Sugar Surge No Taste Of Honey

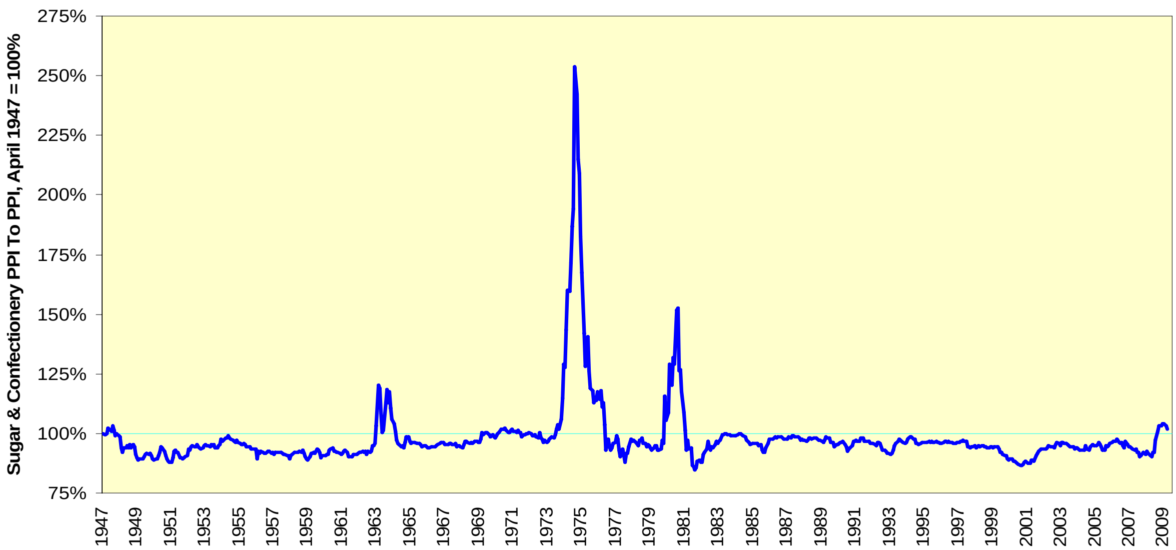
Newcomers to commodities inevitably are impressed by the sheer size of the contract, 112,000 pounds. Veterans in the commodities business can measure their age by how many times they have heard this will be the year when sugar reprises its spectacular rallies of 1974 and 1980: Once every year and this time we mean it.

This time we have to take the sugar rally far more seriously as India, one of the largest producers and consumers of sugar in undergoing a dearth of its normal monsoon rain. Sugar cane, which accounts for about 70% of world sugar production – sugar beets grown in cool temperate climates account for the other 30% - is a hot-weather plant requiring a lot of water.

Sugar has another drawback, one that did not affect the markets of 1974 and 1980, its use as a distillation feedstock for the ethanol industry in Brazil and various Caribbean countries. The tradeoffs between sugar, ethanol, gasoline and the U.S. corn-derived ethanol industry could fill the rest of this column, but mercifully they will not.

We presently are at the highest nominal prices for sugar since 1981, a somewhat disingenuous statement considering the 70% rise in producer inflation since then. If we map the Producer Price sub-index for sugar and confectioneries to the PPI itself, we can see just how much room sugar has to rise before it hits 1980-levels of relative inflation, let alone 1974 levels.

