Rise in Coffee Prices Nearing Peak

The recent surge in futures prices will end as Brazil's currency weakens further and El Niño strengthens.

By
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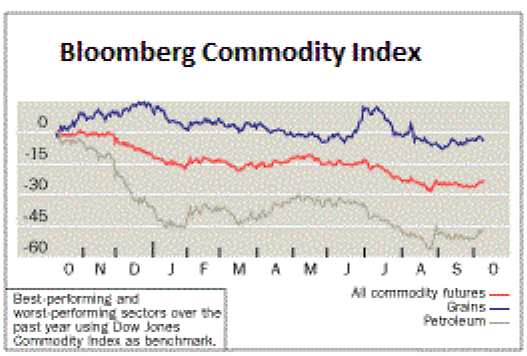
The long rout in the coffee market may finally be over, But its recovery probably is temporary, as more clouds gather on the horizon.

The $10 billion coffee futures market has fallen more than 40% in the past year. Much of that drop has tracked a slide of nearly equal size in Brazil's currency, the real, which has been hurt by rising inflation and a sovereign credit downgrade spurred by economic contraction and various fiscal and political woes.

A weak real encourages coffee exports from Brazil, the world's largest producer, because growers try to profit by converting foreign dollar-denominated sales back into the home currency. Brazil's currency slide has stabilized since late September, and coffee prices have enjoyed an 11% rebound in that time.



Supply-and-demand fundamentals are getting more bullish, too. Coffee inventories registered with the ICE Futures U.S. exchange have fallen below two million bags, slightly less than average for this time of year—as the U.S. and Europe head into peak demand season. Producing countries say their estimates for the harvest season starting in January are lower than previously expected. And with prices bottoming out recently near farmers' cost of production, supply cuts could be in order as producers hold back supply to shore up the price.

Another factor has supported the recent rally: Financial speculators such as hedge funds had placed a near-record amount of short bets against the market that prices would fall. When prices rose instead, some bought futures to close out those trades, pushing prices even higher.

“It’s mostly short-covering,” says David Martin, managing director of $75 million soft-commodity hedge fund Martin Fund Management, whose own fund shorted coffee as it bottomed out. “Whether it’s sustained is a good question.”

ANALYSTS SAY THERE could be added price gains of as much as 5% to 6% into next year. But at that level, the price becomes attractive enough for producers to sell contracts in the market, locking in future profits. That should cap any rally.
“When you see prices fall for 12 months, the market is going to try to stabilize,” says Chris Narayanan, head of agricultural commodity research at Société Générale in New York. Coffee prices gained 2.45**%** on Friday to settle at $1.316 a pound on the ICE Futures U.S. exchange.
The biggest unknown is hard to forecast: the potential for an El Niño–inspired tropical storm in South American growing regions this winter, coinciding with harvest season. El Niño can help prices by interrupting harvests or hurt prices by spurring a bumper crop.

Agriculture-focused Dutch bank Rabobank recently lowered its price forecast for the latter part of next year, citing a “double whammy of early but excellent rains in Brazil” and further depreciation in the real.

Despite recent losses, hedge funds and financial investors maintain a large net short position, according to data from the U.S. Commodity Futures Trading Commission. Brazil is far from out of the woods with its economic woes, and further declines in its currency are possible.

Whatever the seasonal demand spike for coffee, it will be short-lived, analysts say. People prepare more coffee once the weather turns cold and the holiday party season swings into gear. But much of the demand is artificial.

“The biggest consumer of coffee is the kitchen sink,” says Martin. “A lot of it gets made, but not a lot gets drunk.”

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