What's In The Bag?

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Summary

• Growth in coffee consumption has been slowing in more established western markets and traditional drinking formats, but this is being offset by rapid demand growth in new industry segments and emerging coffee markets.

• Consumption patterns vary significantly across age demographics, with the millennial generation driving many of the current trends in coffee drinking.

• Coffee futures have been subject to significant speculation, contributing to a fall in price of 13.5% YTD. Managed money positions remain near November's record short of 48,905 contracts, and we expect this, alongside weather, will continue to drive price volatility.

• We see the 2016/2017 harvest at approximately 156.3m bags, with demand at 156 bags. We expect production will fall to 154.4 in 2017/2018 with demand increasing to 158.

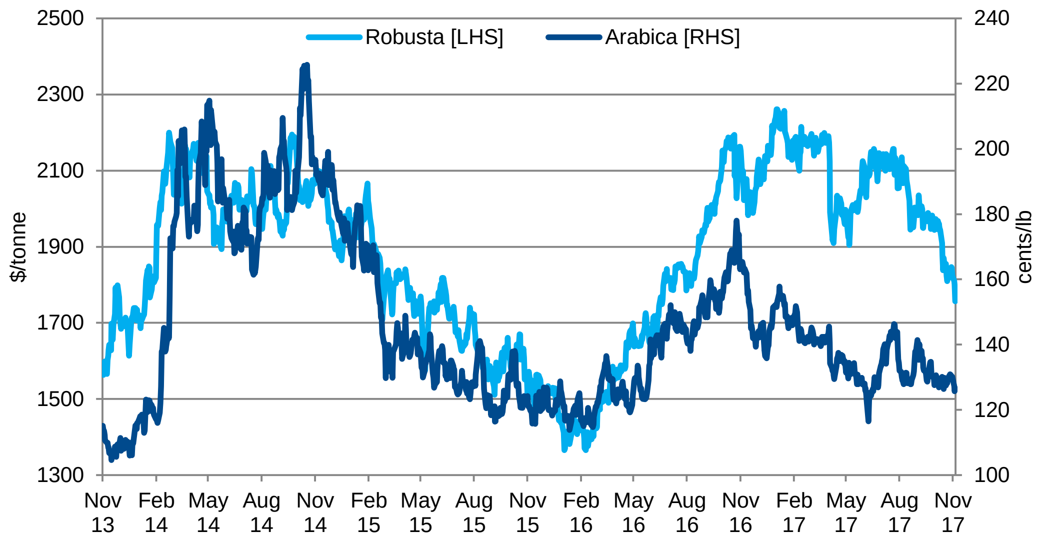
• We expect a slightly smaller Brazilian production of 50.6m bags for 2017/18, the following crop in 2018/19 is expected to be significantly higher at 58-60m bags.

• Weather remains influential to the supply side, and has hampered recent production. While farming practices have improved the resilience of the crop, the increasing likelihood of the La Nina phenomenon forms a slight concern to the 2017/2018 harvest

• While we expect the a large Vietnamese crop of 28.1m bags for 2017/18, there may be some quality concerns due to persistent rainfall and mold growth, with potential for high OTA levels.

• Colombia production has benefitted significantly from improved farming techniques; however, with a large harvest last year, we believe tree stress will bring 2017/18's crop slightly lower to 14.5m bags. The rising possibility of La Nina presents further downside risk.

Arabica 2nd Month vs Robusta 2nd Month: *Both coffee contracts have spent the year under pressure down 8.8% YTD and 17.9% respectively.*



Source: Bloomberg

"Second month Arabica futures contract fell 7.62% YTD to 129.7USd/lb…"

Coffee prices have plummeted over the last year, extending a decline that began in December 2016. Second month Arabica futures contract fell 7.62% YTD to 129.7USd/lb, while Robusta saw a similar 17.9% decline. This is broadly in line bearish sentiment across soft commodities as a whole, with the Bloomberg Softs subindex falling 17.6% YTD. The slide has eroded gains made over 2016 and we expect to this pattern continue into 2018.

Demand: Millennials Espresso Their Feelings

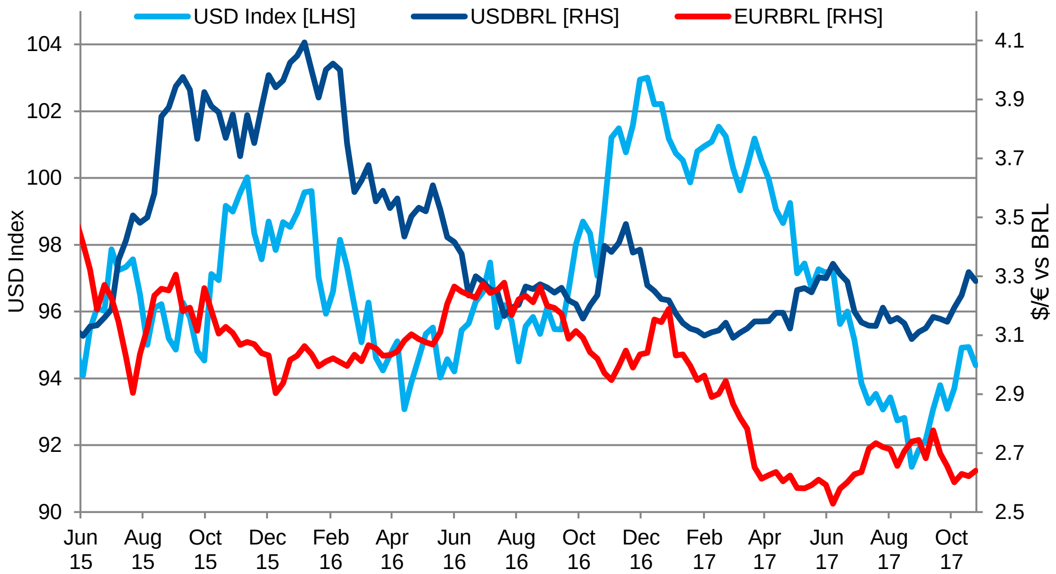
In recent years, steady growth in global coffee demand and a number of supply side issues have produced continuous deficits. However, prices have been depressed over the past year on the back of high stock levels in consuming countries and an increasingly bearish managed money net position as investors anticipate strong supply in the coming years.

Global demand for coffee has grown steadily over recent years, with ICO figures showing compound annual growth (CAGR) of 1.9% between the 2012 and 2016 crop years. Consumption has remained on this steady growth trajectory over 2017, supported by firmer economic growth in major importers, fresh demand from emerging coffee markets, and dollar depreciation. We believe global demand stands at an estimated 156m bags for the 2016/17 crop year, and we expect this will grow 1.3% to 158m in 2017/18.

"…we expect demand growth will accelerate to an average of 2% over the coming years…"

This slowdown is attributable to lacklustre demand growth in more mature western markets, and the increasing maturity of the coffee pod segment, which drove 91% of all hot beverage growth between 2012 and 2016 according to IRI data. However, we expect demand growth will accelerate to an average of 2% over the coming years as rising consumption in less established markets, particularly China, offsets stagnating sales in the EU and US.

USD Index vs USDBRL vs EURBRL: *The BRL continues to trend lower against the USD & EUR but a. USD weakness on the whole could support coffee prices.*



Source: Bloomberg

The US, EU and Brazil remain the largest markets for coffee, accounting for approximately 88.4m bags of consumption in 2016 according to ICO statistics. However, growth in coffee demand is cooling noticeably in these economies, as the maturity and saturation of these markets begins to exhaust remaining opportunities for structural growth.

