



How will China's growing appetite impact global markets?

China Commodities Report

Sugar prices may enter long-term uptrend - analysis

Sugar prices in China have swung violently this year, as fears of severe production shortfalls following the snowstorms in January and February gave way to concerns that increased cultivation would cause oversupply this year, sending prices tumbling.

Oversupply concerns caused prices to plunge to less than RMB 3,150 (\$451.29) per ton from record highs of RMB 4,844 (\$692.10) in March. Total sugar output is expected to reach nearly 15 million tons for the 2007/2008 season, well above last year's level of 11.99 million tons and well above production forecasts last year of 13.50 million tons. By the end of May, output had already topped 14.81 million tons.

Despite the general pessimism in the market, sugar demand growth this year may surprise many in the industry. By the end of May, the national sales ratio, at just under 60 percent, was not far below the 65 percent recorded at the same last year, which is quite remarkable given this year's dramatic increase in production. Traders have expressed concern in recent weeks that transportation disruptions following the earthquake in Sichuan Province had reduced sugar sales in Yunnan Province and artificially boosted Guangxi's sales figures. In fact, Yunnan's sales ratio of 48 percent is 1 percentage point higher than it was at the end of May last year.

With sales on track to equal or even beat last year's sales ratio going into the peak consumption season, stronger-than-expected consumption this year will likely support prices. The Beijing Summer Olympics in August will likely provide a boost in demand for sugar drinks, ice cream and other high sugar-content food.

Spot sugar prices in China are trading at around RMB 3,150 (\$451.29) per ton, RMB 250 (\$35.82) lower than the per-ton production cost for producers.

"As far as I know, government regulators do not have any concrete solutions to boost sugar prices," an official with the Yunnan Sugar Association, who wished to remain anonymous, said. "We have to wait for a market mechanism to bring back equilibrium, such as a shift in planting by farmers in the next season from sugar to more lucrative grain crops."

China's state reserves authorities have traditionally intervened in the market to support prices and protect farmers' interests through state stockpile purchasing. This year, however, reserves authorities have turned a deaf ear to industry calls for state intervention. Soaring consumer prices, particularly for food, have made the government reluctant to engage in any activity that could send prices higher, and exacerbate inflation.

This is the third time since the 1998/1999 season that sugar prices fell below sugar production costs. Earlier price recoveries were driven by an immediate shift to more lucrative crops by low-income sugar farmers, who are very sensitive to crop prices.

"This is more likely to happen now, as grain

prices are much more buoyant," Chen Shuqiang, from Great Wall Futures, said. "This gives us some hope that current prices of RMB 3,100 (\$445.69) to RMB 3,300 (\$474.45) could be a mid-term bottom for sugar prices in China."

The sugar price cycle in China lasts around three to five years, in line with the growth cycle of sugarcane and sugar beet crops. Chinese farmers are quite price-sensitive, and tend to adjust cultivation in line with price fluctuations. Bumper harvests in the last two seasons have pressured price, yet the unprecedented rapid change of dietary preferences in favor of confectionery and convenience food may offset this. More importantly, with the probability of a reduced harvest next season, coupled with continued domestic consumer demand growth, the medium-term outlook for price does appear encouraging.

Unfortunately for farmers, the market turnaround may come after planting decisions for next year have already been made. Inaction by state regulators could have serious repercussions next year, and in years ahead, if farmers react by switching to more profitable grain crops. If production cutbacks materialize next season, we may see a repeat of this year's price rally next spring due to supply shortages as demand continues to grow at a rapid clip.

Per capita sugar consumption in China is less than 8 kg per year, well below the world average of around 24 kg, and an average of 35 kg to 40 kg in western countries. Although China's per capita sugar consumption is low compared with the world's average, China is the world's fourth largest sugar consumer, after Brazil, India and the European Union. Aggregate domestic sugar consumption has exceeded 10 million tons per year since 2003.

Low per capita consumption suggests great potential for future growth due to changing dietary habits. Sugar consumption in China is expected to grow at an annual rate of more than 10 percent for at least the next few years.

High sugar-content food production in China maintained strong growth in the first quarter of this year, according to the National Bureau of Statistics. The production of major high sugar-content food products, including cake, dairy products, canned food and soda all rose at an annual rate of more than 10 percent, with biscuit and frozen food production soaring 71.57 percent and 50.63 percent year-on-year, respectively.

Lifestyle changes leave Chinese consumers little time for cooking, boosting the consumption of convenience food.

The cold snap in late January and early February affected beverage production growth in the first quarter, but the sector is expected to see a full recovery ahead of the peak summer beverage consumption season.

Rising living standards coupled with population growth have led to an increased

demand for sweet food. Among the high-sugar content food, frozen food and canned products will continue to see the fastest growth, due to increased urbanization and changing cooking habits.

Although China has been actively promoting biofuels and alternative energy, there is little potential for the sugar-based ethanol industry. China's arable land is already strained by the growing demand for food, and the country is not capable of clearing uncultivated land to expand sugar cultivation, at least in the near term.

Furthermore, converting sugar to ethanol in China is not cost-effective. Sugar is cultivated by small-scale, widely-scattered households. Small-scale domestic sugarcane cultivation incurs substantially higher production costs than large-scale sugarcane farms in countries like Brazil.

China is a net sugar importer to the tune of 1.4 million tons annually in recent years, although this has nothing to do with domestic demand. It is based primarily on politically motivated trade agreements with Cuba and other sugar producing countries. China imports about 400,000 tons of crude sugar from Cuba each year, which is stored in state stockpiles.

Little, if any, Cuban sugar has ever or will ever see the light of day in China, given ample domestic production in recent years. All these shipments serve to do is improve relations with Cuba and take up precious space in state sugar depots that could be used to store some of the surplus in the domestic market, which would prop up prices.

Based on Interfax analysis, sugar demand will be stronger than expected this year and sop up much of this year's production surge, which may lead to a price recovery later in the year. However, this will do nothing to support prices in the short term, as farmers in southern China decide whether to reduce sugarcane cultivation for the 2008/2009 season. However, given this year's combination of a larger-than-expected increase in cultivation coupled with a severe cold snap early in the year that reduced yields, it is possible that production will remain stable next year even if there are significant shifts away from sugarcane, as long as there is no repeat of this year's cold snap.

The long-term price outlook remains positive, given increasing domestic demand at both the consumer and industrial levels. At the current rate of demand growth, output would need to maintain at least 10 percent growth. Furthermore, this increase will have to come from improved yields, as acreage is limited. Global oversupply is expected to ease in the next two years, and funds and speculative buying on this expectation will underpin international prices. Therefore, although continued volatility in domestic and global markets is to be expected, prices may enter a long-term uptrend.

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