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Crude Palm Oil – waiting to take off

Background data – Crude Palm Oil (CPO) is a vegetable based oil obtained from the palm fruit. Palm fruit is reddish in colour and is roughly the size of a large plum. The fruit contains a kernel which also yields oil, known as palm kernel oil. For every 10 tons of CPO, 1 ton of palm kernel oil is obtained. The kernel oil is lighter and is exclusively used for food. CPO on the other hand is a versatile product which can be used in soap, detergents, ointments, cosmetics, machine lubricants and also cooking oil, shortening and margarine.

By 2007 – 08, the output of CPO was up 20 times as compared to 1970. In terms of production, Malaysia (42%) and Indonesia (44%) are the largest producers of this commodity worldwide. Other marginal producers are Thailand (2.7%), Nigeria & Columbia 2% each.

In terms of global exports, Malaysia is the leader with 46% and Indonesia follows with 43 % of the world export stakes. Primary importers are China 19% and India 14%, followed by some imports by USA and Europe.

Critical update – of late, there is a dangerous situation in terms of possible supply side constraints threatening to impact the pricing of CPO in the coming quarters. Pressured by the global situation, Indonesia and Malaysia are no longer keen on mere CPO exports, but wish to add value to their exports by offering a higher share of RBD (refined, bleached and deodorized) oil, a product obtained after refining the crude palm oil (CPO), which will offer job creation to the domestic population as well as higher export profits.

On the other hand, led by the domestic Indian edible oil refining industry, there is a resistance to import RBD, as CPO is cheaper and will entail offering jobs to the refining plant workers. Malaysia and Indonesia are moving towards a regime of encouraging RBD exports by offering subsidies to the RBD exporters and contemplating tariff barriers for CPO exports. Indian importers are likely to be at a disadvantage and the falling INR is adding to the cost pressures of the domestic players. India exports groundnut oil (peanut oil) to Indonesia and Malaysia. We feel, this imbroglio may add to the cost pressures and the price of CPO is headed higher over time.

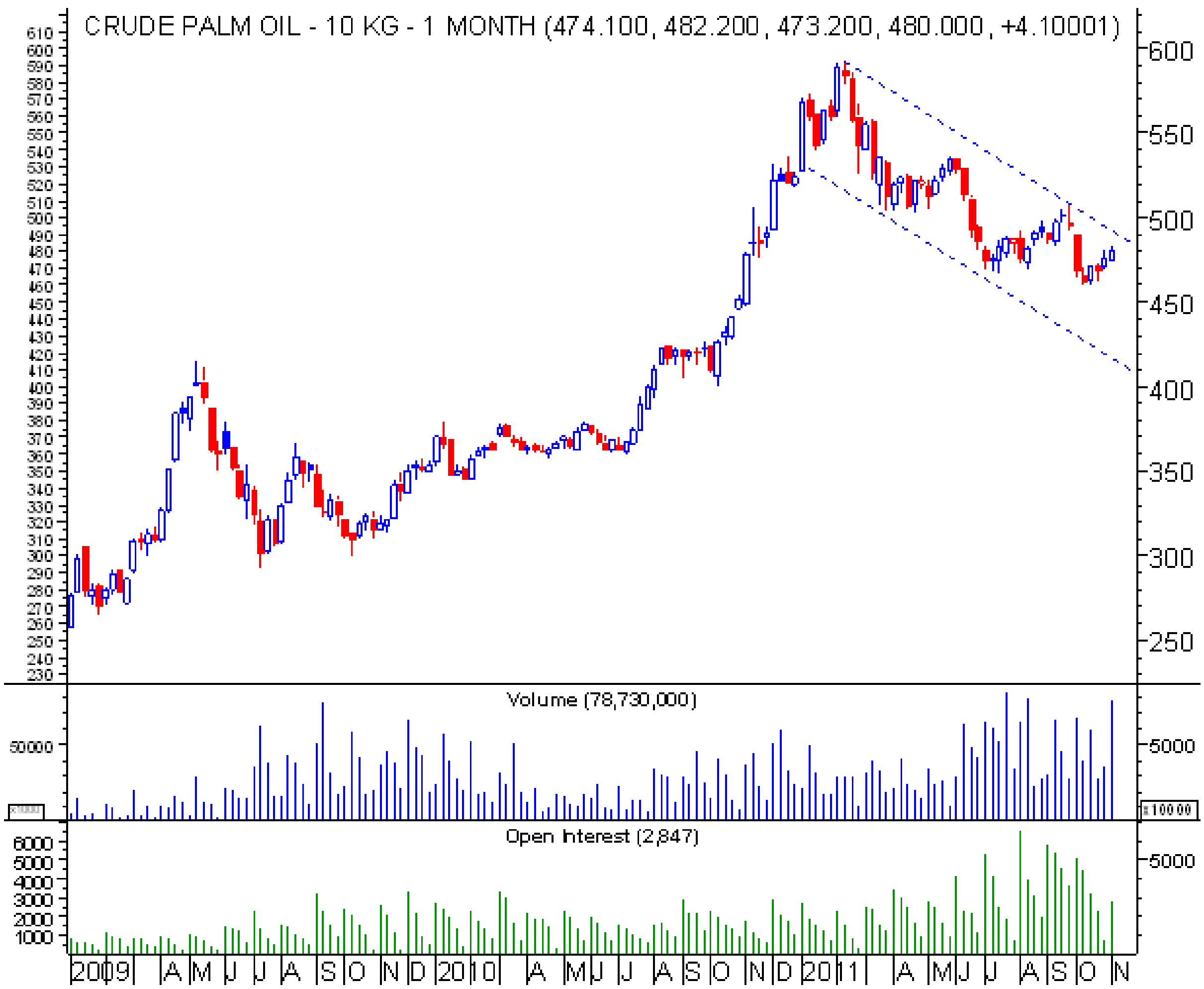
Future price triggers – the Indian parliament is likely to pass the Food Security Bill (FSB), the largest endeavor of it's kind in the world, costing Rs 1,00,000 Crs with Rs 13,000 Crs as cost overrun allowance. The bill is likely to be passed in the winter session of the parliament. The bill involves providing wheat and rice to 75 % of the below poverty line (BPL) families in the Country at Rs 3 & Rs 2 per Kg respectively. The FSB is likely to flag off a major demand spike for all varieties of grains, edible oils, vegetables, pulses and fruits. Higher food inflation over the long term is a given. While policy measures may see temporary price declines, the long term trajectory is higher.

