

Softs In-depth Report:

Spotlight Cocoa

23 August 2009

Judith Ganes-Chase, President
914-232-1362
914-232-1364 fax
judyg@jganesconsulting.com
www.jganesconsulting.com

The Cocoa Market Should be Emerging from Period of Erratic Price Behavior Soon and Trend Lower Instead

Fundamental Highlights

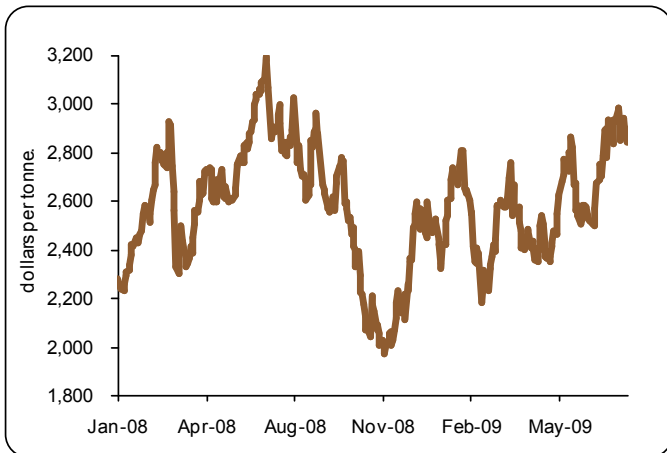
- The cocoa market has continued to fluctuate wildly, not only week to week but also day by day with gains and losses frequently exceeding former "limit moves" when the cocoa market was bound by daily price restrictions of \$88 per tonne. This type of market behavior was not unexpected and to some degree, common for this time of year when the market is rather unsettled about the size of the upcoming main crop harvests. The twists in the dollar, however, reflecting uncertain consumer sentiment about the economy has contributed to the market's prickly behavior, making the market somewhat more erratic. Other non-crop developments have also had an influence, as restricted credit is believed to have hindered sales and with the demand outlook still uncertain at best, manufacturers have been reluctant to extend coverage at higher prices, more so than usual.
- While the market has spent the past several months yo-yoing in a rather wide trading band, the fundamentals have been shifting to the bearish camp. The tail end of the Ivorian mid-crop harvest has gathered pace, narrowing the gap between last year's production and this year's, although the disparity is still wide. Prospects for the developing main crop appear favorable and production is not only expected to rebound but the harvest may even commence earlier than usual, which is in strong contrast to this past year when reform within the cocoa sector to fight corruption led to chaos in the administration of the marketing of the crop and delays in the start of the Ivorian 2008-09 season. A planned cut in export taxes could also reduce hoarding of beans and allow the new main Ivorian crop to flow smoother. This might also prevent some quality degradation, although disease does remain an ongoing threat. High humidity this year exacerbated the quality problem giving rise to increased incidence of black pod disease. All in all, 2008-09 was a troubled season for the world's top producer, but that chapter is now closing and the 2009-10 season is expected to begin on a more positive note, although upcoming elections may be a wildcard.
- Production prospects elsewhere also appear promising despite the threat of a developing El Nino and the negative impact this weather phenomenon can sometimes have on output, particularly in Indonesia. The extremely high prices much of this year should help to boost productivity with farmers generally responsive to a rising market. Planned rehabilitation and expansion in Ghana and Indonesia should start to yield positive results.
- Current high prices will discourage a renewed interest in chocolate and consumption is likely to continue to suffer as a result. Grindings were down sharply the past several quarters and may not see a recovery too quickly with product prices not providing sufficient margin for manufacturers to step up grindings just yet. A shift away from pricier premium dark chocolates caused a slash in grindings. SE Asia was particularly hard hit and many processing plants were idle as a result while others ran simply to meet prior commitments but lacked fresh demand. While undoubtedly consumption was soft, a reduction in inventory levels contributed to the extreme weakness in use. Eventually the need to restock the pipeline could lead to a recovery in grindings, but this is not anticipated any time soon due to the ongoing exorbitant prices. The market will need to fall sharply to encourage a recovery in use.

Other J Ganes Consulting Reports include "Coffee Weekly", "Coffee In-Depth", and "Softs Weekly Round-up".

Click on www.jganesconsulting.com to subscribe.

Price Outlook

Chart 1: Cocoa Prices Should Head Lower



Source: FutureSource

The cocoa market remains extremely vulnerable to a sharp selloff in the months ahead (\$2200 target) especially if prospects for the Ivory Coast main crop harvest point to a strong recovery following this season's reduced output. The market has been locked in a rather wide trading band, hovering just off the highs, but has not been able to pierce through this ceiling as supply worries have started to ease.

The longer prices hold at higher levels the more bearish the market outlook becomes as manufacturers are not likely to extend their coverage beyond immediate to nearby requirements especially with the increased possibility of improved supplies in 2009-10. Cocoa product pricing remains unattractive even with powder prices having increased. Cocoa butter demand remains soft for the timing being and is not likely to recover until at least 2010.

While the Ivory Coast cocoa sector is not likely to see reform plans implemented at least until November elections are over, the severe troubles that crippled the harvest at the start of this season, which ranged from sacking cocoa officials, port strikes, and delaying announcement of official prices, are not likely to be repeated and marketing of the new crop should start out far smoother, which will also help to remove some of the angst from the market. A planned lowering in export taxes should also help to keep crop arrivals flowing.

