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Consumers Lose Taste for Cocoa Under Covid-19

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Food & Agribusiness
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Andrew Rawlings
Associate Commodities Analyst
+44 20 7664 9756

Introduction

The effects of Covid-19 on cocoa demand have been a major concern for market participants since the virus started to spread outside of China. In this article, we aim to summarize the effects so far and what is likely for the remainder of the 2019/20 season.

Initially, Covid-19 appeared to have little effect on cocoa consumption in Q1 (other than reduced chocolate sales at Easter), as supermarkets struggled to adapt to changing consumption patterns amid lockdowns. European cocoa processors actually increased grindings in Q1, as they anticipated the potential for future plant closures during lockdowns. Grindings were fairly in line with expectations in Q2, with all major regions showing year-on-year declines. European Q2 grindings fell 8.9% YOY, the largest year-on-year percentage decline in Europe since 2012. North American Q2 grindings fell 10.5%, and Asian Q2 grindings fell 6% YOY. Collectively, this represents a decline of 8.2% YOY for Q2 and a 2.6% YOY decline for the first three quarters of the current 2019/20 season in these major regions. This decline in grindings is starkly different from the last major global demand decline in 2014/15, which was largely due to a smaller crop and higher cocoa prices causing demand to fall 4.2% YOY as production fell 2.7% YOY. This time, it has been due to outright lower demand in the fallout of Covid-19, with production growth expected to flatten year on year and average prices to be lower.

Growth in cocoa grindings has been slow in North America and Europe, averaging a rate of 1.5% to 2% over the last ten years, whereas in Asia, the growth rate has averaged 6%. Asian cocoa grindings have performed much better than European and North American grindings in 1H 2020, and it will likely recovery more quickly as well.

Fund Positions Melted Quickly

Funds were fast to react. Before the Covid-19 pandemic, managed money had a sizeable net long position in both NY Cocoa and London Cocoa, reaching a maximum of 78,780 lots and 70,181 lots, respectively, on February 25, 2020. Many of those positions were quickly closed out, with open interest falling sharply amid market uncertainty due to the initial spread of coronavirus and the lockdowns, not to mention the volatility in differentials arising from the Living Income Differential (LID), which results in futures being a less-than-perfect hedging tool. In the last six weeks, managed money positions have begun to take a more confident direction, reaching a net short position of -28,077 lots in NY Cocoa and -11,108 lots in London Cocoa as of July 14. Clearly, funds don't believe this is the bottom. Managed money net short positions have increased, due to a negative demand outlook and expectations of increasing availability. This has combined with exchange-certified stocks rising in London. However, US merchant stocks have actually been declining (although at a much lower rate than in previous seasons), and this has led to more pressure on London Cocoa prices than on NY Cocoa prices.

Where Has Consumption Gone?

Consumption likely fell as consumers were stuck at home and their confidence fell with the prospect of a global recession. Much of chocolate demand is comprised of impulse and gift purchases made at physical retail shops, vending machines, airports, or while traveling. With the instant gratification of an in-person purchase unavailable and the prospect of a recession, consumers are more likely to shun the decision to purchase indulgent snacks, especially those considered a luxury. Initially, chocolate sales in US supermarkets increased in April as consumers stockpiled goods. However, there was a sharp month-on-month decline in May and then again in June, as consumption declined or moved away from traditional outlets. As a result, industry cocoa demand declined over the last few months, as companies and supply chains cancelled or delayed orders from processors to give themselves time to adapt to the changing environment or to shift toward the expectation of lower sales volumes.

Where Will Supply and Demand Go From Here?

With the mid-crop harvest well underway in West Africa and no major weather issues, cocoa availability at origin should be extremely good and will likely keep pressure on prices until availability weakens or a weather issue develops ahead of the main crop in October. The effects of Covid-19 on supply in the region appear to have been minimal and will likely continue to be. We currently estimate 2019/20 global production at 4.733m metric tons, -0.5% lower than 2018/19. We maintain our estimate of a 3% YOY decline in 2019/20 grindings, which will likely come in at 4.639m metric tons, resulting in a surplus for 2019/20 of 94,000 metric tons. The recession resulting from Covid-19 and social distancing measures will likely extend into 2020/21 and continue to affect cocoa demand. Processor stocks are likely to remain high, and Q3 2020 grindings, although showing an increase from Q2, will probably continue to show year-on-year declines in all major regions. In short, cocoa demand is unlikely to resume its growth trend until 2021/22, assuming a complete relaxation of social distancing measures.

Imprint

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