According to Mintel, coffee shop openings, a barometer for demand growth, have slowed in the US to growth of 2.17% per year, the lowest rate since 2011. There are currently an estimated 33,000 coffee shops in the US, and to address such crowded retail market, a number of coffee chains have targeted overseas expansion and sales of higher margin gourmet coffee.

"…less established coffee markets have seen significant growth in consumption in recent years"

In comparison to the US and EU, less established coffee markets have seen significant growth in consumption in recent years, spurring some investment interest. Consumption in exporting countries is estimated to rise at a CAGR of 4.5%, supporting global demand. China is a particularly large potential market, with demand rising 45% over the last three years to 3.16m bags in 2016/17.

There remains significant potential for further growth, with consumption trends similar to those in Japan from the 1960s onwards, and demand concentrated in younger consumers. Chinese per capita consumption averages 4-5 cups/year, rising to 150 cups in the Hong Kong region. Comparatively, Japan's annual per capita consumption reached 207 cups in 2014 (Euromonitor).

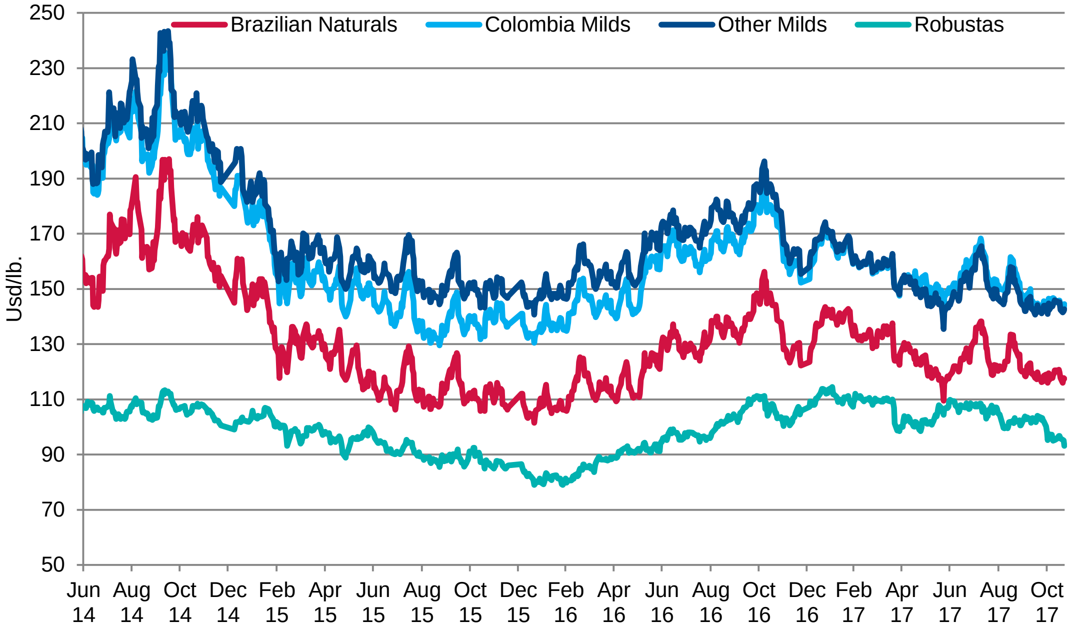
"We believe China will experience consumption growth in excess of 14%p.a. over the next few years"

This potential has spurred investment from coffee chains, with Starbucks and Whitbread targeting a Chinese store presence of 5,000 and 700 respectively by 2021. We believe China will experience consumption growth in excess of 14%p.a. over the next few years, with the Chongqing exchange expecting 5m bags consumed by 2020.

"…we expect Chinese production to respond to the improvement of domestic consumption."

Demand growth in emerging coffee markets may spur significant tightening of the fundamentals over the coming years, particularly for the Robusta bean, which Euromonitor suggests makes up over 90% of Chinese coffee sales. However, we expect Chinese production to respond to the improvement of domestic consumption.

ICO Indicator Prices: *Despite a brief spike in July/August prices have been on a downward trend.*



Source: Bloomberg

Consumption Trends

"..62% of Americans drink coffee on a daily basis…"

Over the last few years, growth in global demand has been predicated on a number of significant shifts in coffee drinking trends and demographics. The frequency of daily consumption continued to grow across all age groups, with National Coffee Association NCA) data showing 62% of Americans drink coffee on a daily basis, up from 57% in 2016. Growth in consumption was strongest in the 13-18 age range, whose consumption rose to 37% from 31% in 2016. These figures are more pronounced in specialty coffee, with gourmet coffee accounting for 70% of sales to the 13-18 age group, and 59% of total sales in the US, according to the NCA.

Similarly, specialty coffee has gathered significant attention in the European market, spurring a wave of consolidation in the industry as retailers target a stake in the gourmet market. Recent acquisitions include Blue Bottle and Chameleon Cold-Brew Coffee by Nestle, and Intelligentsia Coffee & Tea by Keurig.

This growing preference for specialty coffee, termed the 'third wave of coffee', is likely to place pressure on higher quality Arabica beans. We expect this trend will weaken demand for Robusta as roasters favour Arabica beans. However, rising demand from Chinese markets for Robusta is likely to offset this in the medium run.

"The increasing maturity of coffee pods in the primary US and European markets has limited further growth…"

Coffee pod sales have been a significant driver of global demand growth in recent years, with NCA data indicating that ownership of a single-cup brewer reached 33% in the US, up from 29% in 2016. According to IRI statistics, single-cup coffee accounts for 41% of retail sales in the US. However, growth in this segment has shown signs of slowing recently. The increasing maturity of coffee pods in the primary US and European markets has limited further growth, with household penetration of coffee machines already at high levels.

The environmental sustainability and cost of the aluminium coated pods has been an additional cause for concern, with Mintel reporting that 17% of US consumers view pods as environmentally damaging, and 34% believe they are expensive. Pod sales grew 3.7% in the 2016/17 crop year, compared to 5.6% the year prior.

While slowing growth in pod segment may drag on overall demand growth for coffee, we expect this will likely be offset by rising sales of gourmet coffee in coming months. The ready to drink segment, currently 20% of coffee sales, represents an additional source of potential growth, with participants including McDonalds, Starbucks, Dunkin and Coca-Cola. In the US, sales in this category doubled between 2011 and 2016, and are forecast by Euromonitor to grow 13% over 2017.

Macro

"…globally, annual imports rose 1.2% in the 2016/17 year."

Economic growth and FX have provided supportive tailwinds for coffee consumption. While consumption has historically been fairly inelastic, depreciation in the dollar over 2017 has provided some support for demand, with the DXY briefly hitting a low of 91 in September. The ICO indicates that globally, annual imports rose 1.2% in the 2016/17 year. The dollar has stabilised in recent months the dollar and currently stands at 94.5. A continuation of this recovery may slow demand growth as coffee imports become more expensive.

Economic growth has firmed in major economies, with employment figures posting record highs in major coffee markets over the last year. We expect this growth will continue over the medium term, providing support for coffee consumption.

Given consumers will likely face higher prices and a significantly greater mark-up under the 'third wave of coffee', price elasticity of demand over the coming years may potentially be significantly higher than long-term norms. Consequently, a slowdown in growth or falling employment levels could significantly hinder further growth in consumption, particularly if demand from the more financially vulnerable millennial demographic falls.