Wrap Up 2008-09: A Season of Reduced Production but Even Worse Demand

For the majority, it will be good riddance to the 2008-09 season, one that was plagued by weather problems, disease, political upheaval, economic turmoil, tight credit and high costs, skyrocketing prices and crashing demand; It has been a year of uncertainty that created unprecedented volatility in the cocoa market. From the outset of the season, troubles began with delays in the marketing of the Ivory Coast crop as the government attempted to tackle corruption and arrested many of the Cocoa Board officials. This left the decisions for pricing and export registrations up in the air and decided far later than usual, slowing the movement of the crop and immediately creating concerns about the degradation of quality in the early harvested beans that might not be stored adequately during this period of limbo. The market immediately advanced and then rushed even higher when workers went on strike, creating further delays. The market was swept even higher during the broad based commodities run back in February as the banking problems and credit crisis reared its head; in unison with other markets, cocoa prices also collapsed promptly thereafter when the short covering frenzy ended.

The weather added another element of uncertainty with high humidity in the Ivory Coast fostering a breeding ground for the spread of black pod disease and the market was able to quickly rebound off the lows and pushed back up towards the former highs. Meanwhile, despite the worst economic slowdown since the Great Depression, the media continually quoted the trade as being hopeful that chocolate consumption, as a small luxury indulgence, would be largely recession proof. The ICCO was also slow at acknowledging the abrupt downturn in demand that was too happen, but the handwriting was on the wall early on as manufacturers slashed inventory levels starting to fear the worst. Demand was bound to slip due to the exorbitant prices for cocoa butter, but the poor economy hastened the melt down. While the love affair with chocolate has not ended, the premium priced market has suffered with consumers scaling back purchases and opting for less expensive brands. Perhaps an even greater reason for

Cocoa In-depth Report – 23 August 2009

grindings to have weakened as much as they have is that the number of new product introductions was substantially reduced and manufacturers also cut back on SKU's of premium product lines which immediately reduces demand for cocoa. The market cascaded lower on the acknowledgment that despite a fairly large drop in production, the actual supply deficit forecast for the 2008-09 season was going to be minimized due to the weak grind.

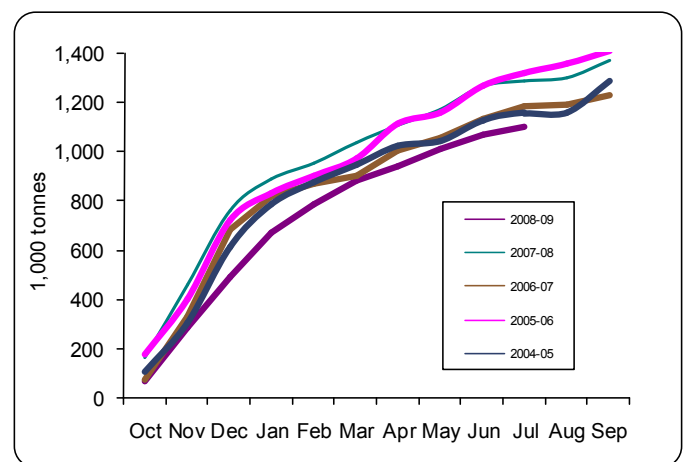
It didn't take long for the market to bounce back again, however, and soar to new highs on renewed concerns about the size of the Ivory Coast mid-crop after a disappointing main crop harvest. Quality concerns remained paramount and worries that El Nino would create problems in the year ahead compounded the market's anxiety. At the same time, the strength in the market left some manufacturers with limited coverage, which helped to fuel the rally. Although the market may have experienced extremely volatile action in the past two months, there are actually few revisions to the supply side of the balance sheet since the publishing of the *J Ganes Consulting June Cocoa In-Depth Report*; instead the greater adjustment is on the demand side, where grindings have been even worse than the already grim projections laid out before, but more significantly the possibility for a quick revival in consumption seems bleaker.

The ICCO had last pegged world cocoa production at 3.466 million tonnes, down 7.2% or 269,000 tonnes less than 2007-08 when production fell just short of record highs. A 7% drop in production, especially after rising more than 9% the year prior is neither excessive or out of the norm. While concerns about production being highly concentrated amongst a few key suppliers are certainly merited, especially with the problems that have plagued the Ivorian cocoa sector, the high prices this year should help to assure that productivity is increased long term.

It has been a decade since the liberalization of the Ivorian cocoa sector and the end of the CAISTAB, which oversaw the marketing and control of production, but since then power struggles, corruption, and a lack of support to farmers with prices that consistently were lower than that received by farmers elsewhere, has kept reinvestment in cocoa plantations limited. The ongoing civil war and division within the cocoa

area under cultivation with some under rebel control hasn't helped the industry prosper either. There is a push to end the liberalization of the sector, which seems to have been mostly to the benefit of exporters and not farmers but any changes are not likely to happen until after voters return to the polls, which is now slated for November. There is a possibility that elections could be postponed again and that in the period leading up to this date, civil disturbances could occur. Foreign workers, which constitute a large part of the labor force on the farms, may be unsettled and leave the country, potentially posing a threat to the harvesting of the crops. Should there seem to be unrest, the downtrend in the market could be temporarily waylaid. In addition to the ground swell of support to end liberalization, as part of the reform movement of the cocoa sector and to follow World Bank mandates for debt relief terms, the high export tax is to be lowered for the 2009-10 season. This tax, known as DUS (Droit Unique do Sortie), put the Ivory Coast farmer at a disadvantage because of its excessive levels compared to other neighboring countries and therefore discouraged investment in cocoa plantations. Under the proposed tax reform plan the registration tax may be cut 5% to 10% inclusive of CIF.

