CHINA'S SHANDONG PROVINCE TEXTILE/ APPAREL/PETROCHEMICAL COMPLEX EXPERIENCES MASS BANKRUPTCIES

CHINESE FIBER DEMAND COLLAPSES AS TEXTILE WOES MOUNT

RECORD US 2018/19 EXPORT SALES REMAIN UNSHIPPED

2019/20 CROPS REMAIN UNHEDGED

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KNOWLEDGE IS THE NEW CAPITAL

CREDIT ISSUES NOW IMPACTING COTTON AND MMF USE IN CHINA AS CAPITAL FLIGHT AND USD SHORTAGES ACCELERATE

HSBC Hong Kong

Shandong Jinmao Textile Chemicals Group files for bankruptcy

On August 15, 2015, China stunned the world markets when they devalued the RMB against the USD by 1.9%, and then had to spend billions to support the Yuan. Between August 2015 and mid-2016, China is estimated to have spent more than 500 Billion USD of its currency reserves defending the RMB. Eventually China would be forced to put in place capital controls to stabilize the exchange rate. This event marked the beginning of China's problem with capital flight, as many of their wealthy citizens and corporations created ways to move their money out of China ahead of the coming clampdown by Xi Jinping. It has been reported that over-invoicing of imports and under-invoicing exports to and from Hong Kong, purchases of insurance products from Hong Kong, use of the casinos in Macau, money laundering and property purchases in Australia, New Zealand, Canada, US, and London were all used to get money out of China. On August 5, 2019, China triggered market chaos as it devalued the RMB by almost the same amount as in 2015, resulting

in the RMB/USD rate falling to 7.095 in the offshore rate, for a loss of 1.7%. The move was preceded by comments on Chinese social media over the weekend relating to capital flight out of China. China's RMB/USD exchange rate is set by the Central Bank and does not freely float. The move raised fears that China has lost control of the currency or did not have the reserves to defend it. This was preceded by the appearances of major discrepancies between official and estimated adjusted foreign exchange reserves. On Monday afternoon the US reacted by naming China a currency manipulator, which means that China must negotiate with the US or face new sanctions. China reacted to the administration's move by raising their exchange rate fix on Tuesday, which allowed US markets to calm down. However, another event was lurking behind the scenes that could have far greater implications for Chinese finance.

On Monday, another news item made its way into the financial press headlines - the CEO of HSBC suddenly resigned. HSBC, Hong Kong Shanghai Banking Corporation, is the seventh largest bank in the world, and its roots in Hong Kong go back to 1865. The sudden resignation of its chairman set off a host of rumors. Details have yet to surface, but it is believed that he may have been fired by the bank's board, regulators or both for allowing the bank to provide a record loan to the Chinese government to facilitate support of the RMB against the USD. Other European banks were also rumored to be involved. The amount of the facility was rumored to be 400 billion USD. If any of this is close to being true then China's USD shortage has reached a very critical stage. The escalation of unrest in Hong Kong has added to the squeeze on access to USD as financing options are being affected. It also means capital flight is again very real, and a crisis is imminent with payments coming due for USD debt. Adding to the uncertainty is an estimated 1.5 trillion USD of external Chinese debt that is unaccounted for. Much of the borrowing occurred in Hong Kong, Singapore, and New York. There are now new questions regarding how China's foreign exchange reserves are calculated.

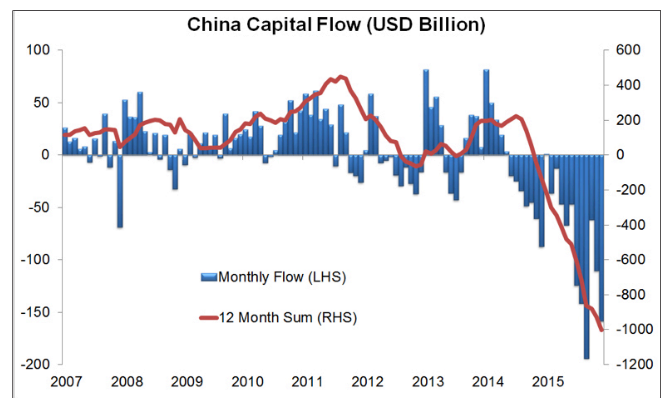
The mystery and intrigue around developments at HSBC Hong Kong expanded. On Saturday, the HSBC executive in charge of China also suddenly resigned after 27 years with little explanation. HSBC and Standard Bank Hong Kong are subsidiaries of the International Banks and reported to be "ring fenced," which means the parent does not guarantee the debt of the subsidiaries. Kyle Bass, a major Hedge Fund manager, has described the unfolding events in Hong Kong as "the Quiet Panic" and has warned investors to be careful which Hong Kong bank to hold deposits. The issue is that, as the crisis has unfolded in Hong Kong, the city has the highest private leverage/ credit to GDP in the world, at 850%. 280% of the entire GDP of Hong Kong is reported as having been lent to Mainland China. This makes the events unfolding at HSBC Hong Kong very important to the entire financial crisis now underway on the mainland. The degree of leverage that has been used in Hong Kong to finance the mainland is shocking. For example, in 2018 Hong Kong, as we discussed before, exceeded the NYSE in its IPO market and drew the attention of the world. The IPO's were mostly Mainland Companies. It has become known that one of the reasons for the success of the IPO's is that the Hong Kong-based banks allowed investors over 90% leverage to play the IPO market. Bass says that, "HK sits atop of the largest financial time bomb in history."

