

Coffee prices stimulated by supply concerns

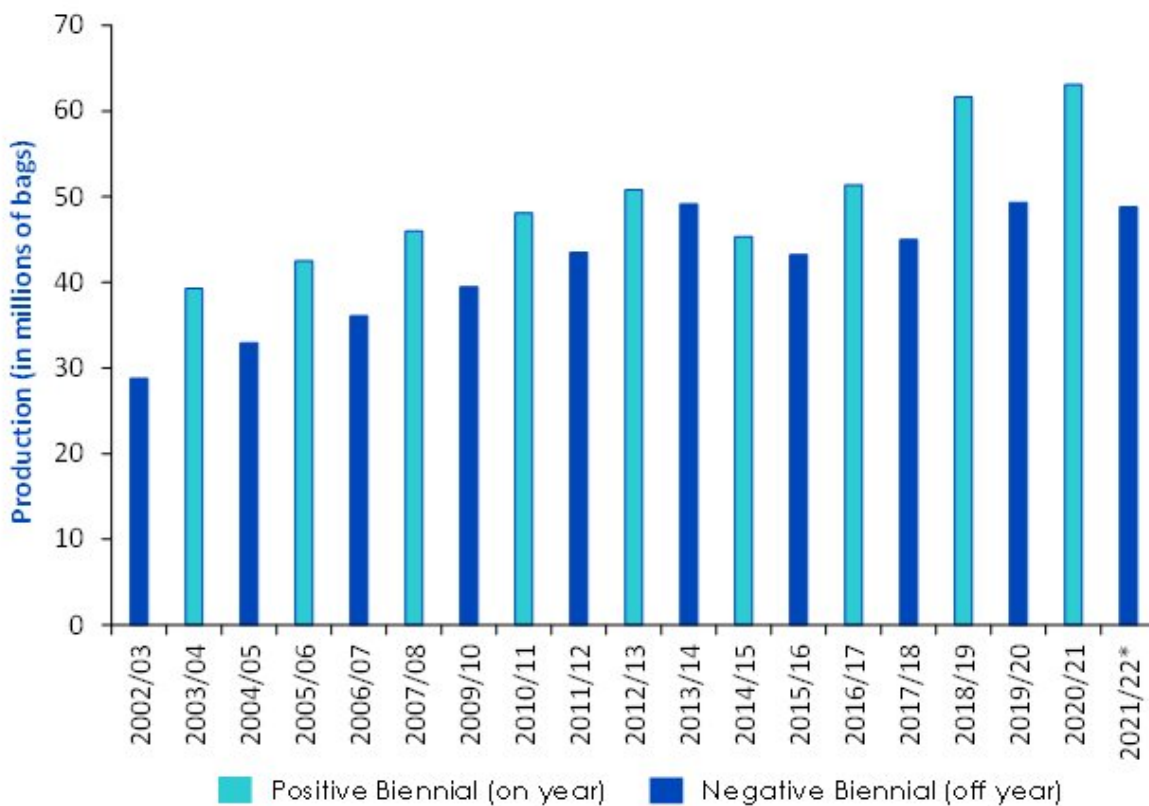
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Aneeka Gupta

Director, Macroeconomic Research, WisdomTree Europe

Coffee prices are at a 4-year high¹ owing to supply tightness. This comes at a time when demand conditions are improving as COVID led restrictions are being lifted globally. Coffee prices tend to be very volatile, owing to their sensitivity to environmental factors. Coffee tends to flourish in a sub-tropical climate, with an adequate amount of wet and dry periods. Volatility in weather patterns affects supply thereby resulting in volatile prices. Supply of coffee remains an important price determining factor. To give you a sense, between 2009/10 and 2019/20 crop year, the annual increase in production of Arabica coffee ranged between -43% and +18%, with five annual decreases recorded over the decade². The coffee harvest has a biennial cycle. This implies that a crop year with a good harvest (the “on year”) will be followed by a crop year with a lower harvest (the “off year”).

Figure 1: Brazil coffee production



Source: Conab, Wisdom Tree as of 27 May 2021, Please Note: * denotes estimates for the crop year 2021/22.

Historical performance is not an indication of future performance and any investments may go down in value.

Dry weather puts Brazil's Arabica crop at risk

In Brazil (the world's largest producer and exporter of coffee), the current season will be an off-year in the biennial cycle, resulting in lower production potential in the upcoming crop. Harvesting of the Arabica crop has only just begun in Brazil, with harvesting work expected to be completed between mid-June and early July. While it is still early to tell, private trade as well as official institutions are lowering their estimates for the upcoming crop year 2021/22. The main reason for this being the persistent drought and high temperatures in major coffee growing regions in the second half of 2020 and in the early months of 2021. According to IHS Markit, some growing areas have seen half the rainfall that would usually be expected during the wet season between January and April. In its second official estimate, Conab forecasts the Brazilian coffee production for the crop year 2021/22 at 48.8mn bags, down 22.6% from last's year bumper crop of 63.1mn bags. This is close to the upper limit of Conab's first estimate in January this year, that pegged production between 43.85 and 49.85mn bags. Production of Arabica is forecast at 33.4mn bags, marking a 31.5% decrease over the prior crop. Several growers have also pruned their coffee fields at above-average rates after the record crop in 2020, thus reducing the area to be harvested by 1.45mn hectares for Arabica. This usually leads to yield loss in the short term but an improved performance over the long term. The persistently dry weather is also reducing the outlook for the following crop 2022/23 in Brazil which would mark a high yield year in the biennial cycle. Several public institutions in Brazil have been issuing warnings in recent days about water shortages and fire risks. The Parana Basin (home to Minas Gerais, the biggest coffee-producing state by far) has been among the worst affected regions.