Chart 2: Ivory Coast Arrivals Lagged from the Outset this Season



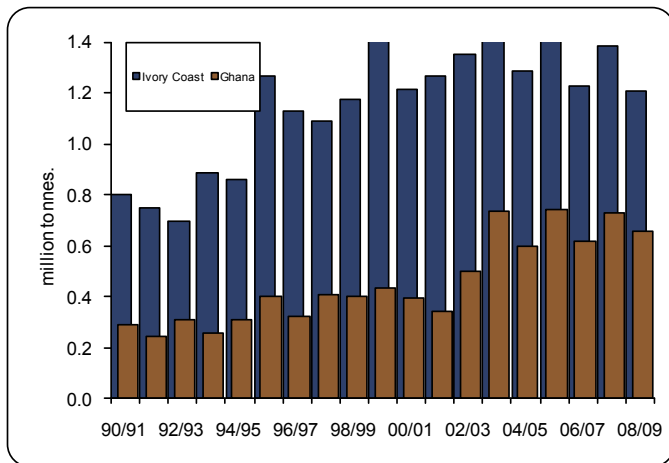
Source: Reuters, Dow Jones, trade estimates

The pace of arrivals in the Ivory Coast lagged from the outset and never was to catch up with any of the last four seasons, although in recent weeks the gap has started to narrow with a strong tail of the mid-crop compared to last season. The

Cocoa In-depth Report – 23 August 2009

improvement in the mid-crop has also led to optimism about the start of the 2009-10 main crop with farmers expressing hope that the season can start early as pods are developing well. The ICCO last pegged the Ivory Coast crop at 1.210 million tonnes down from 1.382 million a year ago. Cumulative arrivals have reached 1.114 million down from 1.296 million by mid-August 2008. If there are no adjustments to prior figures and arrivals continue at faster pace than last year, then the ICCO estimate may prove to be shy of the final tally, although not by much.

Chart 3: Ivory Coast and Ghana Production Estimates Understated Based on Arrival/Purchase Data



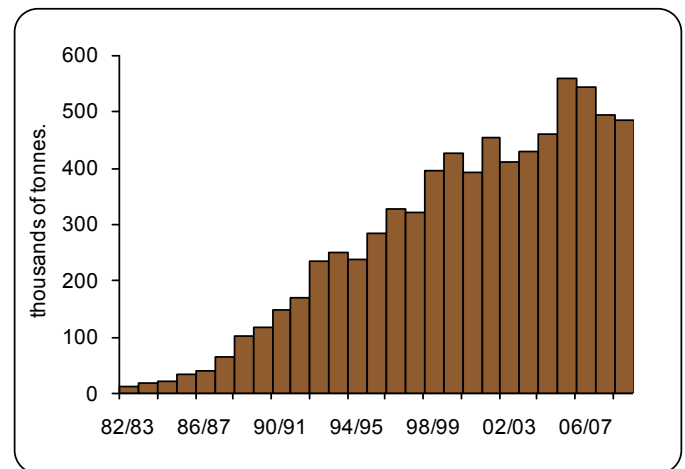
Source: ICCO

Ghana's main crop purchases actually exceeded official expectations although reportedly the figures included some buying of the fly crop which helped to boost the tally. The ICCO had estimated Ghana's output at 660,000 tonnes and main crop purchases (through early June) totaled 636,000 tonnes. Last year's crop was 729,000 tonnes. Actual production this year may be as much as 700,000 tonnes, an improvement over the ICCO figure by as much as 40,000 tonnes. Farmers are optimistic about production rising to at least 750,000 tonnes in 2009-10. Government involvement in the cocoa sector is aiding prospects and warehouse systems are being updated, creating greater efficiency and will help to better maintain quality control. The World Bank recently approved a \$535 million credit facility to help stabilize Ghana's economy and this should filter into the cocoa sector, an important foreign exchange earner for

the country. Ghana's Cocoa Board (Cocobod) is syndicating a loan of \$1.2 billion to help finance purchases of the 2009-10 crop. The country has faced difficulty supplying the local manufacturers with sufficient cocoa to meet processing demand and maintain exports.

With the possible increases in just the top two producing countries alone, the expected deficit for the 2008-09 season could be reduced from the 84,000 tonne shortfall last indicated. Indonesia's production is pegged at 485,000 tonnes down from 495,000 tonnes last year due to poor crop maintenance and delays in replanting but for 2009-10 production prospects are more hopeful unless the El Nino weather phenomena creates weather issues.