This Could Go Higher



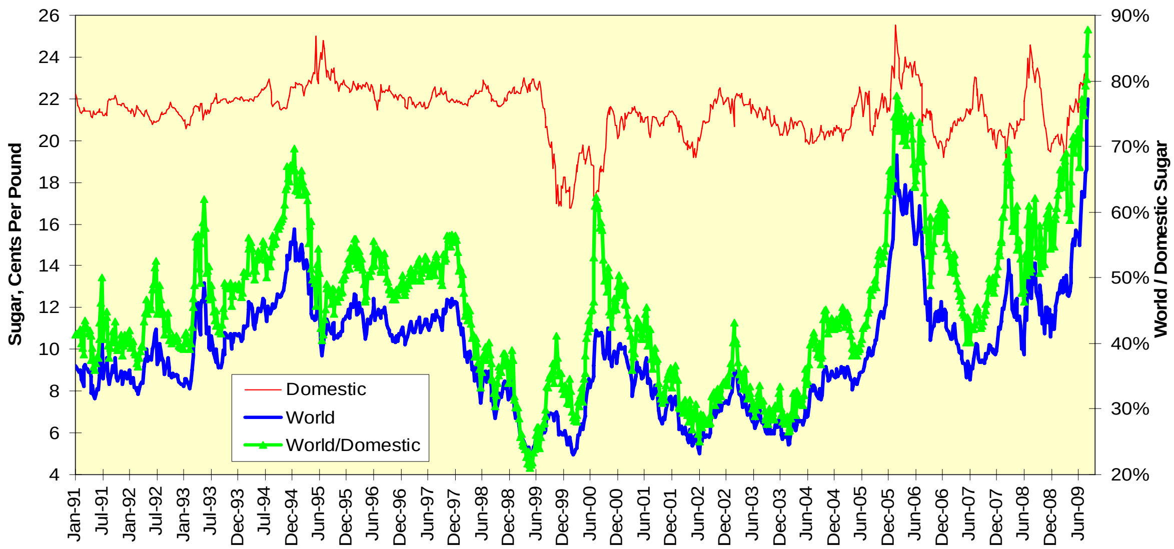
Two Different Sugar Markets

The sugar traded on the Intercontinental Exchange is raw, or unrefined, sugar. The principal contract, for No. 11 grade, reflects a world price; the lesser-traded No. 16 grade reflects a domestic price. The U.S. has engaged in a starkly protectionist policy for sugar for years enforced by import quotas; blame can be distributed to cane growers in Florida and Louisiana and to beet growers in North Dakota.

As all import quotas do, these have maintained U.S. sugar prices well over world prices to the detriment of bakers, confectioners and soft drink makers in the U.S. and to sugar exporters in the Caribbean. The circle of idiocy is squared by sending foreign aid to those sugar exporters instead of simply buying their sugar at a lower price.

The current surge in prices is reflected primarily in the world price, which now stands at approximately 88% of the U.S. domestic price. As recently as February 2004, this ratio was 27%.

You Have Been Paying The High Price For Years



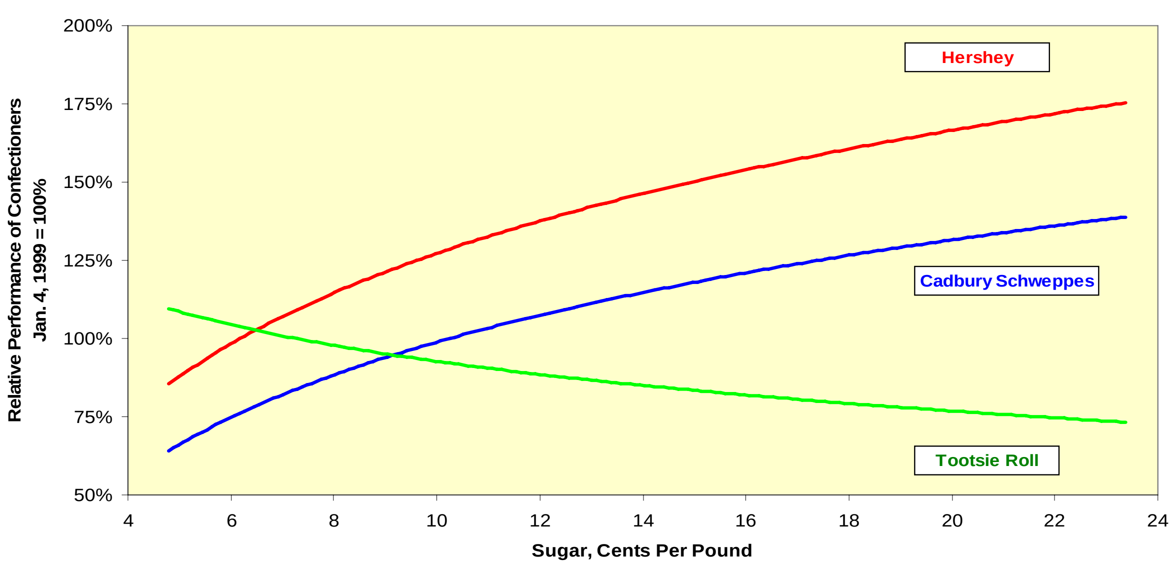
Stock Market Impact

A market such as sugar presents a conundrum for most investors. Few want to trade sugar directly, and I cannot say this reticence is at all misplaced. It is a market best left to either commercial traders or professional commodity trading advisors. Until recently, it was not sexy enough to support an exchange-traded fund by itself, unlike gold, crude oil and natural gas, and given the problems we have seen in all of these commodity-based ETFs, this, too, is probably well and good.

