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COTTON PRICE BEGINS TO FIND DEMAND ABOVE 100 CENTS

As we near 2022, the global cotton market is battling a host of features that it has not had to deal with in modern times. The December/March 2021 ICE event will mark the year and long be remembered as the period when over 90,000 contracts of Dec short hedges were rolled at a 300–500-point premium at a time when the US internal supply increased daily. Never has the US internal supply been so tight to force such an event despite the lowest weekly export pace in decades. The demand squeeze on merchants/coops was almost matched by the inability of some spinners to obtain shipments either on time or to find the traditional supplies. Such disruptions on a global scale are unusual over several-hundred-year periods, including periods of global civil disruption.

The most difficult aspect to get a good handle on is consumer demand. The events of Covid presented the world with challenges thought unimaginable only a short time ago. For the past 100 plus years cotton prices of over 100 cents have been short-lived and destructive to demand. The first came in the 1975 period. It was limited to approximately 60 days, and prices peaked at 117 cents a lb. This bull market was followed by a bear market that lasted until November 2001, with a low of 29.75 cents. The next event occurred in October 2010 when prices remained above the USD, reaching a high of 215.06 cents before moving back below 100 cents 13 months later. These represent the nearby ICE futures nearby contract.

Cotton has a unique place in the history of fabric. Up until the intervention of polyester/man-made fiber, cotton and wool dominated all apparel worn by the world and thus played a major economic role. In the 1860s, cotton was the center of global commerce. The US Civil War set off a shortage that took New York prices to a high of 189 cents. Cotton sold in the Southern US at 12-20 cents a lb., but, due to the war it was in short supply in New York and London. The panic reached its height when European banks issued three million British pounds of the “Erlanger Bond.” The bond paid 7% over 20 years and was oversubscribed, with 80 million British Pounds against 15 million offered. The bond could be repaid by British Pounds or French Francs. In addition, the buyer had the option to be paid in cotton at a fixed price of 12 cents, which was very attractive against the cash price at the time of 48 cents a lb. The bond, issued in five countries, was the largest issued by the Confederate States of America.

The bonds soon began to fall, never trading above 95% of value. Before it was over, the bonds expired worthless. Thus, the cotton bull market of the 1980s ended in tears. The price spike it triggered played a major role in stimulating the expansion of the Egyptian commercial cotton industry. A couple of weeks ago, we discussed in detail why we were cautious about joining the raging bull market in Dec above 100 cents. Each of the above illustrations ended in great pain and losses, and each time the bulls always said, “this time is different.” In the Civil War illustration, different conditions prevailed, but the events that followed 1970 provided an alternative to cotton through Polyester and other man-made Fibers. Polyester was invented in a Dupont lab in the 1930s and moved into commercial production in 1941. It was first used in apparel in 1951, and the battle began. The Federal Trade Commission defines polyester as “a manufactured fiber in which the fiber-forming substance is any long-chain synthetic polymer composed of at least 85 percent by weight of an ester of a substituted aromatic carboxylic acid, including but not restricted to substituted terephthalic units, and para substituted hydroxyl-benzoate units. The polyester most commonly used for fibers is PET, the same as plastic bottles.

By the late 1960s, polyester’s image was very popular, with polyester leisure suits for men and polyester double-knit pantsuits for women embraced by the middle-aged and elderly. To combat the image embraced by college students and younger buyers, the Tennessee Eastman Company launched a "polyester campaign" to revive its image. The Man-Made Fiber Producers Association, which became the Manufactured Fiber Producers Association – Polyester Fashion Council, launched its own campaign. Both groups focused on polyester's easy-care properties instead of its cheapness. In 1984, the Man-Made Fiber Producer's Association and the Council of Fashion Designers endorsed collections made almost exclusively of polyester or polyester blends. Well-known designers including Oscar de la Renta, Perry Ellis, Calvin Klein, and Mary McFadden, participated. Such publicity helped launch polyester as an acceptable fashion item. This gave the Fashion industry an alternative to cotton and a competitor on price. This was illustrated after the 2010/2011 bull market, which caused cotton's market share to collapse. China took control of the polyester and man-made fiber market during the 1990-2010 period and continues to expand. The overcapacity of polyester has been illustrated as crude oil rallied from below zero in 2020 to nearly 90 USD a barrel, and the standard polyester staple in China remained trapped in 50-60 cents a lb. range. Currently, the FOB warehouse polyester staple price is 49 cents a lb. vs cotton at over 155.00 cents. Never has cotton in China been priced at over three times the level of polyester.