Hong Kong International Airport sit-in, August 9/10, 2019

Based on data from the FX market it appears Chinese state banks have been using foreign exchange Chinese Yuan forwards to support the Yuan and slow the depreciation against the USD. The banks were very active in the forwards the previous week prior to Monday's devaluation. An estimated 675 billion USD in forwards have been sold. Last week, the offshore Yuan/ USD one year forward soared to a premium of 321 points but has since retreated. The use of currency forwards is an active tool used by central banks to hide their actions. The use of currency swaps and forwards gained a lot of publicity in their role in the Asian financial crisis and in the Greek debt crisis. The RMB/ Yuan trading range is set at 2% up or down against the reference point. On August 8th, the PBOC set the reference rate at 7.0039, the first time the reference rate was above 7 since the global financial crisis. The Yuan/ USD exchange rate ended last week at 7.0623.

Shandong Dahai Textile Group files for bankruptcy

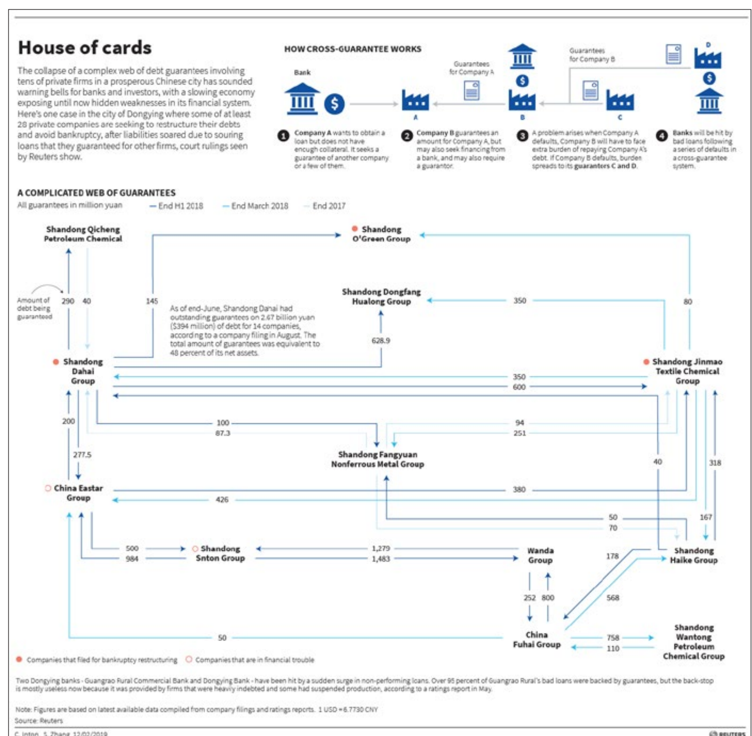
The case shortage has become very acute across the supply chains. The Chuying Agro-Pastoral Group, a major pork producer traded on the Shenzhen Stock Exchange, posted an announcement on the exchange that it was suffering a cash shortage, and revised its 2018 earning to a 2.8 billion RMB, or 585.9 million USD loss. It also said the shortage was so acute that it could not buy adequate feed supplies. The company also announced it had paid 271 million RMB (39.56 million USD) of debts in ham and pork meat packages. Its shares are now trading at .69 RMB, which is down from a 3.36 RMB high in the last year. Hainan Airlines offered to pay a debt payment in airline tickets instead of cash.



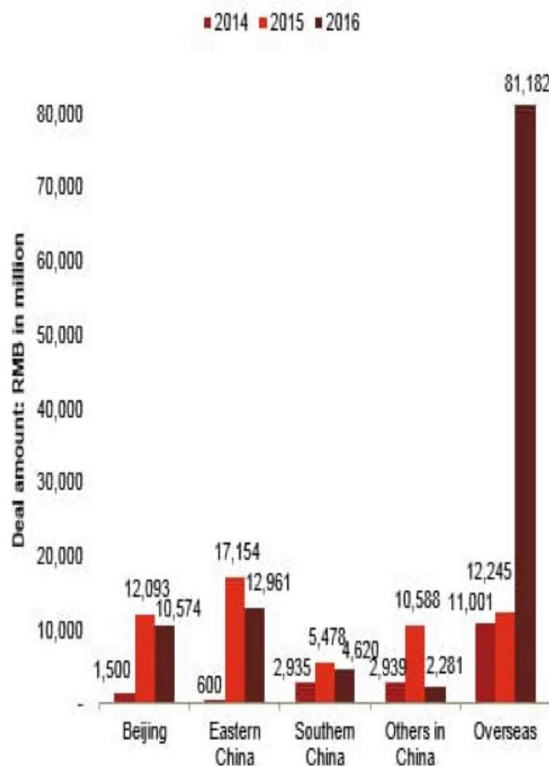
1.3$ Trillion USD of Capital Flight from China in 2015, source, Harvest

