Traders: *Money managers huge net long has diminished*



Source:Bloomberg

Technical Analysis

NY: Activity in second month cocoa futures on the ICE US exchange has traded in a narrow downward channel since mid-2016, after peaking at $3,240/tonne in Q2 of last year. Support towards $2,800 briefly attempted to prevent any further downside moves in Q3, however, downside momentum proved too strong. Heavy selling throughout Q4 pushed second month futures back below $2,200, registering the worst annual loss for 2nd month cocoa futures on record, down 34% in 2016.

This year has started on the back foot as **resistance posed by the downward trend channel shows no signs of being breached**. Selling on higher volumes has dragged futures below $2,000 for the first time since December 2011.

Near term support in the form of a previous low stretching all the way back to 2008 could offer some **temporary support around 1884**. However, the current outlook suggested by the technical indicators suggests further downside momentum in the near term.

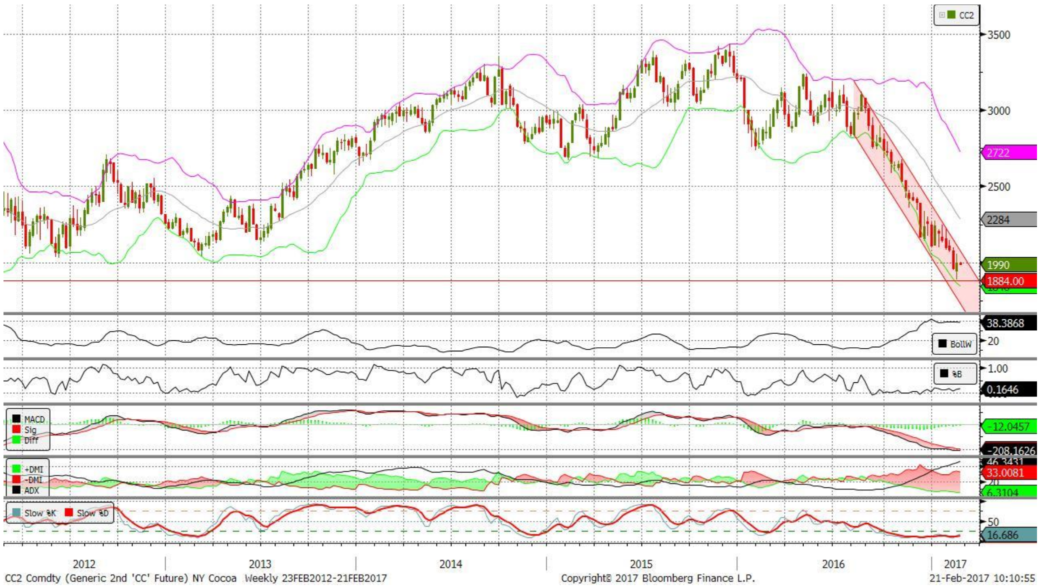
An ADX of 44.6475 underlines the strength of the current trend with the -DMI well above the +DMI, far in excess of the 25 points needed to confirm the current bearish outlook. Since 1990, there have only been two other occasions where the ADX has pushed above current levels, one in a bull market and one in a bear market. In studying these past trends, particularly the bear market moves, **losses can persist for a sustained period and with current momentum showing no signs of slowing down we could see further selling** throughout the remainder of Q1.

The MACD indicator reinforces the current strength of sentiment with the indicator touching its lowest level since December 2011 while both the RSI and slow stochastics confirm the downside outlook.

We are (very) hesitant on the approach towards previous lows at 1884, and while this has been supportive in past moves, with momentum so firmly on the downside prices may struggle to hold around here.

The lower Bollinger bands have failed to offer any meaningful support on recent tests and **we anticipate volatile trading to dominate the months ahead**. On the long term weekly candlestick chart the Bollinger bands have widened steadily throughout the second half of 2016 with the upper Bollinger band only recently starting to close the gap. This could provide additional downward pressure as the Bollinger moving average closes in, potentially capping any limited recovery

New York 2nd Month



Under the current trajectory, **futures are targeting levels towards 1730-70 by the end of Q1 2017**, coinciding with previous highs and lows. We would hope for some consolidation around this level if 1884 is breached and any test of near term resistance and subsequent move lower will only continue to reinforce the bearish outlook.

