QUARTERLY MARKET OUTLOOK FEBRUARY 2006

Sugar

2005/06- world statistical deficit revised upwards to 2.2 mln tonnes
Better than earlier expected production in Europe
Brazil: no production expansion in 2005/06?
A strong recovery in India's output
Tightness in the trade balance
World prices at a 25-year high
Sharp rises in domestic prices in Brazil, Russia and China

WTO

End-April deadline for agriculture modalities

RTAs

US and Peru conclude agreement

HFS

US producers win higher prices

Molasses

Stagnant trade and high prices to continue

Biofuels

Fuel ethanol demand booming in Brazil, US and the EU

International Sugar Organization, 1 Canada Square, Canary Wharf, London E14 5AA, UK
Tel: + 44 (0) 20 7513 1144 Fax: +44 (0)20 7513 1146 Website: www.isosugar.org E-mail: economics@isosugar.org

International Sugar Organization
One Canada Square
Canary Wharf
London E14 5AA

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Contents

General Enquiries:
00 44 20 7513 1144

Publications:
00 44 20 7715 9436

E-mail:
economics@isosugar.org
Website:
http://www.isosugar.org

Contributors:
Sergey Gudoshnikov
Senior Economist
Lindsay Jolly
Senior Economist
Leonardo Bichara Rocha
Economist

Executive Brief

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World Sugar

Since our previous *Quarterly Market Outlook* in November, world market prices for both raw and white sugar have exploded. The daily spot price for raw sugar (ISA daily price) improved from 12.03 at the beginning of December to 18.46 cents/lb in late January. On 3 February the ISA daily price reached 19.25 cents/lb, the highest price for 25 years. Then the rally stalled and raw sugar prices have recently suffered a minor downward correction. On 24 February the ISO daily price was as high as 17.85 cent/lb. White sugar prices followed a similar pattern moving from USD305.50/tonnes (13.86 cents/lb) at the beginning of December to USD460.50/tonne (20.89 cents/lb) on 23 February. On 24 February the LDP (whites) was 445.00/tonne (20.18 cents/lb).

Our forecast for the 2005/06 deficit rose from 1.015 mln tonnes seen in November to 2.225m mln tonnes. The ISO third assessment of world sugar balance for the period from October 2005 to September 2006 shows world production at a new record at 148.969 mln tonnes, raw value. A further growth in output is not expected, however, to cover growing demand, which is currently put at 151.194 mln tonnes. A continuing global statistical deficit is expected to result in a further decline of stocks. The ISO anticipates that 1.939 mln tonnes of sugar from stocks will be used to cover production shortfalls and growing consumption worldwide in 2005/06. By the end of the season, world sugar stocks are estimated to decrease to 58.274 mln tonnes, or 38.5% of world consumption as against last season's 40.69% and the record high of 46.72% in 2002/03.

Moreover, our latest revision adds to a cocktail of bullish fundamentals (the third season of global deficit and a further decrease in stocks as well as in the stocks/consumption ratio) one more powerful ingredient: tightness in the trade balance. Our second revision of the world sugar balance shows that for the first time since 1999/00 world export availability is expected to diminish from the level achieved in the previous season. This makes the world trade balance extremely tight. In fact, there is a small gap of 286 thousand tonnes between import demand and export availability. Obviously, one cannot import sugar which has not been exported. By the end of the season, the difference between availability and demand will be clarified through changes in stocks. What is important, however, is that this season the world statistical deficit (the gap between projected consumption and production) is reinforced by tightness in exportable supply.

The current understanding of sugar fundamentals provides strong support for the market upbeat mood. What the fundamentals cannot predict, however, is whether the current level of world market prices between 17 and 19 cents/lb is the peak of the current bull's run or a launching pad for new highs above 20 cents/lb. World energy prices, currency movements and policy developments are playing a greater role in determining world sugar prices. The ISO believes that the world sugar market has entered "uncharted waters", where pure traditional sugar fundamental factors no longer alone determine the world price level. For example, on 22 February Brazil's government announced a cut in the mandated blending ratio of anhydrous ethanol into gasoline from 25 to 20%. Although the measure deals with tight ethanol supply during the inter-harvest period, if extended, then lower demand for ethanol may create additional cane supply for sugar production. That will create 0.5-1.0 mln tonnes of additional export availability with obvious repercussions for world sugar supply/demand situation in the second half of 2006.