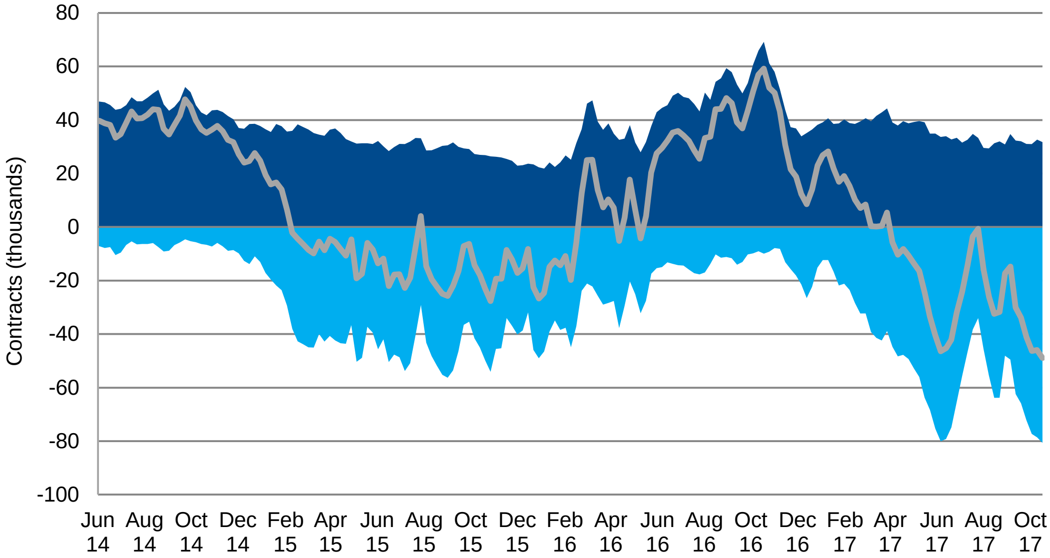
Financials

The ICE Commitment of Traders report underlines the significant shift in market sentiment over the last year. Managed money net positions fell from an all-time high of 59,252 contracts long in November 2016 to an all-time low of 48,905 short in October 2017, as bearish sentiment prevailed in the market and coffee prices extended their decline.

This is in line with market sentiment across soft commodities as a whole, with cocoa and sugar showing similar bearish reversals. Recent price action in coffee may have been significantly exaggerated due to these high levels of speculation, and we expect this volatility will persist over coming months as funds hold highly exposed short position. There remains potential for a sharp rally in coffee futures if we see a surge in short covering. Open interest underlines the amount of speculative froth currently present in the market, with managed money open interest at 119,407 contracts at time of writing, accounting for 49% of market open interest.

"There remains potential for a sharp rally in coffee futures if we see a surge in short covering."

Commitment of Traders Managed Money Net Position: *Speculators have reversed their net long position to a net short.*



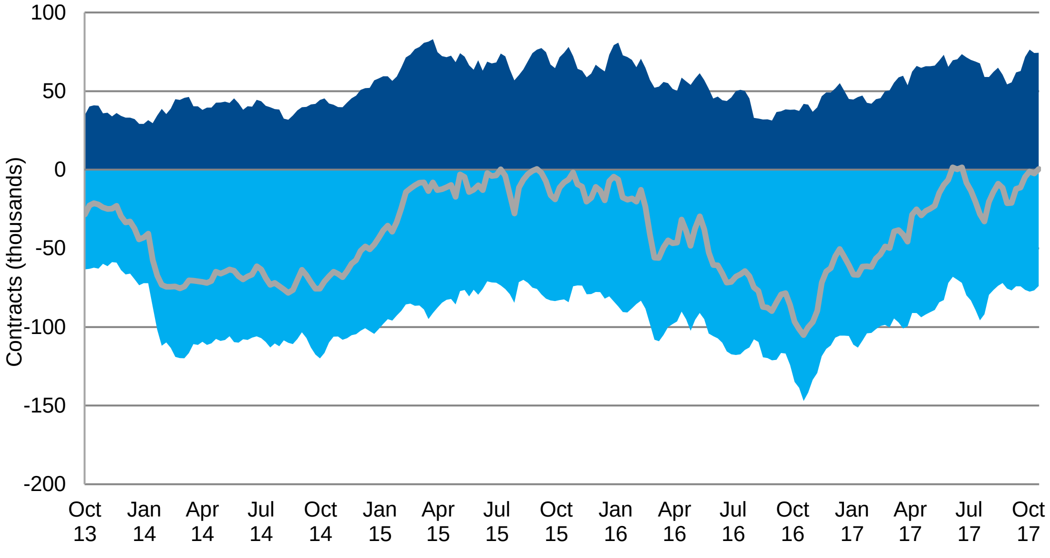
Source: Bloomberg

In contrast to manged money, commercial net length has risen to a slight short of 8,034 contracts at time of writing, compared to a much larger short of 106,000 in August 2016. This reflects the dynamic of falling coffee prices, as roasters have capitalised on the downward trend to lock in prices at lower levels, while growers have cut their short positions, showing a lack of appetite for current prices.

ICO data illustrates this reluctance to sell, with exports from Brazil and Vietnam falling 8.8% and 6.4% respectively between the 2016 and 2017 crop years. As we head into an off year in Brazil and global demand continues to climb, there remains some potential for tighter fundamentals and upwards price pressure. If higher prices materialise, this may prompt an increase in the commercial net short as producers resume selling.

Trading volumes for coffee futures have fallen slightly as prices have declined, albeit from a high base. ICE exchanges recorded a YTD average of 15,645 daily transactions for 2nd month Arabica futures, slightly below the 2016 average of 16,442. However, international interest in the commodity remains robust, with the ICE exchange registering a record high number of traders at 511 in November, and volume growth remaining strong in the recently established Yunnan and Chongqing coffee exchanges. Consequently, the liquidity of coffee futures market is expected to remain robust going into 2018.

Commitment of Traders Producers and Merchants: *Net short position has been unwound with producers unwilling to sell and merchants locking in lower prices.*



Source: Bloomberg

Supply

Demand growth continues, albeit at a slower pace, but the more volatile nature of the supply side can sway the fundamental balance into a deficit. The 4 main coffee producing countries are Brazil, Vietnam, Colombia and Indonesia and weather risk can unsettle global output due to geographically concentrated nature of production. The correlation between the developing weather phenomenon La Nina and coffee is not strong; La Nina has a much greater impact on Cocoa. However, the prevailing trend of increasingly frequent natural disasters may leave a lasting impression on the coffee market. For example, a devastating storm in Vietnam could decimate Robusta coffee production for that year and following years.