Chart 4: Indonesia's Production Dipped but Could Rebound

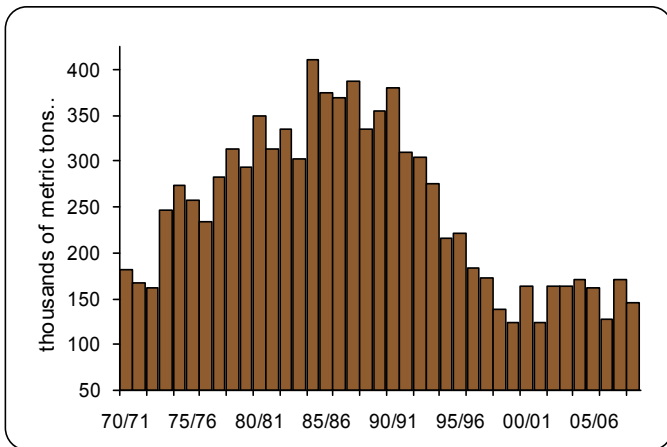


Source: ICCO

Nigeria's production held steady at 220,000 tonnes this season while Brazil is expecting a decline to 145,000 tonnes from 171,000 previously according to ICCO data. Weekly cumulative Brazilian arrivals through mid-August have totaled 137,550 tonnes compared to 154,200 tonnes a year ago. While rainfall may have sparked fears of the spread of black pod disease in Cameroon, steady precipitation has increased the bean sizes of the crop this year and exports have been brisk reflecting the better crop. The ICCO is estimating production at 210,000 tonnes up from 185,000 a year ago.

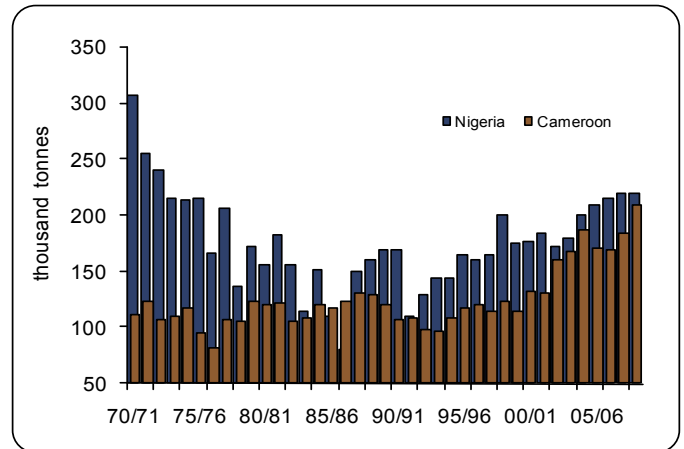
Cocoa In-depth Report – 23 August 2009

Chart 5: Brazilian Production Marginally Lower



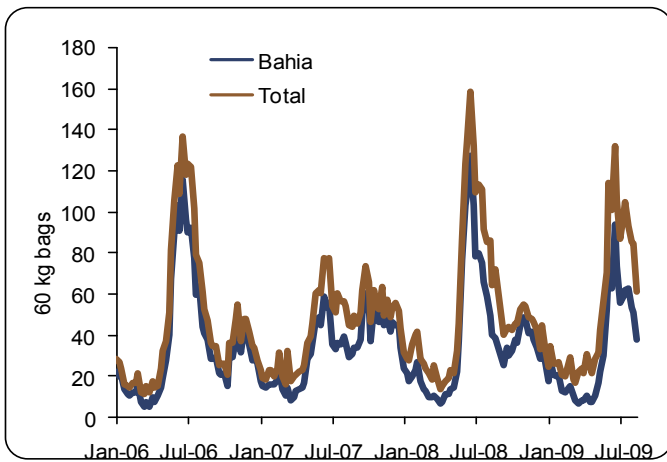
Source: ICCO

Chart 7: Nigeria and Cameroon Responsive to Better Prices



Source: ICCO

Chart 6: Bahia Arrivals Weren't as Strong this Year but Better than Expected

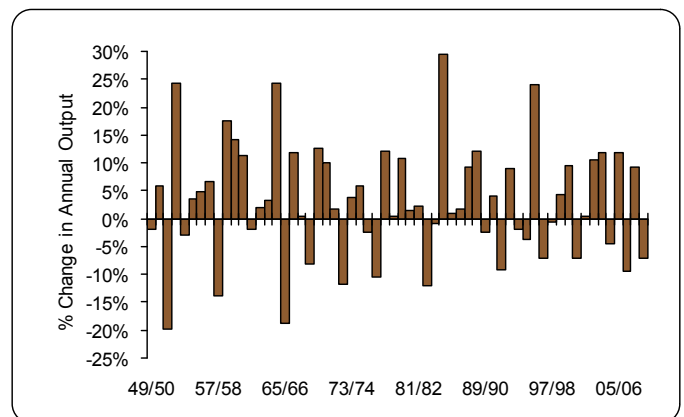


Source: Commercial Association of Bahia

Based on the known production data, the final tally for the season could exceed the ICCO prior estimate of 3.466 million tonnes. Even raising production by a small margin would contribute to narrowing the gap between supply and demand this season. Originally forecast at a 193,000 tonne shortfall and then narrowed to only an 84,000 tonne deficit, the gap may not even be that wide. This certainly would not be the first season where the expected deficit was slashed due to production coming in higher.