Risk / threat perception – the INR could appreciate significantly which may temporarily impact the CPO prices adversely for the bulls. That will not deter prices from rising over the long term as demand expansion from the rising population with a higher disposable income will more than compensate for the currency volatility – over time.

Technicals – note the price has peaked out in Feb 2011 at the 591 levels. The price has since then declined to the 459 levels (a fall of 22 % from the absolute peak). The price decline can be tracked in a falling channel and the last swing low is approximately at the same level as July 2011, which indicates a temporary arrest of the fall, partly aided by the sharp decline in the INR. Since a bulk of CPO is imported, landed prices are determined in USD denominated terms.

In technical terms, a breakout past the 500 levels with open interest and volume expansion will indicate a flag formation which has bullish implications. It is heartening to note the rising open interest in the last 6 months, which indicates a higher risk appetite from the buy-and-hold players. The traded volumes too have risen at a steady pace in the commensurate period as the second window in the chart indicates.

As for the price target after the breakout from the bearish channel, the 540 level will be the primary area of resistance to watch out for. Once this hurdle is overcome on a sustained closing basis, the counter is likely to attempt a retest of the all time high of 591 over the next 2 – 3 quarters.



Our price projection over the next 3 – 4 years is significantly higher as the CPO price is expected to rise exponentially every 3 quarters.

The production cycle for the commodity is unique in that the plant yields output between April – December and the period between January to March is an "off" period. Long term players will note how prices tend to pick up northwards momentum in the last quarter of the calendar year and tend to peak out in a first / second quarter of the following calendar period. So far, the prices have seen a higher tops and bottoms formations and we expect the overall trajectory to sustain over the long term.

Your call of action – we recommend buying the far month futures of CPO on the MCX. The market lot is for 10 metric tons and the price is quoted in multiples of 10 kgs. The margin payable per contract is 5 % of the value and is approximately Rs 25000 per lot. Since agri commodities tend to be volatile, we feel traders should allocate higher amounts for mark-to-market payout as compared to the initial span margins. That will ensure you trade is not stopped out for the want of margin money.

Unless the counter declines below the 410 – 420 band, we do not foresee a bearish trend returning on the counter. Long term players need to dig their heels into this counter and buy on dips in a deliberate manner. Spare cash maybe maintained in the trading account to average in case of a sudden sharp fall of 5 % or higher so as to achieve a lower acquisition cost. Part of the longs maybe liquidated at the 540 levels to reduce the holding costs of the residual positions, which maybe booked at the 600 + levels, possibly by end of next calendar year if the FSB is passed.

Fair disclosure – we hold long positions on the commodity and therefore have a vested interest in this recommendation.

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The author of this piece is the author of "A Traders Guide to Indian Commodity Markets" – India's first commodity trading manual. The book has received sponsorship / recognition from the NCDEX – India's premier agri commodity exchange.

End of the report