A summary of the forecast world balance for 2005/06 (October/September) after the second revision is given in table below (in mln tonnes, raw value):

	2005/06	2004/05	Changes in mln t	Changes %
Production	**148.969**	**144.262**	**4.707**	**3.26**
Consumption	**151.194**	**147988**	**3.206**	**2.17**
Surplus/Deficit	**-2.225**	**-3.726**		
Import demand	**46.005**	**45.759**	**0.246**	**0.54**
Export availability	**45.719**	**46.164**	**-0.445**	**-0.96**
End Stocks	**58.274**	**60.213**	**-1.939**	**-3.22**
Stocks/Consumption ratio (in %)	**38.54**	**40.69**		

Currency movements and domestic prices

Back in July 2005, ISA prices in US Dollars averaged 9.64 cents/lb. Since then, prices have risen substantially by 63% in aggregate terms. The US Dollar has been relatively stable against the currencies of the world's largest importers and exporters. This means that both importers and exporters have seen world sugar prices expressed in national currencies rise to a large extent over the past 6 months. On the back of tight supplies, domestic sugar prices in Russia and China have increased by around 50% between last August and February 2006. In Brazil, domestic prices expressed in USD have risen by 67% since August. Domestic price rises in India, however, have risen by a more tepid 10% over the past 6 months.

WTO

The task before WTO member countries remains formidable in the sluggish Doha Round negotiations. The main decision at the December Hong Kong Ministerial meeting was simply to keep talking: in order to avert another Cancun-style collapse. Ministers deferred discussions on the most contentious issues, instead agreeing an end-April deadline for a comprehensive agreement on 'full modalities' - specific numbers and tariff structures for reducing subsidies and tariffs. Progress towards the end-April deadline in the subsequent two WTO agriculture weeks has been limited.

Sugar and Regional Trade Agreements

The United States and Peru announced 7 December 2005 that they had concluded their work on a bilateral free trade agreement - The U.S. - Peru Trade Promotion Agreement (PTPA). Sugar was not excluded from the trade agreement, but the level of additional access afforded to Peru is small.

High Fructose Syrup

In the United States, the HFCS industry is benefiting from a significant rise in prices and continuing low corn sweetener costs (although offset to some extent by continuing high energy costs). Offtake on the domestic market remains moribund, but export volumes to neighbouring Mexico are rising. This is a direct consequence of waivers on the beverage tax to users of domestically produced and imported HFCS to bottlers as well as the declaration by the Mexican government in September last year allowing duty free imports of US HFCS to the amount of 250,000 tonnes – exact reciprocity for the US awarding Mexico a 250,000 tonne sugar quota.

Intensive Sweeteners

A new branded table-top sugar substitute – Zsweet™ - was launched mid-January 2006 in the United States by a San Clemente (California) based company, Ventana Health Inc.. Zsweet is a patent pending blend of Erythritol and natural flavor enhancers. Analysts observe that Ventana will have some "consumer-education hurdles" marketing Zsweet against its most obvious competitor Splenda (sucralose), which has turned the sugar-substitute market on its head.

Molasses

Although India is re-entering the export market this year (due to a boost to molasses output), and new crop molasses has been available from Thailand and Pakistan since late last year, export volumes from these two key exporters is again likely to be limited during 2006 due to poor crops and competing demand for ethanol production. Market tightness and consequent high molasses prices are also driven by ongoing buyer resistance to the prevailing high prices.

Biofuels

Brazil's demand for fuel ethanol continues to expand due to the continuing enthusiastic reception by consumers of the flex-fuel vehicles. The government has taken action to ensure available supplies fulfil demand during the crucial centre/south inter-harvest period (Dec-March) and have reduced the mandated blending ration of anhydrous ethanol in gasoline from 25% to 20%. For the upcoming 2006/07 campaign ethanol production is forecast to reach 17.4 bln litres, a rise of 1.1 bln litres, mostly to meet rising internal demand for hydrous ethanol in flex fuel vehicles.

In the **United States**, 95 ethanol refineries were in production in 2005, 14 began production, 30 began construction, 10 were expanded and the industry produced a record 15.1 bln litres (4 bln gallons) of ethanol. The accelerated phase-out of MTBE over the next 6 months will boost ethanol demand significantly whilst implementation of the Renewable Fuel's standard (RFS) will ensure a strong longer term future for the biofuel. Analysts foresee another 5 years of frantic investment in production capacity.

ISO

1 Canada Square
Canary Wharf
London, E14 5AA
United Kingdom

Tel: (44) (0)20 7513 1144
Fax: (44) (0)20 7513 1146
Web: www.isosugar.org
Email:Publications@isosugar.org

International Sugar Organization

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