Another indicator of capital flight from China is found in the price of gold. Last week it reached a new all-time record high. The reason this stands out is the fact that there is almost zero inflation in many areas of the global economy and negative yields in Europe, which indicates the buying is not a hedge against inflation. The data has been showing strong Chinese demand for gold for several months. Gold prices have surged since the Yuan began to weaken, as the Yuan moved from around 6.6 to the current level, gold moved from 1,275 USD an oz. to a high last week of over 1,520 USD an oz.

The cash crisis in China appears to be entering a very serious stage, with many businesses going to extraordinary methods to get paid and to obtain cash. Banks have cut credit except to the largest state-owned enterprises. Chinese social media reports last week cited extra security being employed at banks to protect bankers from irate customers who have been refused loans. Arguments and skirmishes are being reported as banks cut credit lines. Then it surfaced that the cash shortage and lack of credit had given way to a large number of companies issuing IOUs to pay suppliers. The suppliers are then selling the IOUs at a discount in order to convert to cash. An OTC market has developed for the IOUs, with the price depending on the market's perception of the company's credit worthiness. It is now estimated that more than 200 billion USD of IOUs are in circulation. The staggering volume of these IOUs and the companies that are issuing them suggests significant problems for China's financial system. The property companies were the first to use them in volume. Evergrande has issued over 20 billion USD worth of the IOUs. Even state owned companies are involved, as evidenced by China Resources, a state-owned group that has issued an estimated 2.7 billion USD worth of IOUs.

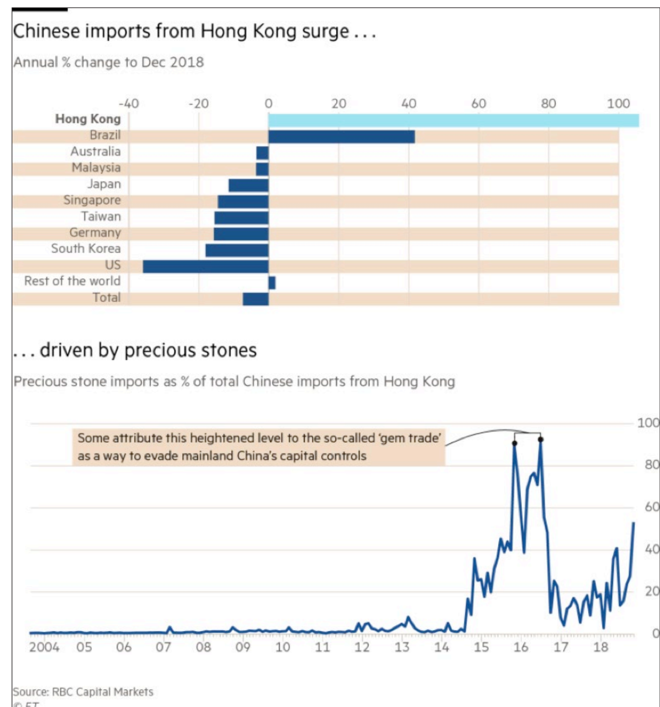


The cash shortage, overcapacity, and debt are now hitting the Chinese textile and apparel industry. Shandong, one of the largest textile and apparel manufacturing provinces in China, is ranked 4th and has 26 large textile and apparel clusters that account for 46% of the total income for the entire province. Shandong is home to several of the country's largest textile operations. The industry there is in trouble as a result of a wave of bankruptcies due to excessive debt loads, decreasing cash flow, and the use of mutual guarantees that companies use to get additional bank credit by guaranteeing the debt of other companies. Shandong is also a major petrochemical hub and home of the second largest oilfield in China. More than 28 major companies have declared bankruptcy, including two major textile companies. Many of the companies have debt ratios of 167%-181.3 %. The use of the cross mutual guarantee between companies is a major problem. Shandong is also home to two of China's largest polyester staple fiber producers.



