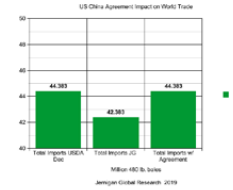
US/CHINA AG PURCHASE REQUIREMENTS ARE JUSTIFIED

PORK DEMAND LIKELY DRIVER IN PURCHASES



EVEN WITH COTTON PURCHASE TARGETS WORLD TRADE IMPACT LIMITED

GLOBAL COTTON MOVEMENT INCREASES AS FUTURES RISE

JERNIGAN GLOBAL
KNOWLEDGE IS THE NEW CAPITAL

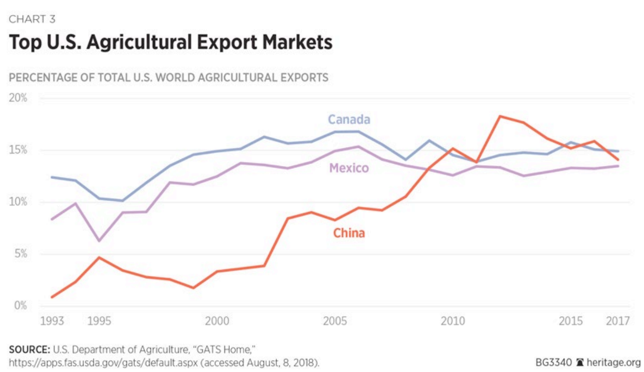
US/CHINA TRADE AGREEMENT – WILL IT BE SIGNED? AND WILL IT HOLD?

The Global agriculture trade industry was in full debate last week over the US/China trade agreement announced earlier. US Trade Representative Lighthizer was a guest on the popular US Sunday news show “Face the Nation” following the announcement of the trade deal. This was quite unusual, because he gives few interviews as he is non-political and a well-regarded professional. The global trade should understand that Robert Lighthizer is a very serious man. He graduated of Georgetown Law before serving as Deputy US Trade

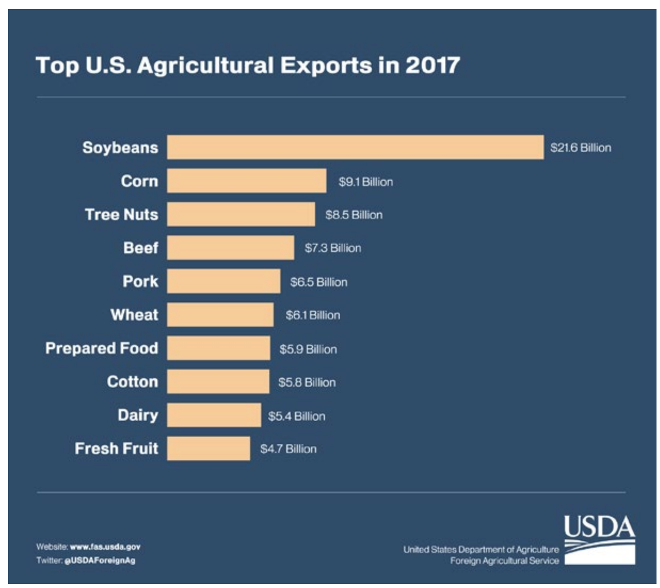
Representative under President Reagan, where he negotiated more than 24 trade agreements, including resolving the dispute with Japan. He is not a politician, and, being a noted corporate lawyer, his statements are precise and accurate. In the interviews, he outlined the agreement and said a few points worth noting. He said the deal was agreed to and would be signed once translated and reviewed by the attorneys. This means the Chinese negotiator has agreed to all the terms. They have been silent on the Chinese side, with each comment talking about agriculture, the fact that purchases must be based on demand, and general noncommittal terms. The Trade Representative released a two-page outline of the deal, which the Chinese have not confirmed. The agreement is an extensive document, 86 pages, which covers much more than the agriculture purchases that have been in the headlines. Mr. Lighthizer made a point to say that the US would implement every part of the deal and enforce the agreement. The enforcement is outside of the WTO.

He has also stated that each commodity had a purchase target. This suggests cotton was assigned a target as well, since it has been a part of agriculture trade with China for centuries. The agreement covers 200 billion USD in purchases from the US and is much larger than the agriculture purchases that have taken the headlines. The debate over just how an agreement would work begins in its 40-50 billion USD target annually and then moves into the issue of price and demand. Let's start with a look at the exact level of agriculture exports to China over the last ten years. The value of these exports ranged from a low of 13.108 billion USD in 2018 to a high of 29.350 billion USD in 2013. It should be noted the peak occurred just after Xi Jinping took office. The data suggest he has been strongly anti-US trade since taking office. The trade pattern indicates that oilseeds and grains have always dominated trade, with meats and horticultural products the next in importance. Cotton exports in value terms have ranged from a low of only 553,828 USD in 2016 to 3.454 billion in 2012.