It is possible that demand also failed to meet expectations and therefore the actual deficit for this season could be minimal despite a previously estimated 7% drop in output, which again, may prove to be too much. If production is bumped up and demand is lowered a notch, it could be that the balance swings from a net deficit to a small surplus, although I'm more inclined to believe that the market will still show a minimal stock reduction than an increase. The market price has been kept at high levels under the assumption that there would be a fairly substantial stock drawdown this season, which now seems increasingly less likely.

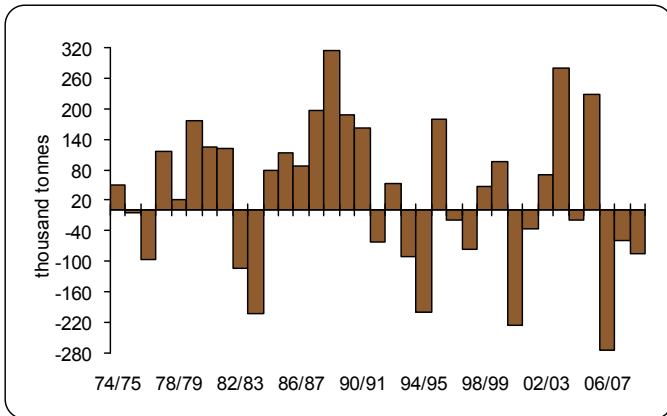
Chart 8: Production May Not Drop Full 7% as Previously Indicated



Source: ICCO

Cocoa In-depth Report – 23 August 2009

Chart 9: Deficit Estimate May Shrink Further for 2008-09



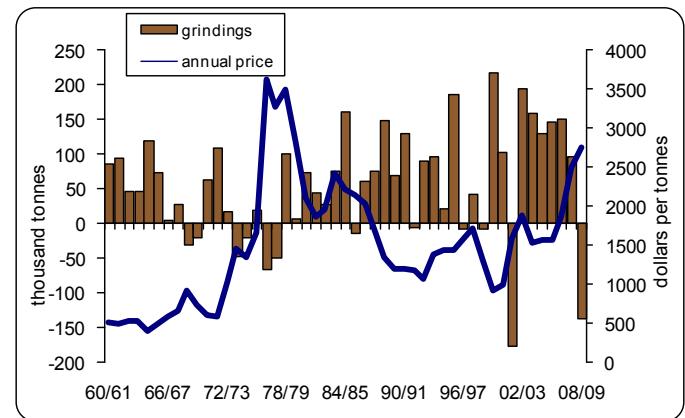
Source: ICCO

While back-to-back production deficits have occurred, rarely are there two extreme shortfalls and in the past 35 years there has not been three consecutive seasons where stocks have declined. The 2008-09 season would be the first, if the deficit forecast sticks. It is also highly unlikely that 2009-10 would show a shortfall, especially since the weather has been more cooperative and demand is not apt to come roaring back just yet.

Across the board grind data was weak for both importing and producing countries and the drop in usage stretched beyond expectations due to the combination of unattractive prices and the poor global economy. While some optimism about the recession is starting to emerge, it is unlikely that demand will bounce back this quarter or next and perhaps even longer. Much of the accelerated rate of growth in cocoa consumption was generated from a switch upstream to more premium chocolates that contain higher chocolate liquor content, which increased bean demand. This shift in demand or conversion to premium chocolate was bound to slow, but also the number of new product introductions, which had reached a frenzied pace, was also unsustainable. For a host of reasons, many of these products introduced to the marketplace were not likely to capture sufficient sales to succeed and would be pulled out of manufacture, immediately reducing demand. The fact that consumers at the same time became more cost conscious accelerated the rate of failure of some new product lines. Tight credit, insufficient

financing, and other issues also caused some of the start-ups or new players in the market place to fail. It is unlikely that furor that occurred the past several years over dark chocolate will be easily recaptured as part of the sensation was also created by increased media coverage extolling the health benefits of consuming dark chocolate. This story received a fair amount of media exposure but has since been played out and chocolate and health is no longer making headline news. Without this additional advertising exposure, it is doubtful that demand will be able to recover quickly. The industry will need to find new ways to revitalize consumption. With ingredient costs high and not just for cocoa beans or cocoa products (sugar raced to 28 year highs recently), manufacturers often trim bar sizes, coatings, or the number of chips in a cookie to avoid passing higher costs on to consumers directly. This "forced" consumption reduction should keep grindings from rebounding too quickly.

Chart 10: Cocoa Grind Falling in Reaction to Rising Prices



Source: ICCO

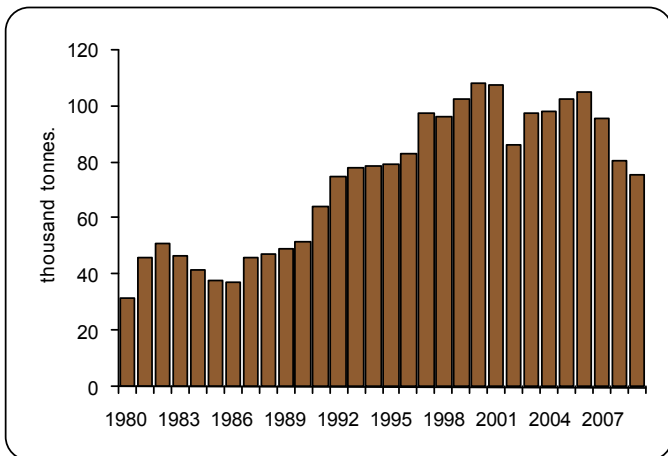
World grindings rarely decline, but when they do a jump in price is generally the reason why with the sharper the escalation in prices, the greater the decline in use. Consumption also has fallen modestly in some years following several consecutive seasons of strong growth. With prices rising as they have, demand would have dropped off, whether there was an economic slowdown or not. The global recession simply contributed to what would have been a weak consumption view but was not the leading cause. Tight credit and uncertainty about demand cause some inventory