Shandong companies rush to move money out of China in 2016, source, PWC

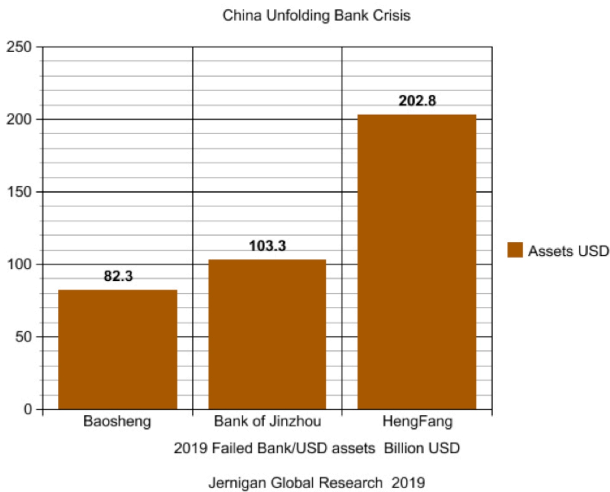
Heng Feng Bank is the largest bank in Shandong and ranked 23th largest in China, and bad loans have resulted in it not filing financial results. Last week, the bank was taken over by Huijin, an operating arm of the Chinese Sovereign Wealth Fund. The bank was reported to have had 1.2 trillion RMB (170 billion USD) in assets. This marked the third major Chinese Bank that has had to be rescued in 2019. The situation in Shandong continues to indicate massive issues. In late July, the head of the China Development Bank Shandong Branch was reported in the press to have committed suicide after being found with his wrist slit. The bank has been investigating massive losses that occurred as a result of illegal loan guarantees.



Capital flight from China via Hong Kong

Shandong Sunrise Petrochemicals files for bankruptcy. Owner, Shao Zhongyi, Shandong's richest man

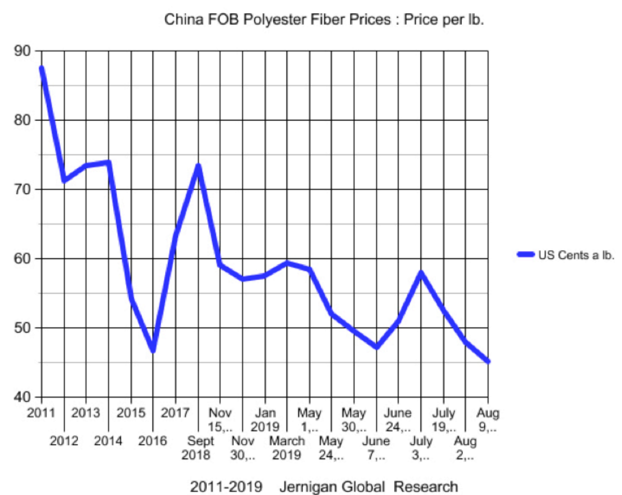
The sharp drop in orders to the USA has also led to companies taking other drastic measures to compensate for the lower prices necessary to offset the tariffs hitting their products flowing to the US. The measures also expose the dark side of globalization, and how labor abuses abound. Global headlines broke last week that a major supplier to Amazon had violated accepted labor practices. The Chinese plant involved was found to have used temporary workers, such as high school interims, that forced the interns to work excessive overtime and reduced overall wages by 16% in 2019 from 2018. The wages paid were found by Labor Watch to be too low to support a decent living. All this was done to offset a 33% drop in US orders. The main plant supplying Apple's iPhones has reduced wages 25% and cut perks in an attempt to maintain profits. As we have discussed, all evidence indicates that wages have fallen in 2019, and this is having a substantial impact on consumer spending, especially regarding nonfood items.



Major issues are building, making it much more difficult for companies to raise capital through either IPO's or issuance of bonds. Financial fraud has become a serious problem, and the companies most exposed to being accused of fraud are those that are listed in Hong Kong. One of China's largest apparel retailers with over 7,000 stores has been accused by a short selling hedge fund of overstating profits and insider trading. Muddy Waters Research accused another major sportswear company of improper conduct. Most of the major Chinese textile and apparel companies are publicly traded, either on Hong Kong or domestic exchanges. The shares of many of these companies came under selling pressure last week. The unrest in Hong Kong escalated last week, with additional rhetoric out of Beijing continuing to follow a very hard line. The chief officer of Hong Kong and Macau held a meeting last week with Hong Kong business leaders, and called the current crisis the most serious since the 1997 handover. He compared the current unrest to the "Color Revolution" that occurred in Eastern Europe, and said China had the right to send in the military to stop the unrest.

The situation has already impacted the ability of companies to use Hong Kong to raise funds, as highlighted by at least three major IPO's being recently cancelled due to current conditions. Last week was a very intense week in Hong Kong, ending with the Hong Kong International Airport once again occupied by demonstrators. There were also rather intense conditions prevailing that stoked fears that China may be on the verge of sending PLA troops into the streets of Hong Kong. Rumors were in circulation that the US was preparing a new round of sanctions against China if the PLA troops are released. This, of course, would add greater difficulty to any resumption of trade talks, and would likely mean the US could face cancellations of all outstanding 2019/2020 cotton export sales that now total over 1.8 million running bales. Late Friday, it surfaced that Cathy Pacific Airlines had been instructed to stop using the term "Hong Kong Special Administration Region" and to use "China Administration Region." This added to the fears that moves by the PLA could be imminent.