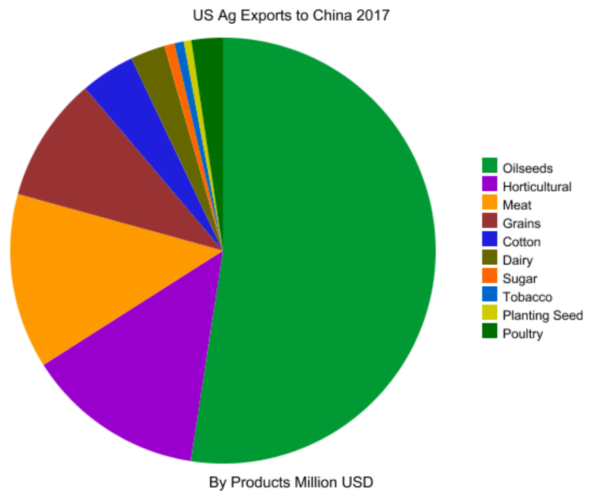
2017 US EXPORTS AS A BASE

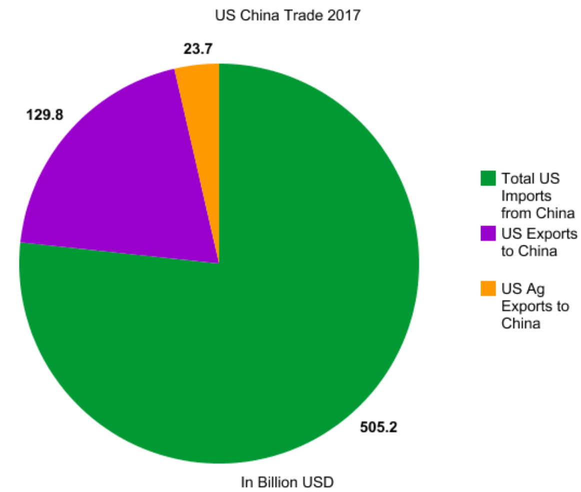


A review of US agriculture exports by commodity reveals that the goal of reaching 40 billion is not as outrageous as some have argued. However, several unknowns exist. First, will China be able to make the bad faith move of rerouting approximately 10 billion in agriculture trade that goes to Hong Kong and simply have it sent directly to Chinese ports? This issue has been raised and discussed. Recently, a Chinese spokesman told the SCMP they would not do this. Secondly, the Chinese side has told *Bloomberg* several times the price has to be competitive, which raises a host of issues. Third, the Chinese side has told *Bloomberg* and others the purchases must be based on demand. That creates an open-ended question and an out for China. In 2017, China imported 131 billion USD in total agriculture imports, which makes 40-50 billion in total agriculture trade with the US feasible and possible.



If one were to assume that, first, there is an aggregate total requirement, and that Hong Kong-diverted trade does not occur, and that the individual commodity targets are not firm and can be adjusted by demand. In other words, if demand warrants China buying say 10 billion USD in meats against a target of five billion, and all other individual commodity targets are adjusted. This flexibility meets the Chinese goal of purchases based on demand and need. If the individual targets are not released, then they should generally always be able to buy at competitive prices. Against this backdrop the agreement looks to be possible.





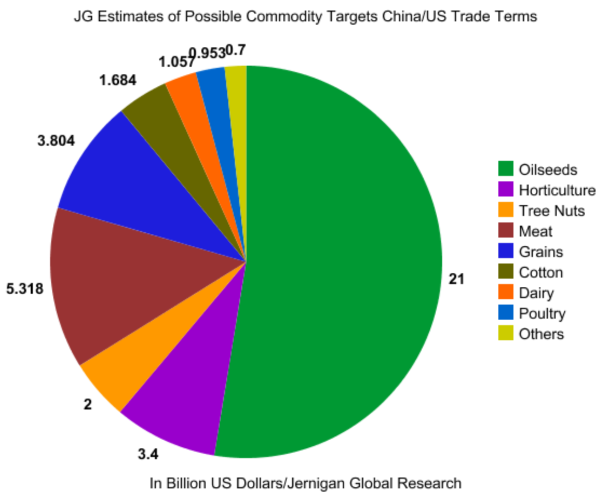
US AG EXPORTS TO CHINA HAVE BEEN UNDERVALUED FOR YEARS

If one takes the 2017 purchases as the base, and then assumes the target before any Hong Kong rerouting is 40 Billion, then the aggregate target becomes more realistic. Again, with total imports of agriculture products of over 125 billion USD annually, then the trade with the US is clearly possible. Given the total US imports from China, agriculture trade has been undervalued and distorted. Up to now, no US administration has attempted to address the issue. For example, in 2017 when China imported 23.689 billion of agriculture products from the US, the US exported 129.797 billion USD to China that same year. In contrast, the US imported 505.2 billion USD of goods from China in 2017. Despite the imbalanced nature of the trade, China took no initiative to address the imbalance and took offense that the US was attempting to address the issue.

The trade in textiles and apparel vs. cotton exports has been one of extreme distortion, as the Chinese side has been underutilizing US cotton since the WTO entry began. Total imports of textile and apparel from China during the last ten years has ranged from a low of 31.760 billion in 2009 to a high of 41.820 billion USD in 2014. The cotton product imports ranged from 13.193 billion to 18.367 billion, which compares to the cotton export trade of only 553 million to 3.454 billion USD. Despite the imbalance, no attempt has been made to address it.