Cocoa In-depth Report – 23 August 2009

shedding also adding to the reduction in manufacture use. The ICCO last forecast 2008-09 grinds at 3.515 million tonnes or 243,000 less than last season, a decline of 6.5%. The greatest declines on a regional basis have been occurring in Asia and then to a moderate extent in North America and Europe, whereas African grind gained market share, helping to offset the poor demand elsewhere.

Second quarter grind data reflected the aforementioned problems and there should not be a revival for the third quarter although the rate of loss is bound to have slowed at least in Germany, because last year's third quarter data already started to show declines. For the United States and the rest of Europe, third quarter grind may be just as weak as the prior two quarters. Derived USA second quarter grind (it is now reported only as North American) was the lowest second quarter usage since 1992! This was the third consecutive year that showed a decline in second quarter usage since demand peaked in 2006 at 104,879 tonnes. Third quarter demand also reached a high that year of 109,115 tonnes. Demand has been sliding since with last quarter falling to 75,329 tonnes. Third quarter grind a year ago was 95,100 tonnes in the United States.

Chart 11: USA Second Quarter Cocoa Grind Plunged

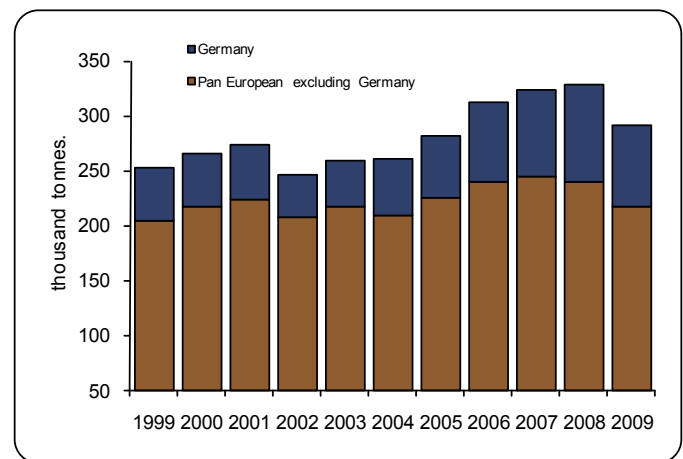


Source: Cocoa Merchants Association

European second quarter grind outside of Germany didn't soften much last year but this year came down sharply to 216,333 tonnes from 239,868 previously. German grind dropped to 75,430 tonnes

from 89,052 in second quarter 2008. German grind had peaked in the third quarter of 2007 at 106,041 tonnes and has declined each of the last seven quarters, not showing any seasonal pick-up. Last year's third quarter grind had already fallen from the highs the year earlier to 88,427 tonnes and therefore it would be surprising if the 2009 third quarter losses were as radical on a percentage basis as well as in tonnes. The slowing in the percentage loss therefore shouldn't be taken as a hopeful sign or indication that the consumption outlook is starting to turn the corner and improve.

Chart 12: European Second Quarter Grind Weak



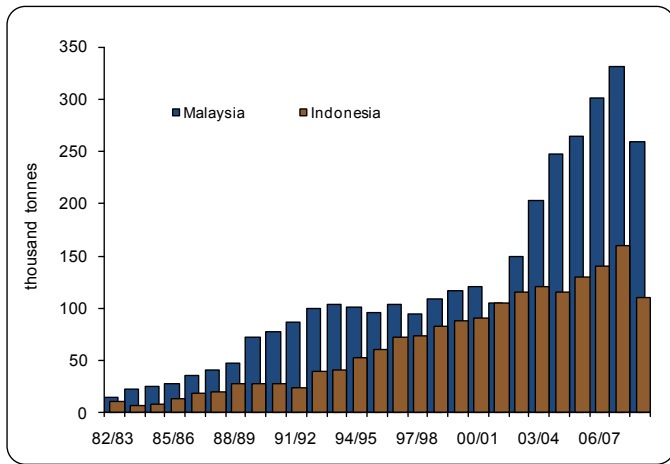
Source: European Cocoa Federation

The data for other countries isn't any more promising; Brazilian cocoa grind is off by 6% and the July data was the poorest showing in about six years. The ICCO, in contrast, had forecast Brazilian use down 10,000 tonnes or 4.2%. Malaysian use was forecast to slip 71,000 tonnes or 21.4% and Indonesia could see a loss of 31.3% or 50,000 tonnes to 110,000 tonnes but grind last quarter was down 41% instead and the Indonesian industry is fearful that demand won't even exceed 100,000 tonnes. Malaysian second quarter grind was off 22% in line with the full season projection made by the ICCO.