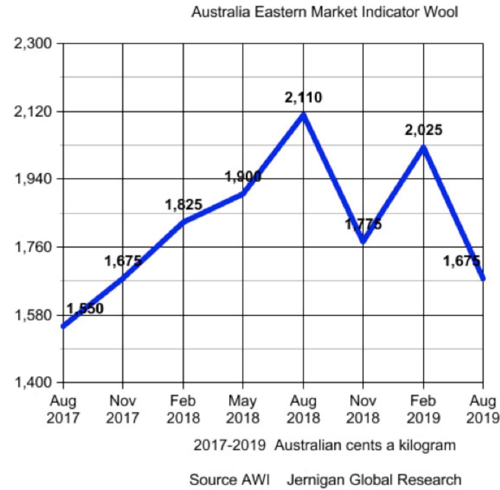
In the textile and apparel sector, cash flow is being restricted by operating losses and building inventories. The situation is most acute in the polyester group, where massive over capacity and new capacity has come online in 2019. Cash flow has turned negative, as prices have continued under pressure. China's entire petrochemical complex is experiencing massive overcapacity. Six major new facilities are expected to either come online or restart operations in the third quarter in 2019. These operations are expected to put additional pressure on the main raw material PTA, which is currently near record low prices. Billions have been spent on these new facilities, and they are coming online regardless of the profitability of the moment.



The weaker the price of PTA goes, the easier it is for polyester staple fiber prices to decline. Last week, polyester fiber plants continued to be willing to sell at a discount. This pressure pushed the average price of polyester staple fiber to a quoted price of 47 cents a lb., while discounted prices of 45.20 cents could be obtained. This is a new record low for PSF, and reflects a breach of the 2016 lows. The entire sector is in its weakest position on record.

In the yarn markets, conditions are very volatile, with prices weak last week. A sharp cut in polyester filament yarns briefly stimulated a pickup in orders. However, in the poly/cotton blend yarns, demand appears to have turned quite weak. Spinners are reporting unsold inventories of poly/cotton yarns of up to 90 days, compared to about 20 days for 100% polyester yarns. Cotton yarn prices were under pressure daily last week. The average prices of the popular 30s combed and carded 100% cotton yarns dropped by about 200 Yuan a ton last week. Spinners appear to be in no mood to buy raw materials, including cotton. The China Cash Cotton Index ended the week at 89.62 cents a lb., reflecting a 3.08-cent drop for the week. Demand for cotton offered at the Reserve auctions declined last week, with the take up at the daily auctions falling to only about 31.8% of the volume offered. Before the collapse of the trade talks, 80% - 100% of daily auctions were sold. The average price paid was 12,069 RMB a ton (77.65 cents a lb.), which was the lowest level of the series.

Wool demand in China has also collapsed, as denoted by the Australian Eastern Market Indicator of the average wool price, which fell sharply last week by 7.15% in USD terms to 1135 US cents a kilogram. The price of wool has fallen precipitously since the trade war began. Out of the 41,543 bales offered, only 26,618 bales sold last week, which reflects a serious collapse in demand. Wool traders report little demand over the last four weeks. The weakest demand is reported for the fine/medium, 19-22-micron Merino wool, which is very popular with Chinese consumers. Several of the largest Chinese domestic brands have focused on the new innovations developed by Woolmark.



Overall, consumption of textile raw materials in China is very weak, and spinners are reluctant to add to inventories. A record volume of unsold imported cotton remains in bonded warehouses and needs to move. Merchants and traders face heavy losses on any of these stocks that are not hedged. Fresh import demand for cotton appears to be at a standstill until some degree of confidence returns. Our earlier estimates for the expected reduction in cotton use in China remains valid but could be subject to another revision lower.

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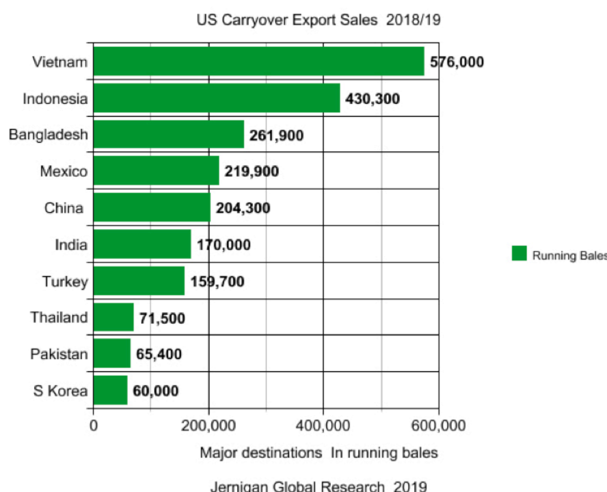
MERCHANTS ATTEMPT TO FIRM CFR BASIS LEVELS DESPITE WEAK DEMAND