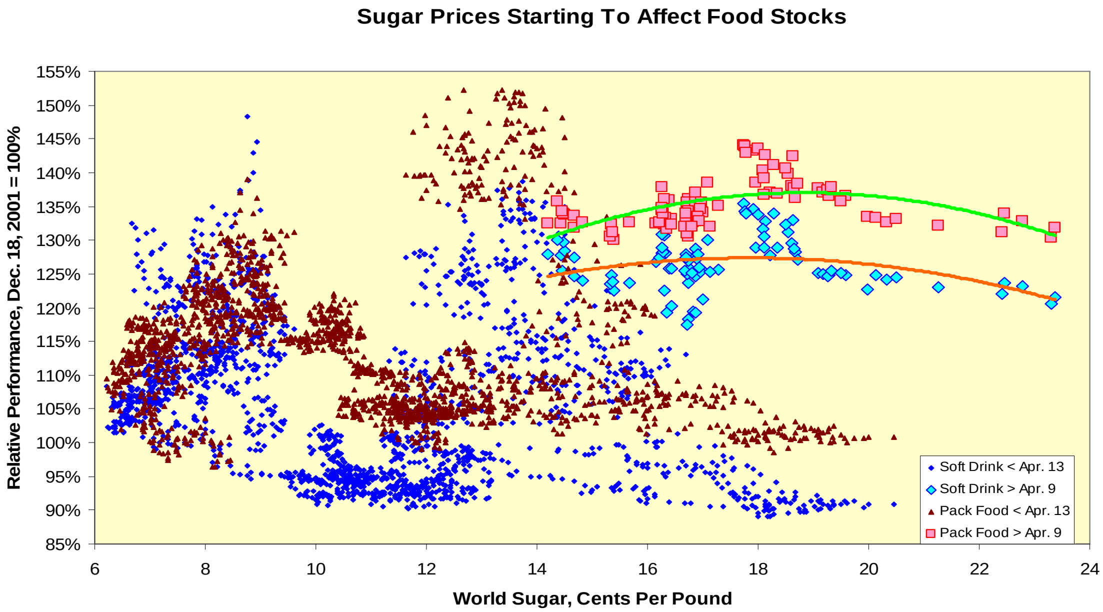
Most sugar is grown under the auspices of either state marketing boards or private growers – this is a common industry structure given commodity volatility - and that leaves few opportunities to play the long side, however imperfectly, via the stock of a producer. The American Depository Receipts of Tate & Lyle may come closest in this regard, but they are hardly a direct play.

We can turn then to the consumer side. As sugar is an input to so many foods and drinks, we should think it would have a direct impact on profit margins. As is so often the case, though, these effects are irregular on a company level. If we map the relative performance of three major confectioners, Hershey Foods, Cadbury Schweppes and Tootsie Roll, to the broad market as a function of world sugar prices, we arrive at two positive relationships. Both Hershey Foods and Cadbury Schweppes' relative performance has increased along with sugar prices (only the trend curves are shown for visual clarity).

Sugar Prices And Confectioners



However, if we extend the analysis to the index level and break it apart in time, disturbing trend starts to emerge. Here the dependent variable is the relative performance of the S&P 1500 soft drink and packaged food indices against sugar. The analysis is split at the close of business on April 9, 2009, just before sugar prices started to accelerate.



Prior to April 13, 2009, both relationships were essentially random; the price of sugar had little effect on relative performance as it rose and fell, and this is as it should be. First, the food and soft drink companies were exposed more to the domestic than to the world price. Second, the price of sugar remained a relatively small percentage of the total cost picture.

After the surge in world prices and their convergence to domestic prices began, the relationship changed. Over the small data sample, just four months, an inversely quadratic relationship has started to form. As world sugar prices rise, the food and soft drink companies' relative performance declines. Once the convergence is completed, we should expect acceleration in this relationship.
As the sugar supply picture is complete for this crop year, we have to wait until the next one begins in October 2010, to see relief. Any acceleration in demand, including demand from state agencies hoarding sugar, will push prices higher. This is negative for the food and soft drink companies for another year at least.