"…the prevailing trend of increasingly frequent natural disasters may leave a lasting impression on the coffee market"

Brazil: Dark Clouds Looming

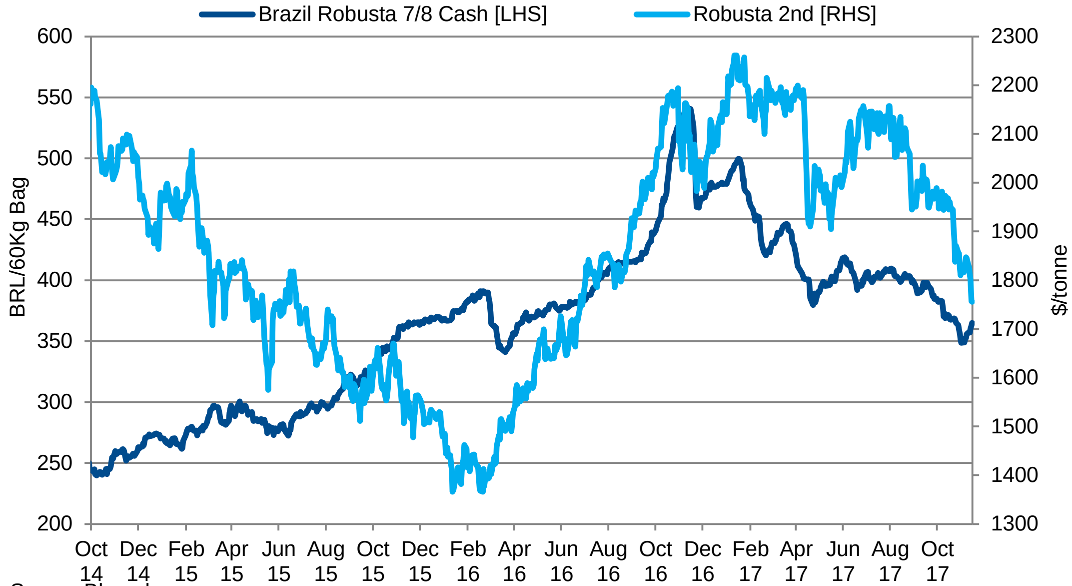
Brazil remains the powerhouse of the coffee market, producing around 1/3rd of the global crop. Indeed, the country produces both Arabica and Robusta beans, although plantings are predominately in favour of the higher quality Arabica bean. Weather concerns have dominated recent activity in the world's largest producer.

Drought caused some moderate stress to some Arabica trees; lack of sufficient soil moisture saw the market grow increasingly anxious about the condition of the coffee trees. Rains returned to key growing regions, giving coffee plantations some much needed water; however, we do not expect to assess the full benefit of the wet weather until December.

"…we increased our forcast for the 17/18 Conilon crop to 12.6m."

Brazil's Conilon crop, which is largely used for domestic consumption, has responded well to the wetter weather, therefore we have increased our forecast for the 17/18 Conilon crop to12.6m bags. As a result, apprehension amongst traders has abated prompting the Brazilian Robusta type 7/8 coffee cash price Espirito Santo to fall to R$357/bag as of the 20th of November, a decline of 25.36% YTD. On the international market, Robusta futures have remained under significant pressure with the 2nd month contract down 17.9% YTD.

CEPEA Brazil ESALQ Robusta 7/8 Cash Price vs 2nd Month Robusta: *Local prices in Brazil hold above R$350/bag as the 2nd month falls sharply.*



Source:Bloomberg

"…weak local currency in Brazil is likely to cap exports on the upside"

The biannual nature of Brazilian production betrays that the 17/18 output is forecast to be weaker as yields suffer from stressed trees. Indeed, next year's monster crop could initiate the return of Brazilian Robusta exports. The caveat, however, is that weak local currency in Brazil is likely to cap exports on the upside. In conjunction with this, we suspect government officials will want to avoid the possibility of importing coffee again. Therefore, even with a bumper Conilon crop, stocks are likely to be replenished to healthy levels before exports are considered.

"…total output for Brazil to 50.6m bags."

For the 17/18 season, we estimate Arabica production to be 38m bags, bringing total output for Brazil to 50.6m bags. Similarly to Robusta, the weather has benefited Arabica growing states. However, there remains some pressure on precipitation to increase the soil moisture to more comfortable levels, especially in some areas of Sul de Minas. Below average rainfall in this region has caused some concern over output, and if this continues until the end of the year woes would be heightened. In some regions, rain has failed to replenish reservoirs, making irrigation a concern.

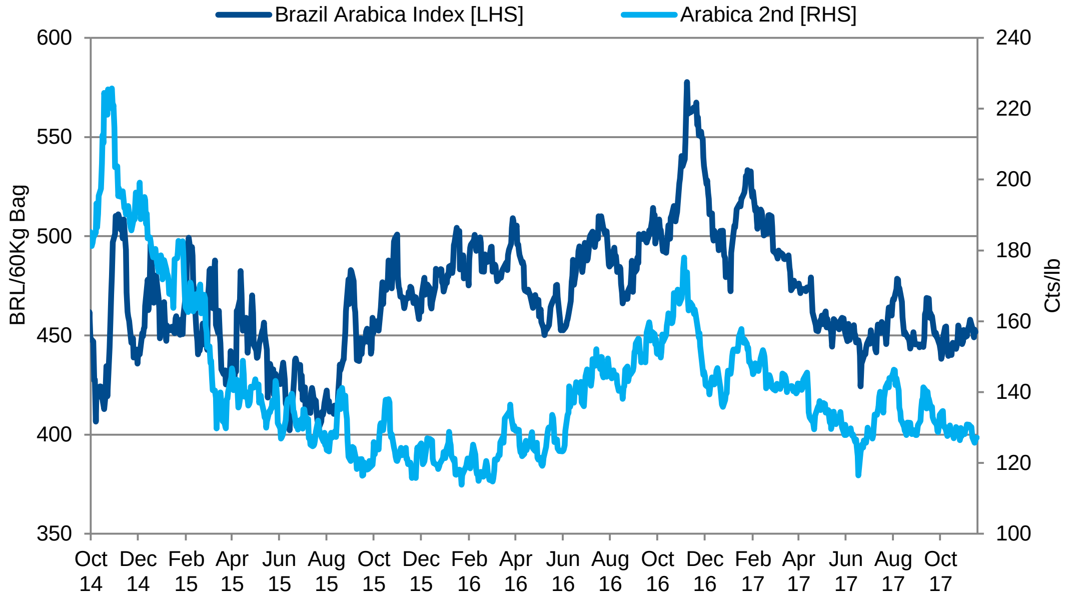
The Brazil ESALQ Arabica coffee indicator has fallen 6.6% YTD but is down 15.7% from this year's peak of R$533/bag. The domestic price remains above the 5 year average of R$420.8/bag. We anticipate the strength in Robusta prices in recent years has prompted demand for lower quality Arabica beans. Owing to this, a stronger Robusta crop in the coming years would likely exert significant downward pressure on prices and thus see consumption return to the norm.

"…near perfect weather was needed for a crop above 65m bags for 18/19…"

We believe the 18/19 Brazilian crop to be considerably larger than this year's crop. However, near perfect weather was needed for a crop above 65m bags. Despite rains arriving in the past month, in our view, coffee regions needed near perfect weather to obtain optimal yields, which they haven't received. In our opinion Brazil's crop will not surpass 65m bags for the 18/19 season and see output around 60-62m bags.

A crop of this magnitude would enable some re-stocking of Brazilian warehouses which have been depleted after years of deficit. Carry-over stocks are low which was confirmed by suggestions of Brazil importing coffee. We do not believe production for the 18/19 season will reach 70m bags, although if it did, the following crop would suffer significantly due to tree exhaustion and we believe international prices would come under severe pressure.