With expectations for demand to continue to be weak, it is easy to see how even minor upward revisions in a few countries could lead to the deficit estimate for the world to be tempered even further.

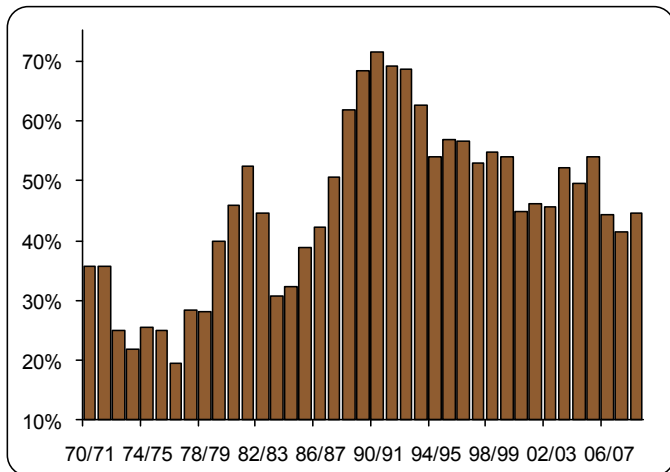
Cocoa In-depth Report – 23 August 2009

Chart 13: Asian Grind Sharply Lower



Source: ICCO

Chart 14: Despite Stock Reduction Estimate, Stocks/Use Increased

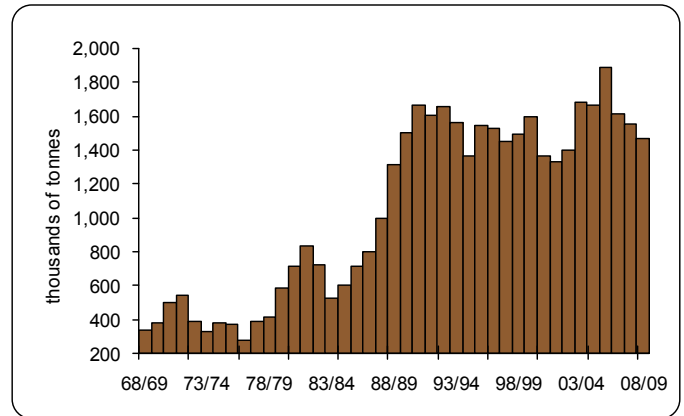


Source: ICCO

Even if the deficit for this season stood at 84,000 tonnes as the ICCO had indicated, a key point is that because of the massive drop in grindings, stocks when measured as a percentage of use are still expected to climb. The stocks/use ratio, without upward revisions to production or further adjustments lower in use, shows a climb to just over 44% from 41% last season. Prices should ordinarily move inverse to the stocks/use ratio. The fact that prices have not shows the market has been propped up by more than just the straight

fundamental factors. The actual stocks/use ratio could be vastly higher with the potential revisions for 2008-09, making current high prices all the more questionable.

Chart 15: Global Stocks May Have Fallen for Fourth Year but Still Not at Historically Tight Levels



Source: ICCO

The 2008-09 season is finally going to be drawing to a close and with the exception of the weekly arrival postings from the Ivory Coast for mid-crop production and to a far lesser extent data from Brazil, market attention should be riveted on the development of the upcoming 2009-10 season, which officially kicks off October 1.

Cocoa In-depth Report – 23 August 2009

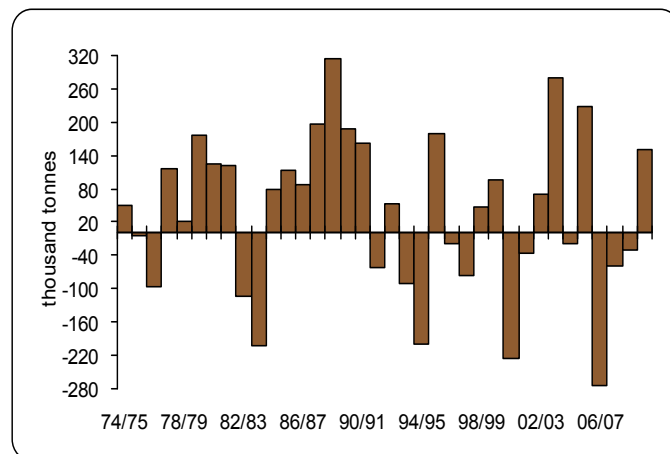
Market Returns to Surplus in 2009-10

With expectations that the 2008-09 season will close with a production deficit of less than 84,000 tonnes, it will be even easier to close the gap in 2009-10 and have a production surplus that could vary between a modest to large amount. Unless the weather turns unfavorable going forward, it is doubtful the market will see a production deficit in the year ahead. Previously, I penciled in a neutral scenario of a 49,000 tonne surplus and a bearish view of a 213,000 tonne stock increase. While it is still preliminary and much could change in the coming months, I do think the surplus for next season will be at least 100,000 tonnes and the neutral view last presented in the June In-Depth Report is on the conservative side. The reason for this more bearish stance is two-fold: the weather has been favorable for the development of the West African crops and with prices attractive, that should help prospects and the second is that with prices staying at higher levels for a longer time, the demand view becomes more pessimistic and it might take longer for grindings to recover.