Logistical issues in Colombia add to supply concerns

Exports from Colombia, the world's second largest producer and exporter of Arabica, are being hampered by anti-government protests accompanied by road closures. The blockades of roads and ports are likely to cause an extended delay to coffee shipments. Adverse weather conditions in Brazil combined with logistical supply issues in Columbia puts nearly 60% of supply at risk, creating a price supportive environment for coffee.

Figure 2: Global Arabica Supply

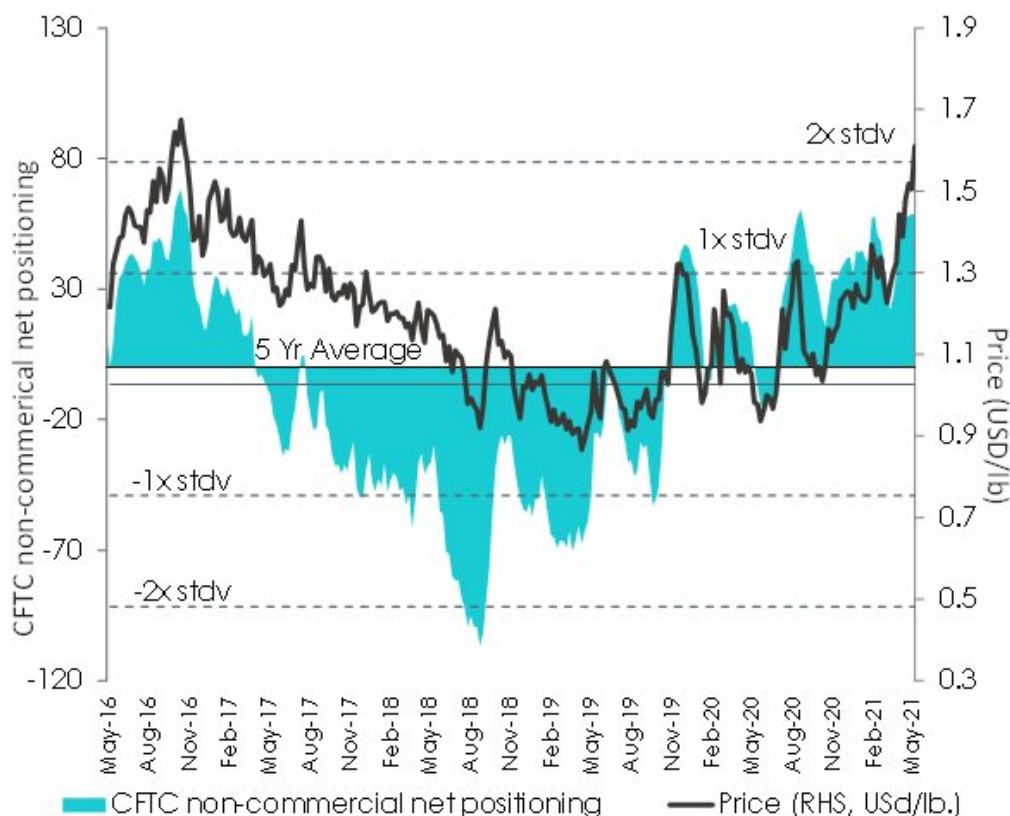
Source: US Department of Agriculture (USDA), Foreign Agricultural Service

Revival in demand post pandemic

Global consumption of coffee over the last decade has increased 27%, with a significant proportion of this growth attributable to rising demand in both developed and developing nations. Global coffee consumption took a hit last year due to the pandemic and associated COVID led restrictions. However as travel and hospitality sector restrictions are eased, we expect to see a revival in demand. The acceleration in the

pace of vaccinations is generating confidence about the revival of economic activities and is restoring confidence in investors. According to data from the Commodity Futures Trading Commission (CFTC), net speculative positioning is more than 1-standard deviation above the five-year average echoing the positive sentiment among investors.

Figure 3: CFTC Net-positioning for Coffee



Source: Bloomberg WisdomTree as of 25 May 2021.

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Stronger Brazilian real lends buoyancy to coffee

As nearly 44% of global coffee supply emanates from Brazil, the Brazilian Real (BRL) has the most impact on coffee prices. As coffee is largely traded in US dollars on the international markets, the stronger BRL makes coffee less valuable in dollar terms, thereby disincentivising traders to sell in international markets. Subsequently less coffee is made available in external markets thereby supporting prices higher. The recent strengthening of the BRL versus the US dollar is also having an upward effect on prices. The Brazilian central bank's hawkish stance, in lockstep with current inflation projections, has helped support the BRL. The central bank has hinted at another rate hike in June to help curb rising inflation and support its economy hurt by the pandemic, which should support the BRL further.

Conclusion

The extension of the adverse weather conditions in Brazil coupled with bright prospects for demand revival is increasing the likelihood of coffee markets entering into a deficit in 2021/22. This is likely to remain price supportive for coffee in the medium term.

1 Bloomberg Ticker KCA Comdty, as of 1 June 2021

2 USDA, Foreign Agricultural Service, Coffee: World markets and Trade Report

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