CEPEA Brazil ESALQ Arabica Coffee Index vs 2nd Month Arabica: *Farmers margins continue to be squeezed as local prices decline further in 2017.*

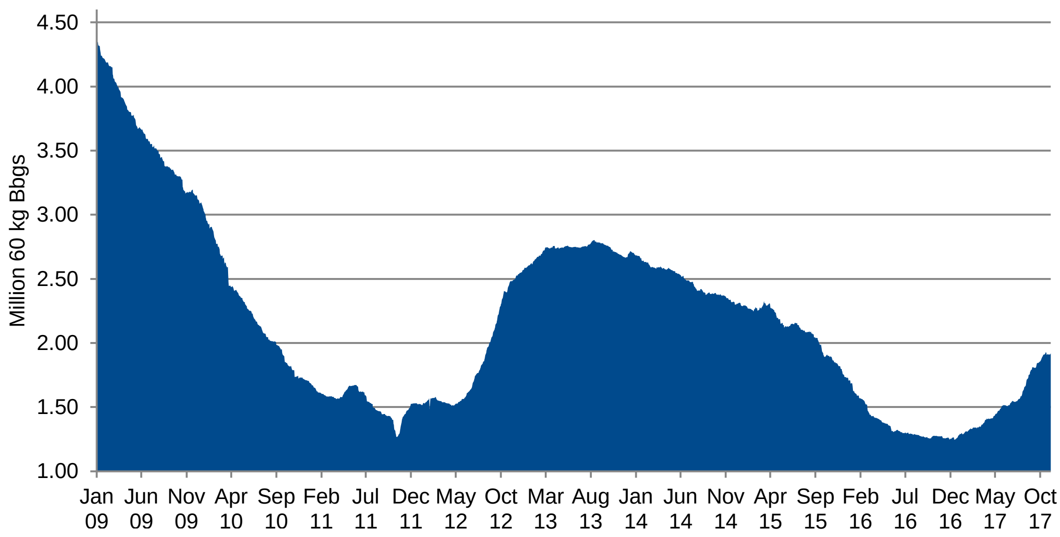


Source:Bloomberg

"20% of total Brazilian coffee exports is specialty coffee."

The logistical situation in Brazil has worsened in recent weeks causing Brazilian exports to weaken substantially year-on-year. According to Cecafe data, September Arabica shipments declined 24% YoY. However, exports in October were equally weak at 2.49m bags, down from 3.3m bags last year. This represents the fifth consecutive month of year on year decline. Contra to this, Robusta shipments improved on a year on year basis by 30% in October, climbing to 16,592 bags. Overall, shipments of coffee between July and October were 9.65m bags, down 15.7%YoY. The Brazilian Coffee Roasters' Association (ABIC) has stated that 20% of total Brazilian coffee exports are specialty coffee.

ICE Exchange Total Coffee Inventory: *Stocks have started to rise but are coming from a very low base*



Source: ICE, Bloomberg

There are plenty of moving parts which could be to blame for the decline in shipments. Santos, which is the main port for coffee exports, is partly to blame due to the delay in dredging which has caused some vessels to leave with only 80% of capacity. Due to the low availability of coffee, some exporting companies have reduced their vessel capacity by 20% to Europe and the US; whilst others have cut the number of vessels used completely. Reports out of Brazil indicate that November containers are being put on February vessels, helping to confirm the situation.

The logistical situation in Brazil has persisted for many years. Our sources suggest the balance sheets of some exporters have been hugely impacted. The weakening of the Brazilian Real has only exacerbated the situation, with some exporters struggling to stay afloat. Year after year of delayed shipments and low prices could cause some of the less established firms to go under, especially if the Real continues to weaken and logistical issues persist.

"Inability to take delivery of Brazilian coffee would see a drawdown in inventories in the EU and US."

As a result, we have seen origin stocks of Brazilian coffee depleted, with inventories in the top consuming countries rising throughout the year. Inability to take delivery of Brazilian coffee would see a drawdown in inventories in the EU and US. It is to our relief that the backlog of containers will start to be cleared as dredging issues subside.

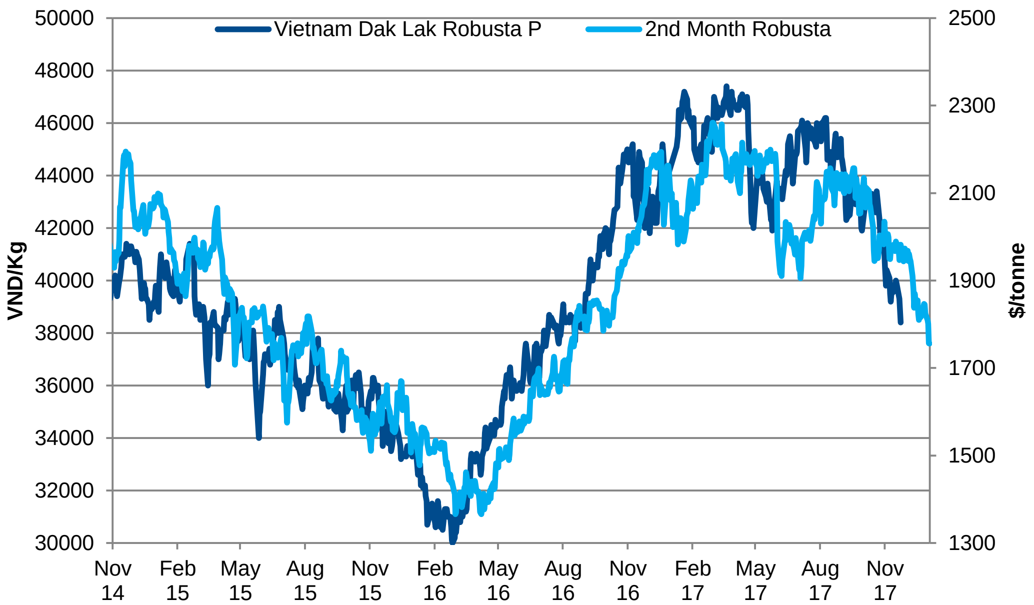
Vietnam: Look In The Bag

Weather in Vietnam continues to hamper the harvest, with only 5% of the 17/18 crop harvested at the beginning of November, we believe this number to be at least 25% now. The heavy rain has not abated as market participants first thought, fears were heightened when tropical storm Damrey hit. Coffee growing regions were only mildly damaged, much to the relief of producers. We do not believe that there was any long lasting damage to the main coffee regions and thus cherry productivity should not be heavily impacted.

"…we believe this year's crop to be 28.1m bags…"

However, persistent precipitation continues to delay the harvest as farmers are unable to pick the cherries. Lack of persistent sunlight may have inhibited the crop with some still cherries green. At first glance, the rains have not impacted the size of Vietnam's output for the 17/18 season therefore; we believe this year's crop to be 28.1m bags. Although weather has now improved, we stress that it is important to see what is in the bag.

Vietnam Dak Lack Robusta Price vs 2nd Month Robusta: *Global prices and Dak Lak prices move in unison. Prices remain under severe pressure.*



Source:Bloomberg

It is our belief that even though output is set to be strong, we anticipate a slight quality issue, albeit not to the level of last year. When there is heavy rain, farmers' use tarpaulin to cover picked cherries, this can cause the beans to sweat and when the tarpaulin is taken off excess water can fall onto the beans. This is why; the recent abysmal weather could cause high levels of Ochratoxin (OTA), known as mould.

