Commodities: China gets taste for caffe latte but investors must wait for returns to stir

Longer-term investors have already started to position their portfolios to capture higher yields they hope will eventually come from rising demand for beans in emerging markets, especially China

Regardless of the variety of beans, retail investment in coffee futures and ETPs is, as with many raw materials and commodities, a bet on China. Photo: Rii Schroer

By Andrew Critchlow

8:00PM GMT 19 Jan 2014

Coffee prices slumped late last year to a seven-year low on a supply glut but investors should focus on the long-term outlook for the commodity as the emerging trend for cafe latte replacing green tea among Chinese consumers picks up.

The price of Arabica coffee has already bounced back by 15pc since the lows reached last year of $1.35 (£0.82) per pound, ahead of Brazil's crucial harvest starting in April. The South American nation is to coffee what Saudi Arabia is to oil, supplying 45pc of the world's beans. The harvest is the single most important event of the coffee trading year and analysts are already speculating about production volumes.

"Because farmers have cut back and there is less growing, we expect that harvests in Brazil could be lower," said Nitesh Shah, a research analyst at ETF Securities.

"High rainfall may also have stopped coffee bushes flowering and made it harder for farmers to put fertiliser on their plantations," he said.

However, many brokers remain sceptical about coffee prices rising further, largely because of lingering concerns about the oversupply of beans.

Macquarie is among the most bearish and doesn't foresee a sustained increase in prices for at least another two growing seasons. Macquarie expects production for the growing year ending in 2015 to reach around 152m (60kg) sacks of coffee, compared with forecast consumption of 147m bags.

"The high prices from two seasons ago encouraged area expansion and increased husbandry across the major producers; but it also prompted demand for high quality coffees to shift towards cheaper coffee types," wrote Macquarie analysts in its Agricultural Commodity Outlook for 2014.

"Although at today's prices only a few Arabica producers are making money, it is unlikely that production will fall back. At the most, we would expect some reduction in husbandry or input use, but trees will not be felled and producers will not switch to other crops."

Despite concerns over excess production, net inflows into coffee exchange traded products (ETPs) last year were a sign that longer-term investors have already started to position their portfolios to capture the higher yields that they hope will eventually come from rising demand for beans in emerging markets, especially China. According to ETF Securities, Coffee ETPs received $203m (£123m) of new investment in 2013, as contrarian investors bet on a rebound in Arabica prices.

Demand for higher quality Arabica has also been hit by moderate growth in established affluent markets in Europe and the US – whereas the market for lower quality Robusta beans, commonly processed into jars of cheaper instant coffee, has remained relatively strong.

Regardless of the variety of beans, retail investment in coffee futures and ETPs is, as with many raw materials and commodities, a bet on China.

Consumption of coffee in the world's second-largest economy and most populous nation is expected to grow by an annual rate of 9pc for the next five years. But it's not just China's large population that should interest coffee investors, it's the rising Chinese middle class, which is expected to grow to 630m people from 230m, who are of the most interest.

Retail coffee giant Starbucks has already placed Asia and China at the heart of its strategy to expand its global footprint. The company now has more than 1,000 coffee outlets spread across 60 cities in China and expects that the country will eventually become its second largest market, measured by sales, behind the US.

Growing demand for caffe lattes in China has not just boosted the outlook for coffee prices in the future – dairy producers also see the shift in consumer tastes away from traditional tea beverages as a major driver for their business going forward.

"Investors should look at coffee in the long term," said Mr Shah.

Iron ore: Steel yourself for more anxieties in the wake of Asian slowdown fears

Despite worries about China's metals consumption, demand for steel-making material remained stubornly strong last year.

Iron ore was one of the few industrial commodities to perform well in 2013, posting an annual price increase. Spot ore prices averaged $135 (£82) a tonne, up 62pc on the previous year, which marked the height of investor anxiety over China's rumoured slowdown in spending. Although fears have receded that the Chinese economy, which consumes the most iron ore, would implode, many brokers remain cautious this year.

"In 2014, concerns over supply again look likely to dominate sentiment towards the sector, particularly over the second half of the year, which is seasonally the strongest period for Southern hemisphere exports," notes the Macquarie commodities team in a recent missive to investors.

However, a bigger concern is the continued growth in supply of ore mostly shipped from Australia, which rose by 91m tonnes last year. Rio Tinto and Fortescue Metals Group will again ramp up production this year as they bring onstream fresh capacity from projects commissioned two years ago. An even bigger risk to ore prices could come from pollution.

Macquarie analysts warn that pollution levels in Beijing and Shanghai could prompt Chinese policy makers to rein in steel mills.

Baltic dry index

Some market watchers, including the BBC's new economics editor, Robert Peston, who thought it worthy of a tweet, became very excited last week about a slump in the Baltic Dry Index. The index, which is thought to be a "canary in the coal mine" for the world economy, shows the charter rate for the shipping of key commodities. The fuss was caused by an 11.4pc drop in the index, the biggest single-day percentage fall recorded. Thankfully, it doesn't appear to have been caused by any collapse in global trade that could be a precursor for economic disaster. Instead, new environmental rules making it tougher for miners to load coal in Colombia were apparently to blame.