Mill demand last week appeared mostly focused on 2018/2019 US old crop recaps that are still offered at up to 200 points discount to offers for October-December, as merchants seek to liquidate inventories. Brazilian 2019 crop also sold. The sharp drop in ICE futures on August 2nd resulted in merchants raising the CFR basis by 50-100 points last week. Even with the firmer basis, merchants still appeared willing to discount the basis in return for volume offtake. In Pakistan, US E/MOT 2018/2019 recaps and 2019/2020 crop GC 41-4-36 sold with the basis for the Greencard 41-4-36 ranging from 800-1000 points on Dec futures. Brazilian SLM 1 1/8 sold at 700-900 points on Dec, while Mexican new crop also sold. The average CFR basis for an E/MOT and Memphis/Eastern appeared to increase no more than 50 points for October-December shipment. Brazilian CFR basis levels increased 100 points. The Brazilian 2019 harvest is advancing, but ginning is slow and the movement has not reached the point at which price or basis pressure is evident. It also appears basis levels are being supported by the lack of receipt of the cotton bartered for inputs that will be converted to cash when movement starts. July export shipments from Brazil were light at 46,955 tons. Export shipments need to average more than 100,000 tons a month to move the record crop, which was estimated last week by CONAB at 2,691,400 tons, an increase of 26,300 tons (12.365 million bales). Both the ABRAPA and ANEA estimates are higher at 2.8 MMT or higher. Despite the size of the crop, the slow movement has left the ESALQ Index of a 41-4-35 at a premium, ending the week at 62.85 cents. The average CFR Asia basis for a SM 1 1/8 ranged from 975 to 1100 points on Dec for October-December shipment. Middling 1 1/8 ranged from 900-1050 points on Dec.

West African new crop CFR basis levels firmed by approximately 50 points following the collapse in ICE, with the average CFR basis for a SM 1 1/8 African Franc Zone for January-June 2020 shipment to 1400-1450 points on the cover month. This is a very firm basis. The firmness in the basis was not tied to demand but to replacement cost. Growers have remained unwilling to sell at current prices.
The early harvest has started in the US, and the FOB basis remains very weak despite the futures collapse. The Texas FOB basis for a 41-4-34 is at 600 points off October futures. It improves to 350 off in the Delta and 225 off in the Southeast. These levels imply very low merchant demand for new crop.

UNSHIPPED US EXPORT SALES A MAJOR LIABILITY AS PRICES FALL



The US has entered 2019/2020 with a major liability – a record volume of unshipped carry forward sales. This represents the highest carryover in ten years, and nearly half that carryover is made up of cotton that was carried forward. A record 2,457,582 bales of 2018/2019 export sales were unshipped as the 2018/19 season ended, which reflected 49% of the total 2018/2019 carryover. These sales have issues. First, all were made at much higher prices. Prices in 2018/2019 moved lower throughout the season with brief rallies. On August 6, 2018, the US had export sales already on the books for 2018/2019, with 8,202,000 bales of upland and 1,328,000 bales sold for 2019/2020. The nearby futures at that time was at 90 cents. Prices on December 3rd were at just over 80 cents, and by July 2019 prices had dropped to 64-65 cents before finally moving below 60 cents as August arrived. Thus, the 2,372,800 bales of upland sales carried forward were sold at prices ranging from 5 to 30 cents a lb. above the current market. The lack of on call positions or short trade hedges suggests these sales have all been fixed and hedges lifted. Second, besides the price issue, some sales have not been shipped due to quality limitations.

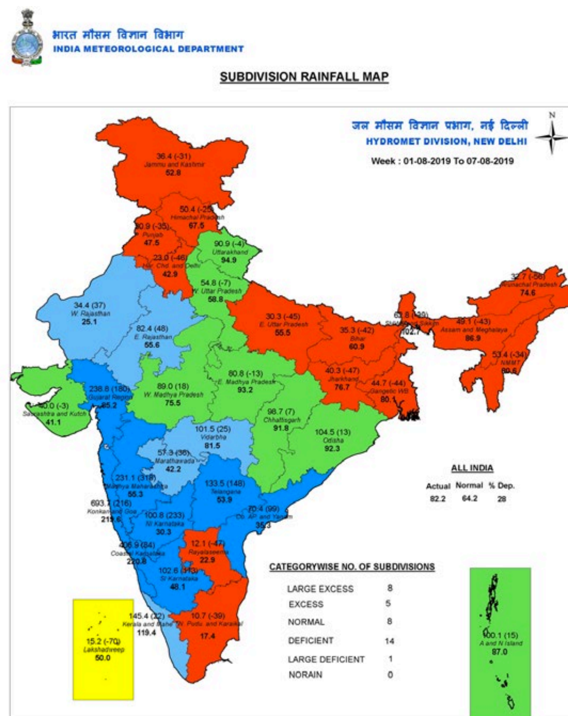
It is in the best interest of all to negotiate and find a way to mange the completion of these sales. We have been concerned about these sales for some time, since no hedge is in place and spinners' ability to manage such losses are difficult. It is clear attempts are being made to settle these issues, but the cotton remains in a warehouse collecting charges, and a large new crop is beginning to move.

A couple of weeks ago we discussed in detail the designations that were most likely to cancel or be renegotiated. The largest volume of unshipped sales rest with Vietnam, which carried 576,000 bales into 2019/2020 and now has 1,327,200 bales sold but unshipped. Mexico had the second largest of carry forward sales at 744,300 bales. Bangladesh is a real concern, with total 2019/2020 outstanding sales having reached 518,900 bales, with 261,900 of that volume carried forward into 2019/2020. Indonesia has the third largest volume of sales outstanding, at 654,700,000 bales, of which 430,300 bales were carried forward. Unshipped sales to China of upland for 2019/2020 stands at 1,812,800 running bales, and all these sales were made at much higher price levels. Given the current state of US/China trade, the fact that the sales were made 20 cents or more higher, and the statement that China made last week saying state companies have been instructed to stop buying US agriculture products, these sales are very likely to be canceled.