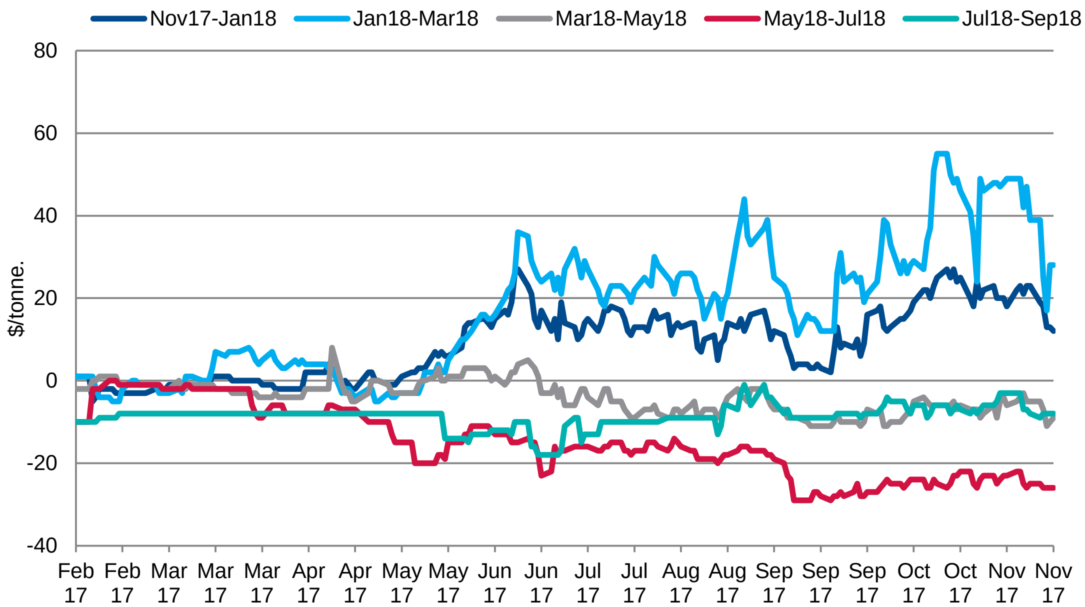
A damp environment heightens the risk of mould and as a result, we could see some downside to the 17/18 crop. The build-up of OTA in coffee beans is as a result of high moisture content. The toxin cannot always be detected by visual control because mouldy beans don't all contain OTA whilst dry beans may still contain the toxin.

"High levels of OTA in a bean mean the coffee is not exportable…"

Green coffee containing high of OTA is challenging for roasters, adding costs to the supply chain as the beans have to be cleaned. High levels of OTA in a bean mean the coffee is not exportable, thus cannot be consumed on the world stage. Any rain from here on out is not welcome and increases the chances of poor quality coffee.

Quality worries are heightened when we factor in the drying of the beans after wet weather. Producers are known to light fires near picked cherries covered in tarpaulin in an attempt to dry the beans. Smoke can gather under the tarpaulin creating a smoky taste and deteriorating the quality of the bean. In conjunction with potentially high OTA levels, the Vietnam crop may be weaker than market expectations.

Robusta Calendar Spreads: *Structure of the spreads points to lower prices*.



Source: Bloomberg

The low carry-over stocks in Vietnam need to be replenished to more comfortable levels; this reduces the amount of Robusta available for export. Indeed, even if Vietnamese output is not further hindered by heavy rain, some of the big crop others are forecasting will need to be allocated to re-stock warehouses. As it stands, the coffee in warehouses is not of a good enough quality to export. When the new crop is delivered, the old and new crop will be mixed together and then exported.

"…we do not expect exports of Robusta coffee taking off until January and February."

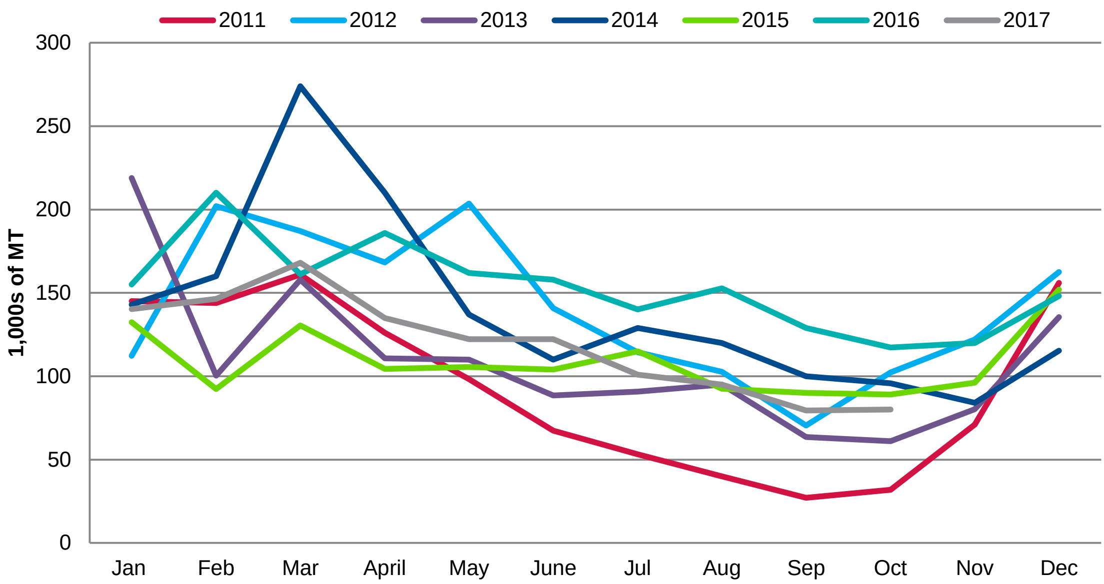
This cannot happen straight away as the samples tested before delivery of the crop will be of a better quality than the first shipment that is received from the coffee fields. As a result, we do not expect exports of Robusta coffee taking off until January and February. We expected exports would be weak in October, below the 5 year average of 82,883mt, and they were, falling 22.1%YoY to 79,078 tonnes (1.318m bags). The low stock levels and slow start to the harvest indicates that shipments will be low for the remainder of 2017.

"Vietnamese farmers are holding the stock and waiting for a higher price."

It is our belief that exports will start to pick up at the beginning of 2018; the 5 year average for shipments in the first 4 months is 156.5mt per month. As mentioned, the delayed nature of the exports this year may cause shipments to improve substantially at the beginning of 2018 and surpass the five year monthly average. The decline in global Robusta prices has meant Vietnamese farmers are holding the stock and waiting for a higher price.

Even with below average rainfall in the coming weeks speeding up the harvest; we believe it unlikely that shipments will see a vast improvement in exports. Due to the story outlined, we believe there could be some downside to the Vietnamese crop, most notably in terms of coffee quality. Even without issues, once the stocks have been replenished and an allocation exported to Indonesia, the supply and demand balance still looks tight. Although the Brazil Conilon crop will offset some of the apparent weakness in Vietnam, the balance may be tighter than some market participants anticipate.

