Mother Nature's Message

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Highlights

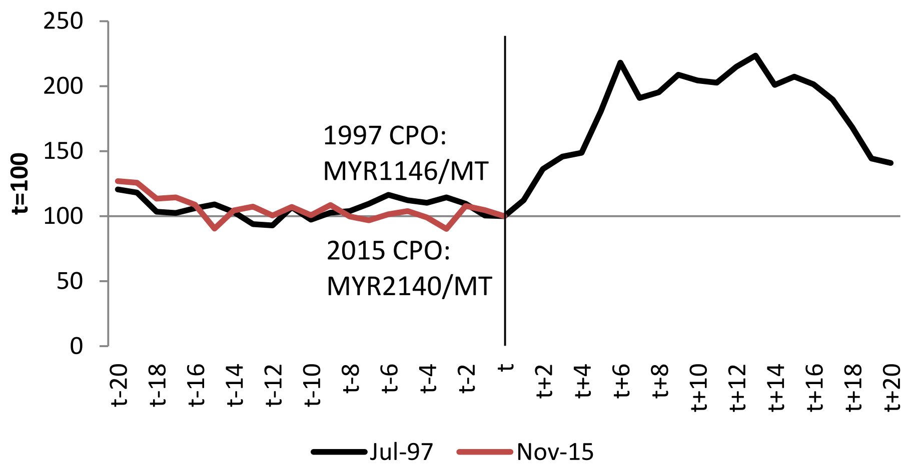
- Just when Asian soil turned brittle and dry from Mother Nature's El Nino phenomenon, she now looks poised to pour heaps of La Nina's moisture to further worsen agriculture produce.
- Despite the onset of El Nino in Dec 2015, agricultural prices still have headroom to rally from last year's phenomenon. Dry weather is expected to continue into 1Q16, before La Nina, the counterpart of El Nino, turns weather conditions too wet for farmers across Asia.
- With palm oil supplies likely to see some downside risks this year, the missing puzzle piece will be the demand outlook. The improving economic conditions in Europe should lend strength to demand, while China's recovery in vegetable oil imports last year is encouraging.

Please listen to our mother

Mother Nature has only one thing to say to us, and the message would be daunting to many agriculture producers in Asia. It is the message of El Nino's overstaying his welcome with sustained heat and drought into the first quarter of 2016, followed by La Nina's visit with her pouring of unneeded rain and storm as early as third quarter of 2016. Or at least, that is what weather forecasters think Mother Nature is saying.

Nonetheless, Mother Nature's message has clear implications to the outlook of agriculture harvest and consequently, its prices. For palm oil, history bestows an important lesson - the current El Nino phenomenon has reached the severity of the 1997/8 El Nino episode, according to the Oceanic Nino Index (ONI). More importantly, the 1997/8 El Nino episode saw palm oil prices rallying by more than two-fold to MYR2,600/MT in early 1998.

Palm oil rally behavior 1997 vs 2015



Source: Bloomberg, OCBC Bank

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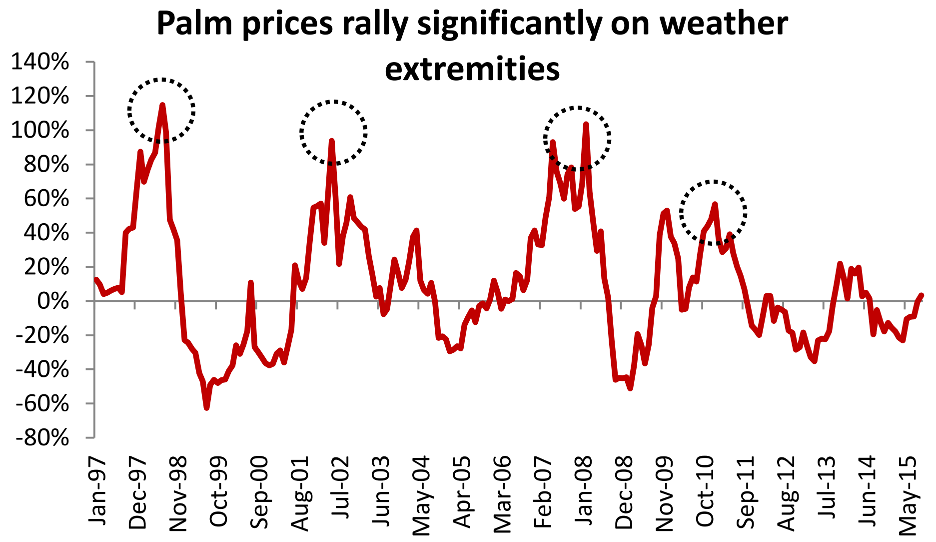
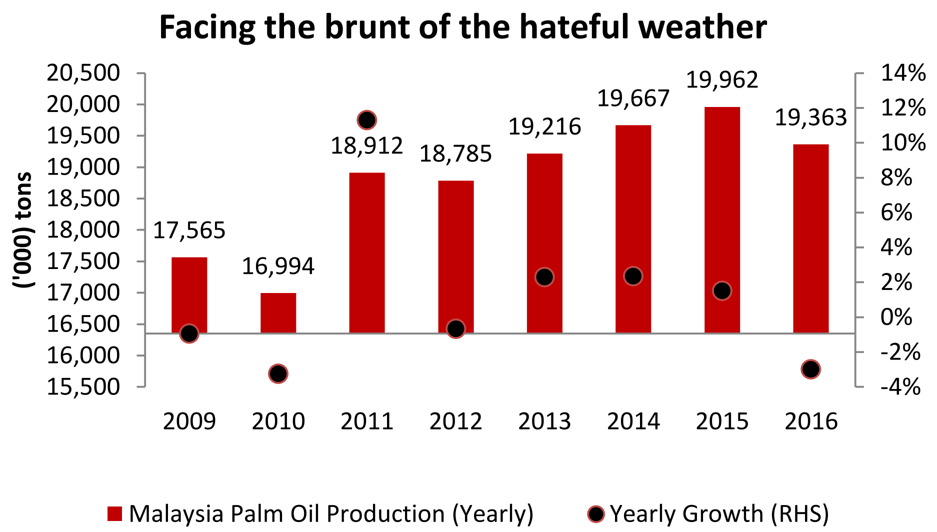
Despite the strong rally back in 1997/8, we do not expect palm oil prices to rally two-fold from current levels, but rather, stage a rally back to its MYR2,650/MT (+47% from trough in Aug 2015) this year. History does have its way of teaching agricultural producers and government bodies to deal better with severe drought, especially given the fact that the El Nino back in 1997/8 was the most severe phenomenon seen in history. This time around, anticipation in dealing with the drought seen in 2015 has been present with water ration programmes, high stockpile of agricultural inventories etc. Still, upside risk to prices will persist into the year as palm oil production fall into the first quarter of this year.