The damage done to cotton use by the 2010/2011 bull market caused cotton market share in the US market to drop from near 60% to the low 40s before bottoming. The surge in price occurred just as the global economy was attempting to emerge from the global financial crisis. Raw material cost, almost alone, drove decisions. In our work with brands and retailers, an up to 100-cents-a-lb. cotton price played a limited role in the choice of fabric for medium to high priced goods. However, the 2010/2011 event illustrated that that had all changed, as cotton prices moved rapidly above 125-150 cents a lb. and some brands/retailers switched from cotton altogether due to either the price level or price volatility. While polyester prices have had very limited price movement, they have fallen. As China's overcapacity has expanded, cotton has experienced wide swings. This is a negative for brands and retailers. First, most, until the last 24 months, have experienced cotton only at the fabric level. They are now much more engaged. Price movements in fabrics have been much lower, with limited movement sometimes for months or even a year. Thus, spinners were left to absorb the swings in prices and would select a much lower cotton market share of the fiber when prices moved out of line with polyester.

This drove the market share of cotton for the most part until 2019, and it was behind the curse of 100 cents a lb. for cotton. The market now faces it first major test of this theory in China. China has always been a price-driven market. However, the size of the domestic Chinese domestic apparel market has grown rapidly, including the higher end of the apparel market. In some months the size of the market equaled the US or exceeded it briefly during the Covid disaster. The Chinese consumer taste has changed, and available data suggest cotton market share is at its record. The boycott of Xinjiang cotton by the US has made it patriotic to wear cotton, and the industry is promoting itself. Several major sports companies have introduced new cotton products and made a commitment to cotton. The Winter Olympics should provide a major boost to cotton as well. Up to now, we have no solid evidence that cotton has lost market share to polyester, despite the price premiums. We take some encouragement from cotton's market share against viscose fiber. Its price has fallen sharply, and it appears that it has not gained any market share against cotton in consumer apparel. In 2021, cotton has been featured in several major local fashion shows. In addition, one major fashion brand that specializes in natural fibers has boomed, something we never believed we would see in China.

The other curse of 100 cents cotton is that it is an annual renewal resource. That means that high prices can cure high prices as profitability increases acreage. The record run in 2010/2011 prices increased world cotton production by 10 million bales. This was accompanied by near a 12-million-bales drop in global consumption. Thus, very profitable prices trigger a sharp increase in prices.

IS THIS TIME ABOVE 100 CENTS DIFFERENT?

The March ICE contract has experienced a contract high of 118 cents, and the Cot look A Index hit 128.45 cents a lb. Since our last market letter, the ICE futures have finally corrected, dropping 600 points. One very interesting feature to the price behavior since the highs and during last week's correction is that a reasonable amount of physical business has occurred. Much of it has been on call, but some fixed price business has occurred. There have also been active mill price fixations of open purchases during the price weakness. Also, increased coverage of the Brazil 2022 crop has occurred as mills took advantage of the record 2022/2023 crop discount. This illustrates that demand has not totally dried up at landed prices of 120-130 cents. Another observation is that cotton yarn prices have also run into very difficult price resistance at current levels, such as 400 USD a ton for Pakistan 20/21 count yarns or Bangladesh 30s near 500 USD a ton. Mills have shown resistance to these prices and lowered prices buying ideas. Spinners have also begun to seek extended coverage in US, African France Zone, and Brazilian for shipment through June/July. Spinners order books appear to be good for shipment through June, and an increase is noted in acquiring supplies and planning for shipment delays.

These conditions suggest, first, that cotton demand today is much more driven by consumer demand and preference than just price. It has been quite exciting to witness the record demand for US Pima/Egyptian ELS despite the ever-advancing price, which is now at a record and showing no signs of slowing. Demand at 350 cents is such that spinners will exceed supplies by several hundred thousand bales that will not exist. Consumers are demanding more and more SuPima for a host of new fashion lines, and it has made inroads into even Athleisure wear. The full impact of the price increases has not yet worked through the supply chain. Shortly, the US will have sold out of nearly every bale.

Against this backdrop, more and more brands/retailers are coming out with new 100% cotton lines, not blends. This marks a dramatic change from the pre-Covid period. Many of the lines also feature the origin of the cotton. This is being driven by the environmental awareness of the damages done by fossil fibers such as polyester. Several major brands have made commitments to 100% sustainable fiber and set dates for the conservation. One observation has been that many have started with organic cotton and then switched to US, Brazilian, or Australian-grown under programs such as the cotton trust protocol. Organic cotton supplies are extremely tight since the exposure of a major fraud in India. Prices are at extreme premiums with quality issues. The volume is simply not available for any large programs. But it has been interesting that the use of organic is a starting point. The issues with recycling polyester have also added to demand as problems with fraud and pollution have become major issues. Collectively, price has become less an issue. Now, don't misunderstand. At the lower-priced end of the market, it remains a battle where brands fight hard for every cent. Consumer preference is helping to win the battle.