Vietnam Coffee Exports: *Exports have fallen below 2015-2016 levels, due to wet weather and low prices.*



Source: GSO, BGC, Bloomberg, Vietnam Agri Ministry

Colombia: Practice Makes Perfect

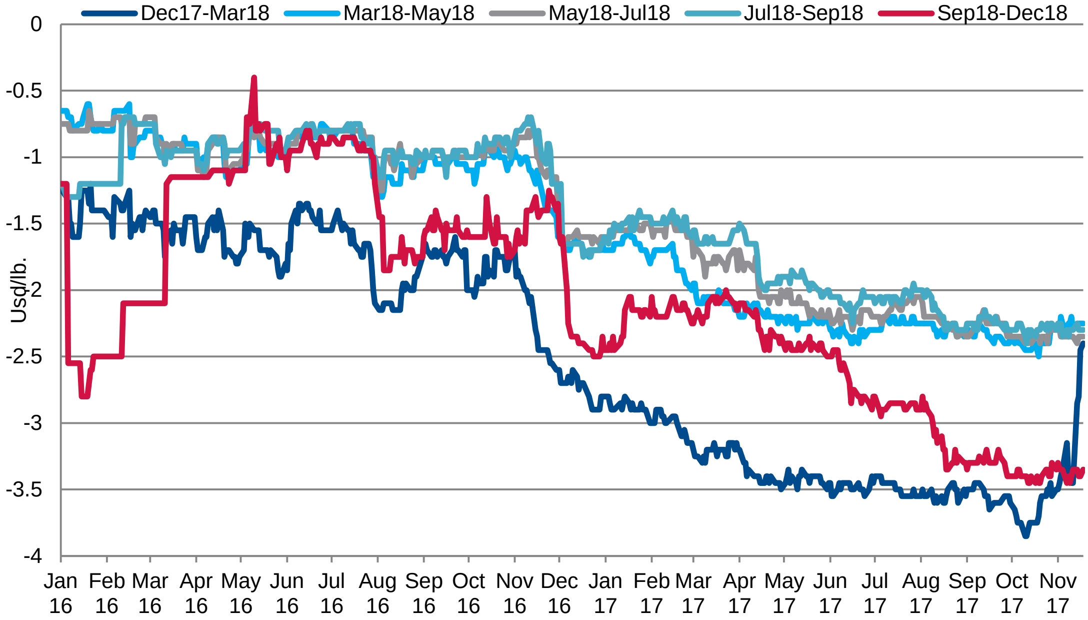
"…we see production at14.3mbags."

The recovery in Colombia's coffee industry continues, as beneficial farming practices come to fruition due to good farmer incomes in recent years. Production for the 16/17 season is at least 14m bags, and we see production at 14.3m bags. This leaves the region as the 3rd largest coffee producer in the world. All coffee produced is Arabica and whilst domestic consumption of coffee country has started to rise, Colombians traditionally do not consume heavily.

"Renovation of trees and research into new bean variations keeps production improving without impacting yields"

The South American country relies heavily on the exportation of coffee and has long been working to increase the resistance of their trees to Hemileia vastatrix, commonly known as coffee leaf rust. Renovation of trees and research into new bean variations keeps production improving without impacting yields. Overexerted trees are more susceptible to rust; causing production to suffer and a knock on affect Colombia's trade balance, with coffee representing approximately 8% of total exports.

Arabica Calendar Spreads: *Arabica spreads trend lower which is beneficial for traders who roll their position.*



Source: Bloomberg

According to the USDA's Bogota branch, Colombia's output for 17/18 will be 14.7m bags; however, we see production fractionally below this level at 14.5m bags. This is due to a softer main crop, even despite the renovations that continue to take place at a steady clip.

Good agricultural practices have benefited Colombian production with persistent year on year growth. Tree condition is good but we do not anticipate a vast improvement on the 16/17 main crop in the 17/18 season. Indeed, the strong nature of the main crop last season suggests there may be more downside due to tree stress. Output in northern regions could struggle. Weather conditions need to be favourable to ensure year on year growth in total output, and La Nina is a slight worry.

". Production for Colombia through to September was 10.3m bags"

A strong mitaca crop may help to offset a potentially flat main crop. The condition of the trees is promising, and we anticipate a strong output for this crop, helping to support total production for Colombia. Production for Colombia through to September was 10.3m bags, up 4% on the 9.9m bags produced in the same period last year. In September alone, the country produced 1.23m bags of mild washed Arabica, an increase of 19% YoY.

Federación Nacional de Cafeteros de Colombia (FNC) indicates that exports in September reached 1.4m bags, up 12% YoY. This brings the total for 2017, from January through to September, to 9.5m bags. For the 16/17 season exports rose 10% to 13.5m bags from 12.3m bags the previous year. This data outlines the strength of production; wet weather in Colombia is likely to be beneficial to the harvest, although heavy rain could lead to a delay. La Nina is associated to excess rain in Colombia and this could weaken the crop prospestus.

Growers in Tolima, one of the largest coffee regions in Colombia, could be on the cusp of even more economic difficulty according to the director of Tolima's coffee committee. The struggles start with the increase in VAT from 16% to 19% on all goods except basic items. Some farmers within the area, who accepted the government subsidy, in times of low income, are now made to pay higher income tax as well as social security for workers. The flood of taxes is likely to reduce funds available for tree renovation, which could hinder future production. Tolima is responsible for approximately 12% of Colombian production and has a target of 20 bags per hectare by 2021, which they aim to achieve through increased productivity techniques. Output per hectare is currently 17 bags.

Honduras Resilience

We have seen a bumper crop from minority producers such as Honduras which helped to improve the supply and demand balance for the 2016/17 season. According to ICE inventory data, we have seen inflows of 609,420 60kg bags year-to-date (YTD). In conjunction with restocking, IHCAFE suggests that Honduras exports were an estimated 7.2m bags in the 16/17 season, despite the fact October exports fell 4.3% year-on-year (YOY). Whilst we expect destocking in non-exchange warehouses to have added some vigour to these figures, there is no question that Honduras output surprised to the upside in 16/17, we forecast production to be at 7.3m bags.

"…we do not foresee output below 6.5m bags due to the resilient F1 hybrid Centroamericano bean"

Looking ahead, the bumper crop of the 16/17 season is likely to be fell offset by a weaker crop in 2018. Yields may fall slightly for the 17/18 season although around 2/3rds of production is rust resistant, we could see production slip below 7m bags however we do not foresee output below 6.5m bags due to the resilient F1 hybrid Centroamericano bean being grown in around 850,000 acres.

Regulatory Changes

The FCA recently published position limits for commodity derivatives, in line with the MIFID II regulations set to come into force in January 2018. Aimed at reducing market abuse and promoting orderly pricing and settlement conditions, the limits restrict a firm's exposure to commodity derivatives, with exposure aggregated across all departments and subsidiaries as the net position (long or short) of the firm. Economically equivalent OTC contracts are included.

Front month exposure limits are dependent on deliverable supply, which is broken down into average monthly production over the preceding calendar year and deliverable warehouse stocks. Consequently, we expect there will be some variation between yearly front month position limits as supply fluctuates. All other delivery dates are dependent on market open interest. Non-financial institutions trading commodity derivatives for commercial hedging purposes can apply for exemptions to these limits.

"The FCA has set a front month limit at 20% of deliverable supply, 19,700 lots for 2017."

On the ICE traded Robusta coffee contract, The FCA has set a front month limit at 20% of deliverable supply, 19,700 lots for 2017. All other expiries are set at 25% of open interest at 35,800 lots. We do not foresee these limits having a significant impact on market liquidity, as these quantities are currently far above average trader positions. Based on current forecasts of production and open interest, we expect they will remain so in coming years.

Supply and Demand Balance

Whilst we see global demand growing at a CAGR of 1.3% to 158m bags for the 17/18 season, consumption in major producing countries is relatively unexciting. As mentioned, we see future Chinese growth as a bright spot for the coffee industry. The younger generation in mainland China and Hong Kong drive demand growth.

"Chinese consumption is in favour of the lower quality Robusta bean."