London: A similar year for London listed second month cocoa futures as prices topped out in June last year, triggering a somewhat staggered trail lower throughout H2 2016. Futures attempted to hold onto support towards £2,200/tonne and again at £2,000, where sideways ranges dominated trading activity for some weeks.

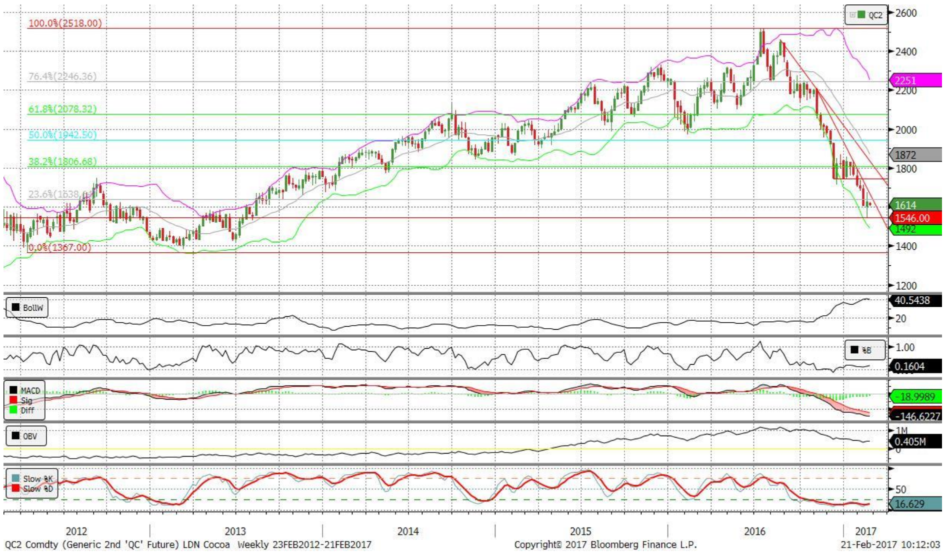
However, the market remained unconvinced and after some modest reversals, momentum on the downside was reaffirmed and futures were dragged lower, ending 2016 year below £1,800/tonne, a level last seen in May 2013.

After struggling to hold onto £1,800 2nd month London cocoa futures have mimicked Q4 moves, trading sharply lower and breaching £1,550/tonne for the first time since February 2013**. Futures seem to have entered an accelerated downward trend** with technical indicators predicting an under pressure outlook throughout the first half of the year.

Looking at the **ADX downside momentum continues to build** despite coming off of recent highs towards the end of last year, the spread between the -DMI and +DMI continues to widen, reaffirming the underlying strength of the downward trend.

The MACD indicator confirms the negative outlook and after a momentary respite at the start of the year which saw some modest improvement albeit still oversold, the MACD continues to extend lower trailed by the signal line. Both the RSI and slow stochastics converge on the bearish outlook and with stable trading volumes after the December lull we could see losses extend lower in the coming months.

London 2nd Month



The wide spread between the Bollinger bands suggests a continuation of volatility, with the upper Bollinger band only recently responding as it starts to drift lower. Additional near term resistance offered by the Bollinger moving average as it drifts lower towards 1800 could cap any hopes of a retracement and trigger further selling over the coming months.

Assessing recent activity, **the mid-February dip below 1600 could prompt a modest recovery and consolidation around this level for the remainder of the month**. Tentative support here could prompt some sideways trading, similar to the recent activity around £2,200, £2,000 and £1,800. However, if downside momentum holds, London cocoa futures could next target levels between 1490-1500, an area of previous consolidation.

Downside Pressure Will Dominate

In summary we anticipate global demand to remain under pressure until lower prices filter through to end users. However, in economies where chocolate is a non-essential good we expect demand to be more sensitive to changes in income per capita.

With this taken into account as well as forecasts for a strong production year owing to favourable weather conditions, we expect prices to remain under pressure in the coming months as the season materialises, an outlook that is confirmed in the technical analysis. Having said that, any political unrest and risk of late Harmattan winds could potentially see a short term spike higher, however due to high levels of global stockpiles ample supply will likely cap any material upside potential.

"…high levels of global stocks the fundamental outlook is likely to cap prices upside potential."

With farmers unable to plan for next year due to the current situation in the Ivory Coast and some favouring more profitable crops, we may see prices end the year on the front foot as current low prices act as a tailwind for demand and next season's production is threatened. As with the downside moves that have dominated the last three quarters, we anticipate further spikes higher on likely short covering.

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