While gross 2019/2020 US export sales are the second highest on record for the start of the season, when adjusted for China and unshipped at risk sales commitments, those sales drop dramatically, illustrating the challenge the US faces in meeting 2019/2020 export targets.

ADDITIONAL RAINS REPORTED IN INDIA'S GUJARAT REGION

India has now planted 11,514,600 hectares as of August 1st. That includes the planting of 619,400 hectares in the prior week. Gujarat planted an additional 125,700 hectares, bringing total acreage to 2,469,575 hectares. 1,752,200 hectares of that acreage is in the Saurashtra region. Maharashtra planted an additional 135,700 hectares to bring total acreage to 4,198,800 hectares, and Telangana has planted 1,678,200 hectares. Heavy monsoon rains have continued across much of the cotton belt, with Gujarat 2019 seasonal rains now normal and at a surplus in the region outside of Saurashtra. 60 days ago, Gujarat dams were empty, but Friday the Sardar Sarovar Harmada Dam has risen to a 131-meter water depth for the first time since being built. Very heavy downpours occurred last week across south Gujarat, a very small cotton area with only 156,900 hectares planted. Season-to-date rainfall in Saurashtra and Kutch is now only 3% below normal, which has allowed the crop to emerge in improved condition.



All attention is on Maharashtra, given that the size of its acreage and seasonal monsoon rains are now at a surplus for the entire state, which is quite unusual. The concern has now shifted to the reported outbreak on a small scale of the pink bollworm. The Bollworm has showed up in fields that were planted in the last week of May and first week of June, which is earlier than the recommended planting date. Additional monsoon rains are expected in the near-term. Overall, the outlook has improved, and yields could improve from last season. The only threat at this point is how extensive the pink bollworm problem becomes.

The spot price of S-6 1 1/8 ex-gin ended the week at 74.50 US cents a lb., which remains at a premium to international values. The declining relations between India and Pakistan suggest Pakistan import demand will be met with US and Brazilian styles, with trade in Indian cotton likely to be very limited.

ICE FUTURES FIND SUPPORT FROM LACK OF TRADE SELLING

Despite the continued price pressure, the commercial Trade refrained from selling ICE futures in the week ending August 6th. The lack of Trade hedges, despite the size of the Brazilian and US crops, is remarkable. In the week ending August 6th, the Trade purchased 7,582 contracts (758,200 bales) and sold 2,268 contracts (226,800 bales), leaving the net Trade position long for the first time ever. The net Trade long position is 919 contracts, which is the first Trade net long position on record. It was the speculative groups who sold the market into new lows, and the Managed Funds sold an additional net 3,637 contracts, pushing the Fund's net short position to a new record of 47,428 contracts. The Other Reportable speculators, which have been Chinese Hedge Funds in some cases, were also net sellers of 2,728 contracts, while the small Non-Reportable specs sold a net 1,220 contracts and are now also net short. SWAP dealers did add 2,594 contracts of new longs. This leaves the market in a very different position, as the Trade, and especially US producers and coops and input suppliers in Brazil, appears to be shouldering the risk. The net position, however, means the record carry forward US export sales that are unshipped have no risk protection, and the risk is believed to be on the spinner to settle the contract. It would appear that the largest crops in the US affected by the trade war are both unhedged as harvest approaches. The net trade short in CME Soybeans is also very small at only 14,824 contracts.

It remains to be seen how long the Trade can hold back selling. In Brazil, price pressure is likely, as crop movement accelerates later this month and as crop input providers sell bartered supplies. Brazil must sell and ship 1.514 MMT (nearly 7 million bales) between July 2019 and June 2020 just to maintain a record carryout. The risk of this position must be housed somewhere, and it is not on ICE. In the US, the adjusted world price at which cotton can be redeemed from the CCC loan has fallen to 52.67 cents, the lowest level of the season. This will allow old crop cotton still in the loan to be redeemed at prices below the cost of carrying and warehouse charges. A further decline in the AWP would create the first Pop payment to growers. Growers can receive a payment based on the difference between the loan rate and AWP to forgo placing the cotton in the loan. Thus, additional movement in prices to the downside would accelerate US growers selling. Grower groups in the African Franc Zone are not selling and are maintaining a very firm basis on any sales.

Against this backdrop of growers' reluctance to sell and the Trades unwilling to force hedges despite the price decline, will this be enough to allow prices to stabilize? There is not an easy answer, since the global cotton market has entered a very uncertain time. In the previous 25-plus years the answer would have been much easier. For during the past period there was always a reference point at which cotton demand would generally find a solid base. In many instances, that base was China, as Chinese import demand was always possible, either from the Reserve or even via imports outside the quota when prices dropped low enough. These conditions meant that at any given time that reference price could provide stability. Therefore, since prices collapsed following the 2010/2011 spike, prices were able to find a rather stable range.