Source: Bloomberg, OCBC Bank

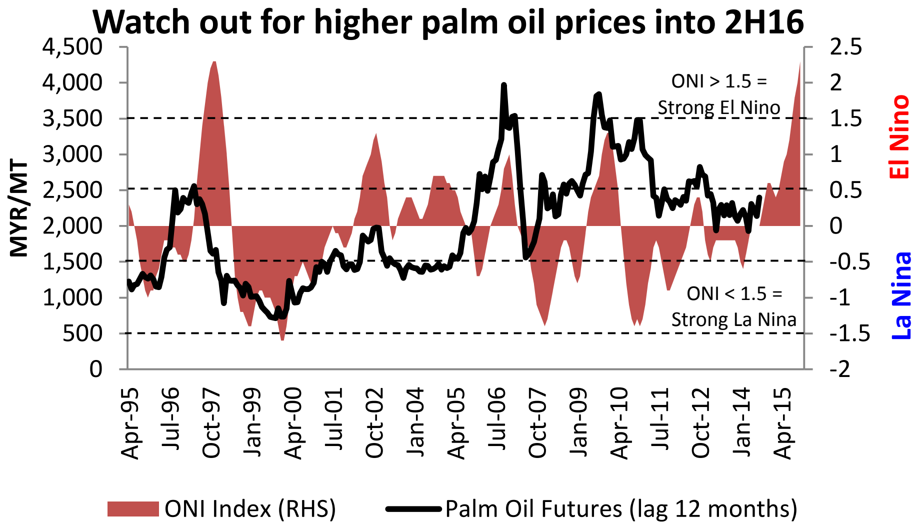
A lagging effect

Even as we speak, palm oil prices have rallied distinctly given the falling seasonal production cycle seen in Malaysia and Indonesia, the two largest palm oil producers in the world accounting for 86% of total supply. Empirically, Malaysia's crude palm oil production has fallen to a paltry 1.4 million metric tons in December 2015, the lowest in 10 months. Measuring it in annual basis, Malaysia's total crude palm oil production in the last year slowed considerably to 1.5% year-on-year growth, the slowest since 2012.



Source: Bloomberg, MPOB, OCBC Bank

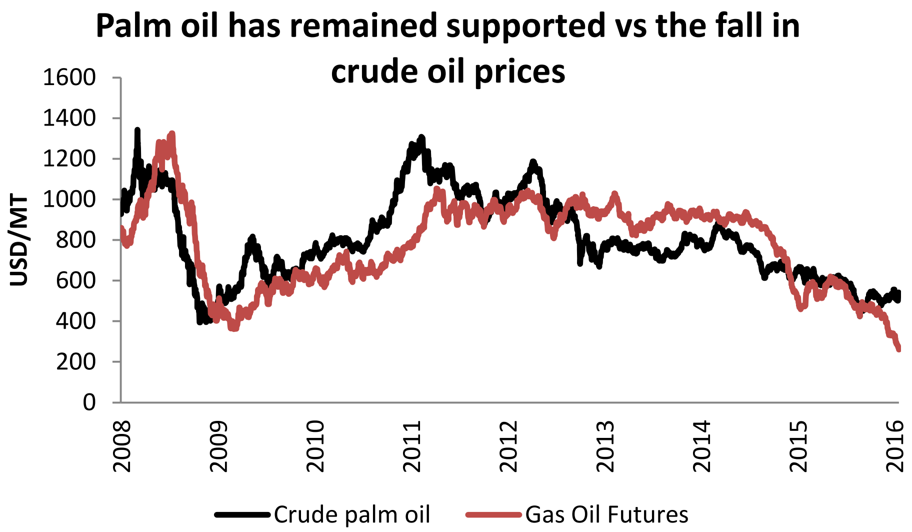
Importantly, the slowdown in production will be significantly pronounced given the poor weather conditions, as we account for the poorer harvest from drought damage, as well as expected poor harvest from wetter conditions brought by a La Nina phenomenon. In this, we project a 3.0% contraction in total crude palm oil production in 2016, given the approximate 12-months lag from the peak of palm oil prices versus the peak of El Nino severity.