The downside of the cheap polyester/man-made apparel products is becoming highlighted by UK mass cheap retailers and China's e-commerce giant, Shein. Shein is an e-commerce only Chinse apparel retailer that exploits the tax-free import limits in the US and other countries for e-commerce purchases. It is the top e-commerce apparel retailer in the US, and it sells 95% of cheaper polyester apparel targeted at young adults. The company offers dresses, blouses, coats etc. at prices far below the cost of production unless slave labor was used. The company produces 100% of its products in China. It has no email or phone number or any other easy way to contact it. A British fashion writer reviewed an order and found the product was poor quality, ill-fitting, and didn't not resemble the advertisement. The product is highlighting the poor quality of polyester to a young generation that doesn't yet know the economic and environmental damage done by the product. It is shocking that the US has not yet outlawed the exemption that allows this toxic product in duty free.

Two other developments are driving brand and retailer fiber selection. The first is a commitment for zero carbon emissions by 2030, which is simply unattainable while using fossil fibers. The second is related, with major ESG commitments that also mean reduced use of both fossil fibers and ocean freight. Neither can or will be accomplished easily and without major changes. When a firm commits to 100% natural fibers, that means 80-90% cotton for the major brands. Hemp has great promise but must be "cottonized" before entering the textile system. The infrastructure to process to that point is a century away. Cotton and recycled cotton will lead this role. Look for much more work and progress on the issues with recycled cotton.

NEW PRICE LEVELS NOW ACCEPTABLE FOR COTTON

These conditions appear to have set the stage for a new range for cotton prices. The most difficult aspect of this is the role logistics are playing in demand and the level willing to be paid for cotton. The logistics squeeze that occurred in the liquidation of Dec ICE futures was not expected by us. It isn't yet fully understood how the trade could pay such premiums to roll hedges, which they did. The way the situation was handled by ICE exchange was inexcusable, and the exchange did nothing to ease the trade's burden or to control the speculative squeeze. No open discussion has begun on certificated warehouses, certification procedures, or any modernization of the process. The new speculative trading limits that go into effect in January are not being discussed or debated and are supported by at least one large merchant. Such conditions leave cotton to be impacted by excessive speculative plays. Inflation remains as main investment forces are looking for opportunities at all times. Just review last week's US equity movements.

Against this backdrop, the general price range of cotton prices would appear to now extend to the 125-130 cents a lb. landed the mill as destructive to demand. This changes the risk management parameters for both growers and spinners as well as the entire supply chain. This range is based on cotton's market share continuing to expand, which we will discuss further in a minute. It should also be remembered that cotton is an annual renewable resource. There is no doubt that this bull market was also different in another major way. The logistics supply chain collapse changed cotton sourcing dynamics for probably a long time to come. For the last 25-plus years, cheap freight has allowed spinners to source at any location, which was true for cotton, yarn, and fabric. Local cotton producers record limited investment and resources, and it's always about price, with just-in-time delivery the main strategic advantage. That all changed in the major consuming markets that also were large cotton producers. Local cotton free of the logistical bottlenecks moved into favor. In Pakistan, growers reported a sharp increase in yields, with local prices reaching record levels and prices proven to be more profitable than other crops. Growers were then willing to spend the money on needed inputs. A major expansion in acreage is likely in 2022. In India, growers also are receiving record prices far above record MSP. Record acreage is also likely in 2022. Turkish growers also experienced excellent yields and record local prices, and an increase in 2022 is very likely. For spinners, these events have illustrated the strategic advantage of having access to a local crop free of port or ocean freight charges. We expect new excitement and investment in local crops in these regions. These events will also change sourcing patters that leave Bangladesh and Vietnam at strategic disadvantages. The current price level has also set the stage for a record African France Zone crop, with selling organizations likely to post record seed cotton prices.

The big question is what these prices will be due to acreage in USA and Brazil. The issue is input cost, with fertilizer cost up 200% or more, and shortages are likely. In Brazil, where the ability to expand second crop cotton acreage is almost endless, this is an issue. Fertilizer shipments orders over nine months ago have not arrived, and there are major questions over whether growers will use supplies to expand cotton or for corn. Some corn growers may use much less fertilizer. For now, a record cotton crop is expected. The extent of that expansion remains open. In the US, an expansion of 10% or more is likely. There is the expansion in Texas, and in the Mid-South/Southeast some corn production could switch. Following this discussion, a record world crop is possible. This brings us to demand.