Today, however, the world has changed dramatically due to the ending of globalization and the fact China is rapidly ending its role as the global sourcing center, especially for the US and Europe. In textiles and apparel, the move will not occur overnight, but each passing day the headlines for brands and retailers sourcing in China are highlighting new risk. In recent weeks, the link of the Xinjiang prison and forced labor camps to many of the largest textile and apparel groups in China has finally moved into the spotlight. The use of the forced/slave labor now has the attention of US customs, which has the power after an investigation to ban imports. We believe it is a real possibility that some bans could be placed, and there is no lobbying to prevent it. A ban can occur simply based on the agency findings and the power to do so is law, the precedent being Turkmenistan when the law was used to ban

all cotton-related imports. What Turkmenistan was found guilty of was far less than what has happened in Xinjiang. This is a real risk over the next several months. Then, you have the mass persecution of Christians and Tibet nationals. As if the risk to these brands wasn't enough, last week it surfaced that companies are lowering wages and mistreating workers to attempt to maintain orders. The companies have been stockpiling textile and apparel imports, expecting the 10% tariffs that will be put in place shortly and will likely go higher. These inventories provide some cushion to switch sourcing locations.

China has such a concentration of industry that the movement of this capacity will not be easy. However, the rapid movement of the decoupling of the US/China supply chains means new capacity will soon begin to be installed in all key areas in other locations. As we finish this week, we are really concerned about Hong Kong due to all the rhetoric and bluster out of Beijing that suggests China is very close to sending the PLA troops into the streets. The US is rumored to be preparing new sanctions against China and a revoking of Hong Kong's special trade status with the US if this happens. Such an event would end any hope of a trade deal or even peace settlement. Over the past week China has made it clear it is not going to focus on sourcing agriculture products from the US under the current leadership. The government made public that it had instructed the state buying agencies to stop buying US agriculture products. The June import data was a direct slap at the US administration and US farmers. While making plenty of statements about buying US soybeans, China imported 8.64 MMT of soybeans in June, the highest in 11 months. But those imports were dominated by Brazil. Moreover, this demand pushed Brazilian beans to a very positive basis over CME futures. This import data put to an end to the notion that China was buying fewer US soybeans because of the swine flu crisis. On Friday, the Trump administration stated it was delaying the approval of any of the purchases needed by Huawei, after China failed to buy US agriculture products.

Earlier we discussed in detail the massive over capacity prevailing in the Chinese textile and apparel industry, and a shortage of credit for all small and medium sized companies that was impacting financing. A wave of bankruptcies has been triggered in the textile and apparel powerhouse province of Shandong, which then led to the takeover of its largest bank due to a large block of defaults on loans. The Chinese spinners are in no mood to add to inventories of cotton, polyester staple fiber, wool, Viscose, or any raw material. Polyester staple fiber ended the week trading at an all-time low. The Chinese commercial sector is holding a large volume of unsold domestic cotton, with Xinjiang crop movement not far away. Bonded warehouses are at capacity and need to be liquidated, yet there is little demand. The absence of demand was made evident by the lack of take up of cotton, even at the Reserve auctions. This also explains why the Chinese Cash Cotton Index lost over 3 US cents a lb. last week, as compared to only a 52-point decline in Dec ICE – no demand, lack of credit to hold inventories, and a lack of confidence.

Credit has simply dried up for Chinese companies, with the exception of the largest state-owned groups, and even they have issues. As we all have seen, China has been a land of tremendous achievements, but it does seem to always take things to the extreme, and the imbalance requires dramatic measures before harmony is restored. We appear to be at one of those points for the textile and apparel sector, as well as other industrial sectors. The problems are now expanding to the banks and the local and provisional governments.

Weekly Nearby ICE Cotton Futures 2010-2019

It went without too much attention, but the CCB offered a full bailout package to repair the finances of the Hunan provisional government. This is quite an irony, given the fact the local government has been spending much of its time persecuting Christians that make up a very high percentage of the local population. Now, Shandong, a much larger economic force, appears to be in deep trouble.

Without the reference point of Chinese demand, cotton prices are in an uncertain period. Market conditions are not returning to pre-June 2018 conditions, and China today does not have the capacity to absorb the excess supply. We discussed several weeks ago that one of the biggest dangers for cotton was how to deal with the flow of cheap polyester staple fiber apparel. With a spot price discounted at just above 45 Cents a lb. on Friday, products can flow into the US never knowing a 10%-20% tariff was ever applied, and flow even cheaper into every other global market where the tariff is not in effect. The flood of cheap Chinese textile and apparel imports has limited the Brazilian industry's ability to recover, and is continuing to strangle it. And so it goes. We continue to expect prices to remain on the defensive, and feel that the unhedged crops, collapse in Chinese demand, excessive cotton stocks on hand, and lack of resolution of the record carry forward sales in the US remain a major risk.

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