Source: NOAA, Bloomberg, OCBC Bank

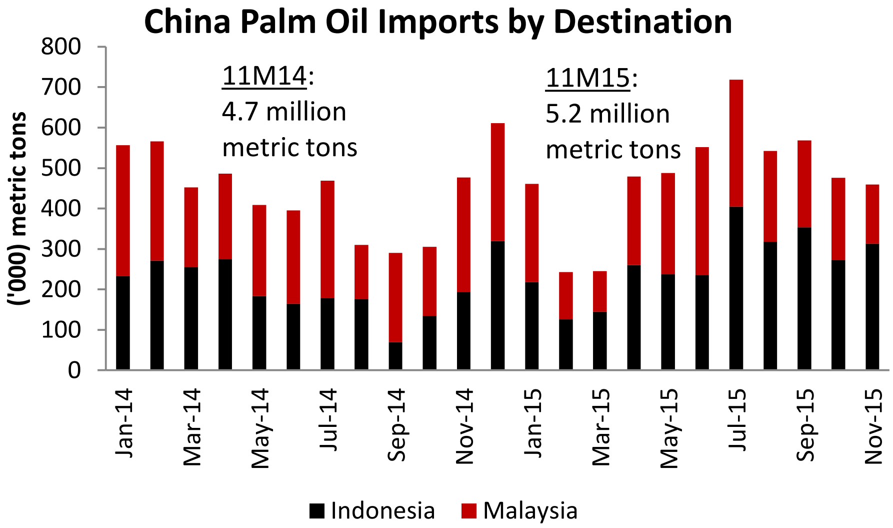
Demand outlook is mixed

Despite the certainty of lower palm oil production into 2016, the demand climate is a wildcard that would finally determine how prices may trend. The demand outlook is mixed however, given that palm oil is generally influenced by vegetable oil demand and lower oil prices.



Source: Bloomberg, OCBC Bank

With palm oil's use in the biofuel space, much of price movement would likely be influenced on how crude oil prices may trend. According to our estimate, palm oil as a biofuel is only viable when crude oil prices print above $50/bbl, which suggest that palm biofuel is grossly expensive compared to crude oil at this juncture. The comfort to this however, is the fact that palm oil futures has resisted any pull-down from the fallout in crude oil prices in late 2015 for a number of reasons: (1) palm oil production is seasonally lower at end-year, (2) demand has been favorable on the back of improving EU, India and China's imports of vegetable oil, and (3) government policy in Indonesia and Malaysia has been supporting palm oil demand as a biofuel from its B15 (slated to increase to B20 in 2016) and B10[1] progamme respectively.



Source: Intertek, OCBC Bank

The truth is, that palm oil demand in 2015 as a whole has been relatively rosy compared to the bouts of risk aversion from Chinese growth slowdown and low oil prices. Empirically, Chinese total palm oil imports has risen to 5.2 million metric tons (+11.1% yoy) in the first 11 months of 2015 despite the growth slowdown, on the back of 35.1% growth in imports from Indonesia (imports from Malaysia fell 9.1%). Elsewhere as previously mentioned, the economic recovery in Europe has led to higher demand for palm oil in 2015, followed by a stark gain in imports from India as palm oil discount to soyoil narrowed.

Putting the puzzle pieces together

The surety of lower palm oil production into 2016 is a strong signal for prices to edge substantially higher into this year. Should we look at history for reference, the severe El Nino phenomenon seen in 2015 should inject higher agricultural prices (including palm oil) into 2H16. We estimate that there is a 12-months lag of how palm oil prices will rally in contrast with the peak in the Oceanic Nino Index. Elsewhere, despite the low oil prices seen of late, palm oil demand should still be buoyed by (1) government policies which encourages palm oil blend diesel in Malaysia and Indonesia, and (2) overall healthy import demand into 2016, seen from improving economic fundamentals in Europe and US and sustained healthy demand from China.

All-in-all, we maintain our palm oil outlook at MYR2,650/MT at year-end as we look to Mother Nature's conduct this year, and it does not look favorable for supplies given the expected poor weather conditions.

[1] The B(%) programme refers to the percentage amount of mandated palm oil blend with diesel.