WILL DEMAND EXPERIENCE ANOTHER SURGE AS COVID PERIOD ENDS?

Last week, US Equity markets were full of optimism that the US economy would manage the inflation, companies would be able to raise prices, and raising wages would create a boom to consumer spending. Some went as far as calling for a major rally before year end. Shortages were expected to continue in many products, creating demand for 2022. Apparel was a feature as the market focused on companies that would benefit from a back to pre-Covid behavior. Apparel was also discussed as a product that has experienced stable prices or even declining prices for over 10 years and could absorb price increases. In reality, the end of globalization means a likely bottom to apparel prices. There has been a race to the bottom for twenty years or more, always seeking the cheapest labor location and squeezing the entire supply chain. Recent events in Ethiopia and Burma illustrate an end to this. Apparel prices have room to increase 10-20% without shock or demand reduction.

The greatest growth to apparel demand has come in two centuries. The first occurred between 1980 and 1990 when cotton consumption grew 21.225 million bales and polyester demand grew even faster. The second was 2000 to 2010 when cotton consumption grew 24.642 million bales. The growth since that time until 2019 was led by man-made Fibers. That period ended in 2019 when monthly market share bottomed in the US at 40.03%. In May of this year, it surged to 51%. This reflects enormous gains and reflects a major volume of fiber. This is for the US only. We believe market share bottomed in the other major markets as well, including China. This is the reason prices have been able to hold above 90 cents, and the upper end of the price range has expanded.

We have been cautious about letting our excitement expand given the chaos or near collapse of the global supply chain. The weak US administration and the

China challenge have made the world a very dangerous place. These same conditions keep us cautious, but we do believe we have entered a new era for cotton. It does not mean that there will not be major bear markets. It just means demand awaits. In the near term, a very complicated situation awaits. There is demand and it will increase. If ICE can return into the 90s, a record 2022 crop is also possible. The greatest challenge is logistics. As of Saturday, it was reported that 90 ships were waiting to unload at the main Los Angeles/Long Beach ports in the new staggered accounting. It was also reported that in January/October 12.1 million 20-foot containers left the USA empty compared with eight million loaded with exports.

Last week, data suggested that the US consumer is spending in a major way, creating major demand. Bank of America reported consumer spending on debit and credit cards were up 12% year on year and up 28% from 2019. Spending accelerated in the second half of 2021. Wells Fargo and Citibank also reported increased spending. JP Morgan reported increased spending of 17%. Citizens Bank reported 25% increased spending from 2019. These conditions are triggering forecasts of increased apparel spending in the first half of 2022, with increases of 10-15% or more. This suggest that orders for 2022 could prove to be stronger than expected.

Using previous periods, cotton use could increase 15-20 million bales or more over the next ten years. There are many potential "Black Swan" events that could disrupt this outlook. Inflation appears set to be a major challenge, as does the weak US administration and the many foreign policy risks. The most encouraging aspect of the outlook is that the spending is driven by increased labor income that is boosting consumer confidence. This makes this recovery and spending much different. The supply chain chaos and lack of any US leadership remains a major concern. The breakdown of the globalization business model is contributing to the increases in labor income and domestic investment. For example, the reshoring of a large portion of the semiconductors and expansion of electric automation manufacturing is alone creating trillions in new local investment and much higher paying jobs.

ICE PRICE OUTLOOK NOW RETURNS TO MORE FOCUS ON DEMAND

The price correction in March extended 16.3 cents from the highs at 118.80 cents, and support emerged near 104-104 cents as mill price fixations returned along with fresh export offtake. Technically, support has appeared at 105 cents. If this area is breached, a re-test of the 90/95 area is possible. We have been warning of a major correction for some time. The US supply chain is rapidly filling up with EWR receipts, now over 11 million bales. This rapid filling of the supply chain has been expected, which leaves so many questions regarding the Dec contract invert and the squeeze exerted on the majority of the trade. Export shipments continue to be less than a third to meet the USDA export target and the weekly target for 2022 increases weekly. The sharp drop in unfixed on call sales of 12,174 contracts reduces the potential for future price squeezes. Any breach into the 90/95 area in March should be used for additional coverage.

Last week we published no market letter due to a medicial emergency.
We appreciate all the thoughts and concern.

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