Rather than the 84,000 tonne shortfall I adjusted the 2008-09 balance to reflect only a minor 30,000 tonne stock reduction. For the scenarios for 2009-10 I revised the expected production upwards by 50,000 tonnes in each scenario but left the

expected change in demand the same. The net result would be in each case to have less of a deficit for the bullish scenario and more of a deficit for the neutral to bearish outcomes. The actual balance sheet numbers will likely fall in the range between the neutral to bearish outcomes, leading to a build in inventories and a further jump in the stocks/use ratio.

Chart 16: 2009-10 Could See Stock Build



Source: ICCO, J Ganes Consulting

Table 1: Preliminary 2009-10 Supply and Demand Outlook

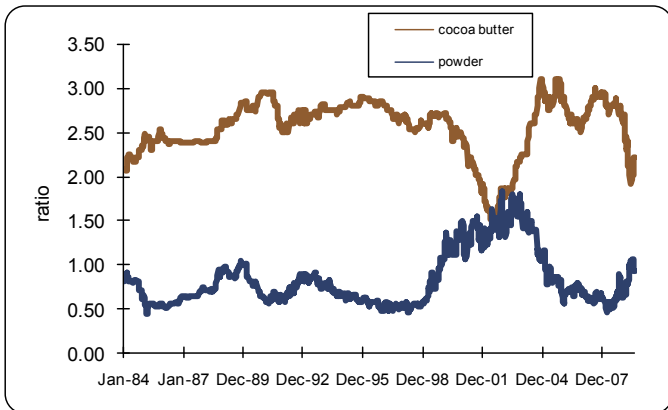
	Output	Chg in Gross Output	Grindings	Demand Chg	End Stocks	Change	Stock/Use
99/00	3,077	9.58%	2,960	7.91%	1,594	97	53.85%
00/01	2,858	-7.12%	3,063	3.48%	1,368	-226	44.66%
01/02	2,867	0.31%	2,885	-5.81%	1,331	-37	46.14%
02/03	3,169	10.53%	3,079	6.72%	1,401	70	45.50%
03/04	3,541	11.75%	3,238	5.16%	1,682	281	51.95%
04/05	3,381	-4.52%	3,367	3.99%	1,662	-20	49.36%
05/06	3,778	11.74%	3,512	4.31%	1,890	228	53.81%
06/07	3,422	-9.42%	3,663	4.29%	1,615	-275	44.09%
07/08	3,735	9.15%	3,758	2.59%	1,555	-60	41.38%
08/09	3,505	-6.16%	3,500	-6.87%	1,525	-30	44.41%
Scenarios for 2009/10:							
Bearish	3,750	6.99%	3,713	-1.43%	1734	263	50.25%
Neutral	3,650	4.14%	3,614	0.43%	1570	99	44.65%
Bullish	3,550	1.28%	3,515	2.43%	1401	-71	39.07%

Source: ICCO, J Ganes Consulting

Cocoa In-depth Report – 23 August 2009

Cocoa butter prices relative to cocoa beans had declined sharply reflecting the downturn in demand this season but have seen a small uptick recently with inventories having been reduced. With the shift to cheaper priced powder and strong reduction in grindings, powder stocks have been reduced and this is reflected in a recovery in the cocoa powder ratio the past several months. In 2001-02 a similar situation occurred where there was a collapse in butter prices and at one point, powder prices actually were quoted on par with butter. Since then, butter prices had been far stronger due to the surge in premium chocolates and increased use of dark chocolate.

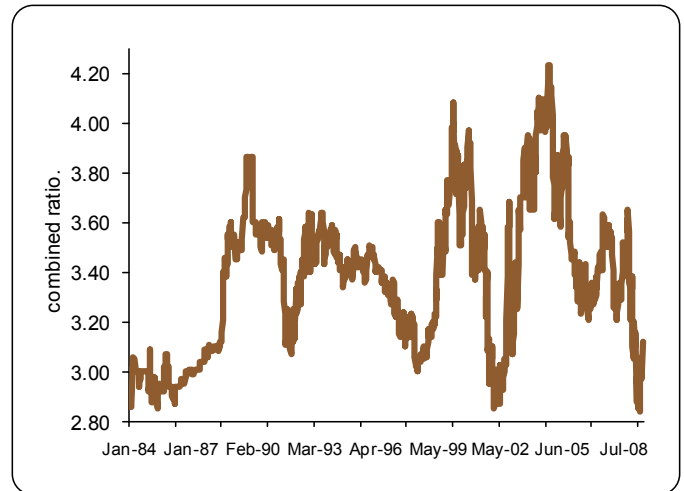
Chart 17: Cocoa Powder Prices Recovering; Butter Weak



Source: *Milling and Baking News*

The combined ratio of cocoa butter and powder relative to cocoa beans has recovered from the extremely unattractive levels for converters that rely on a higher margin to cover costs to grind beans and then sell the products. While the price has started to recover, it is still relatively unattractive and with end-user demand still questionable, it is unlikely that processing will rebound quickly. The margins would need to see a further recovery for this happen. In all likelihood this will begin later in 2010 and supports the views in the balance sheet that demand could be near unchanged in the season ahead or rise modestly but is unlikely to see a repeated steep drop.

Chart 18: Combined Butter and Powder Margins Improving Somewhat



Source: *Milling and Baking News*