Whilst we expect Chinese production to increase at a rapid rate year on year in an attempt to match consumption, we believe production growth will lag behind demand growth for the coming years. As a result, we believe the Robusta market will experience fundamental tightness. This is because Chinese consumption is in favour of the lower quality Robusta bean.

Sticking with industry trends, gourmet and pod coffee consumption constitutes growth areas for the market. Although it has been noted that the efficiency of coffee pods may have reduced the tonnage of coffee consumed, we still believe that this sector will continue to expand, albeit at a lower rate. Gourmet and ready to drink coffee will also

"…global demand of 158mbags in 17/18 season…"

support sales; this could provide some upside risk to our forecast of global demand of 158m bags in the 17/18 season, especially if China surpasses our prediction of 14% growth p.a.

On the supply side, growth in specialty coffee consumption is in tandem with the large Brazil crop which we predict to be around 61m bags for the 18/19 season. For the 17/18 season, Brazilian output is set to fall as it is an off year. We estimate production to be 50.6m bags. We expect a good Robusta crop but rule out the possibility of exports. We attribute this to the low carry-over stocks which will be replenished to avoid any possibility of importing coffee.

Looking at Vietnam, it is our belief that output will reach 28.1m bags. However, the bag's contents may present a slightly quality issue. Appalling weather may increase the OTA content of the bean, and high toxin levels will make the coffee ineligible for export. Once again, restocking at origin will reduce the amount of coffee available for export and we also expect an allocation to Indonesia, leaving Robusta supply tight.

For the next two biggest producers, Colombia and Indonesia, output has been strong. In Colombia, the country continues to benefit from improved agricultural practices and productivity techniques, both of which support output. However, in our opinion Colombian output will be below USDA's forecast of 14.7m bags for the 17/18 season. Production may improve on this year's crop by 0.2m bags to 14.5m but we do not expect a drastically strong crop due to weakness in the main crop.

"Indonesian output for the 17/18 season to be 10.5m bags"

We expect Indonesian output for the 17/18 season to be 10.5m bags. We believe consumption for this area is very strong, which is why we believe they will import a select amount from Vietnam. In order to satisfy Chinese consumption we believe Indonesia will aim to increase output.

"…next year will be a deficit year to the tune of 3.6m bags…"

The above supply and demand balance suggests that for the 16/17 season we see the market in a balanced state for the 16/17 season at +0.3m bags of coffee with supply amounting to 156.3m bags. For the 17/18 season we expect next year will be deficit year to the tune of 3.6m bags with production falling to 154.4m bags and demand hitting 158m bags. Any upside revisions to our demand figure could increase the deficit.

In terms of price action, the market in deficit in the 17/18 season could prompt a befit spike in prices. The move could be aided or even led by a macro move as the oil market looks to rebalance in 2018. Stronger oil in conjunction with a weaker dollar could offer some support to coffee. The COT net short position could prompt at short covering rally. However, we anticipate the dark cloud of a large Brazil crop to cap prices on the upside and as this crop comes to fruition, we expect prices to remain under pressure. In our view, deferring your short position further down the curve could be the optimal strategy. Conversely, if the markets misjudge weather damage and Brazil's crop size, this could fuel a spike in prices, as we do not believe this possibility is currently priced in. For Robusta, we await plantation stats from Vietnam to determine futures prices but we do not expect Brazilian Conilon on the world market due to the low origin stocks.

Appendix

Vietnam Coffee Exports

2011		2012		2013		2014		2015		2016		2017	
Jan	145	Jan	112.2	Jan	219	Jan	143	Jan	132.40	Jan	155	Jan	140.3
Feb	144	Feb	202.1	Feb	100.4	Feb	160	Feb	92.24	Feb	210	Feb	146.4
Mar	161	Mar	187.1	Mar	157.9	Mar	274.0	Mar	130.4	Mar	161.19	Mar	168.01
April	126	April	168.2	April	110.8	April	210	April	104.42	April	185.96	April	134.81
May	98.2	May	203.5	May	110	May	137	May	105.5	May	161.98	May	122.2
June	67.3	June	140.9	June	88.4	June	110	June	104	June	158	June	122.2
Jul	53.1	Jul	114.4	Jul	90.7	Jul	129	Jul	115	Jul	140	Jul	101
Aug	40	Aug	102.7	Aug	95	Aug	120	Aug	92.59	Aug	152.67	Aug	95
Sep	27	Sep	70.4	Sep	63.6	Sep	100	Sep	90	Sep	129.00	Sep	79.50
Oct	31.8	Oct	102.3	Oct	61.1	Oct	95.8	Oct	89	Oct	117.3	Oct	80
Nov	71	Nov	122	Nov	80.3	Nov	84.05	Nov	96.2	Nov	120	Nov	
Dec	156	Dec	162.5	Dec	135.5	Dec	115.4	Dec	152	Dec	148.10	Dec	
Mts	1,120,400		1,688,300		1,312,700		1,678,250		1,303,750		1,839,200		1,189,416
Bags appox. (60kg)	**18,673,333**		**28,138,333**		**21,878,333**		**27,970,833**		**21,729,167**		**30,653,333**		**19,823,600**

Source: GSO, BGC, Bloomberg, Vietnam Agri Ministry *Preliminary exports in blue

Brazil Coffee Exports

2011		2012		2013		2014		2015		2016		2017	
Jan	2,610,000	Jan	2,146,567	Jan	2,567,872	Jan	2,780,355	Jan	3,058,483	Jan	2,809,026	Jan	2,647,000
Feb	2,801,785	Feb	2,243,136	Feb	2,232,519	Feb	2,930,002	Feb	2,743,993	Feb	2,938,361	Feb	2,591,000
Mar	2,740,410	Mar	2,268,728	Mar	2,591,392	Mar	2,782,556	Mar	3,130,175	Mar	3,102,523	Mar	2,833,000
April	2,773,300	April	2,032,732	April	2,775,451	April	3,117,426	April	3,206,554	April	2,458,225	April	2,237,000
May	2,778,607	May	2,131,900	May	2,580,846	May	3,015,673	May	2,925,550	May	2,529,042	May	2,603,000
June	2,673,960	June	1,928,943	June	2,363,496	June	2,960,845	June	2,673,341	June	2,450,947	June	2,191,000
Jul	2,759,788	Jul	2,145,215	Jul	2,232,764	Jul	3,037,055	Jul	2,869,730	Jul	1,967,328	Jul	1,872,000
Aug	2,093,833	Aug	2,628,416	Aug	2,660,238	Aug	3,092,827	Aug	2,898,223	Aug	3,043,610	Aug	2,601,000
Sep	2,961,029	Sep	2,279,953	Sep	2,726,534	Sep	2,988,701	Sep	3,187,244	Sep	3,067,495	Sep	2,427,000
Oct	2,954,777	Oct	2,935,499	Oct	3,234,855	Oct	3,346,067	Oct	3,523,738	Oct	3,363,064	Oct	2,490,000
Nov	3,186,997	Nov	2,855,074	Nov	2,699,059	Nov	3,153,172	Nov	3,492,382	Nov	3,277,106	Nov	
Dec	3,049,164	Dec	2,953,654	Dec	2,996,072	Dec	3,217,758	Dec	3,233,262	Dec	3,262,022	Dec	
Bags appox. (60kg)	**33,383,650**		**28,549,817**		**31,661,098**		**36,422,437**		**36,942,675**		**34,268,749**		**24,492,000**

Source: Cecafe,Bloomberg,BGC

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