To meet the target 0f 40 billion means the aggregate total will have to increase nearly 69%. Oilseeds purchases in 2017 reached 12.418 billion. At the needed increase, a target of 20.963 billion would be applied. In 2017, using an average of 10 USD a bushel, the soybean purchases equaled approximately 34.269 MMT. To meet the new target at about 9.25 USD a bushel, purchases would equal 61.654 MMT. This is against the USDA import estimate for 2019/2020 of 85 MMT. This change would trim Brazilian exports. This is a high target but not impossible, and it would deplete US stocks and open other markets for Brazil.

US PORK EXPORTS MAY REACH 5-10 BILLION USD

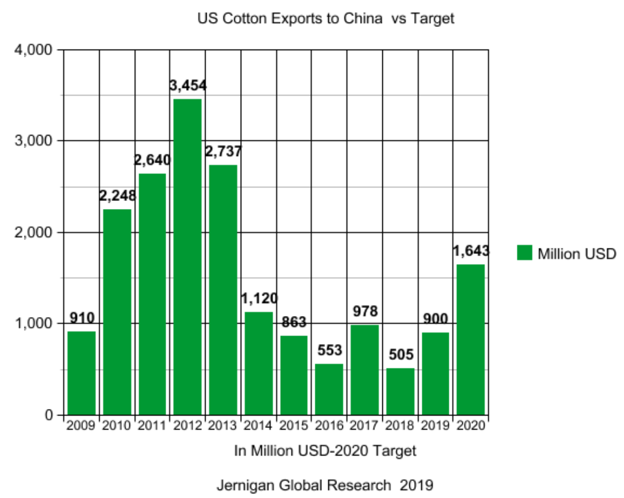


The second largest export in 2017 was horticulture products, which reached 3.213 billion USD with a new target of 5.422 billion, again not impossible. The third largest export is meats (excluding poultry) at 3.1509 billion USD, and the new target is 5.318 billion. Given the protein needs, these imports could reach 8-10 billion USD, which would reduce the other targets across the board. The question is can the US supply and demand handle such exports. Pork prices in China are surging and are posting strong gains in international prices, including the US. The increase in prices is reaching the point where it is impacting some food companies and their profitability.

Some analysts suggest the pork crisis is behind much of the motivation for this entire agreement. The Swine Flu has devastated the China's pork herd, with some private estimates indicating the devastation is much worse than China has admitted. Over 60% of China's hogs may have been lost, and the epidemic has spread throughout Asia. China's efforts to contain the disease have failed, with stories having surfaced of criminal gangs involved in actually spreading the disease to exploit prices. The level of hygiene needed to control the disease is simply not achievable in China, which means that the recovery from the disease will take much longer than expected, and record pork imports will continue.

The grains were the fourth largest export in 2017 at 2.253 billion USD, and a new target of 3.8 billion. This is possible if ethanol is included in this category. China earlier had placed a special dumping duty on US exports before the trade war but has lifted it. China owns the bulk of the world's wheat and corn stocks, and there has never been an independent audit of these stocks. As a result, the percentage of those stocks that are fit for human consumption or even for animal use is unknown. The stocks are stored across the country, and spot checks have yielded mixed results on missing volume and quality. Adding top US quality imports would not be difficult. Distilled grain exports could also boost this total.

COTTON EXPORTS SHOULD RECEIVE SIZEABLE TARGET



The fifth largest export in 2017 was the long unmentioned cotton. Cotton exports in 2017 totaled 978 million USD. The key question is, has each commodity group been allocated an equal increase from the 2017 base? If that is the case and it goes into effect based-on calendar years, the new purchase target for cotton would be 4.279 bales or 1.643 billion USD at an average CFR price of .80 cents a lb. The US currently has 1,577,300 running bales of upland and 14,000 Pima that have been sold to China and unshipped. Assuming this is shipped under the new agreement, it might be reasonable to expect possible additional purchases of just below 2.7 million bales. After adjusting for normal commercial purchases, Reserve purchases could easily absorb two million bales. Would this alter the US supply and demand? Such new sales would offset at least a million plus bales of high priced 2018/2019 carry forward sales that have not been resolved and will be canceled or rolled into the next season. The remaining sales could be split between the 2019/2020 and 2020/2021 seasons because of the agreement.

Thus, a valid agreement that is fulfilled would likely mean the USDA export target of 16.5 million bales could be met. The challenge is the poor shipment level. For the 33.4 weeks left in the season, weekly US shipments would have to average at least 375,175 running bales. This will be a very difficult task. US export capacity to move such volumes for a long period of time is in doubt. The US warehouse system is inefficient and remains unable to perform at this level without some major adjustments. Thus, for exports to exceed the 16.5 million bales would require weekly export shipments to surpass even that level, which is an untested task that might not be possible.

For cotton, the greatest impact could come in year two when China could purchase over four million bales in 2021, which would impact the 2020/2021 and 2021/2022 seasons. Few forward sales means all new business. Chinese cotton demand is weak and will likely remain soft during the next few years due to continued economic weakness and movement of supply chains out of China. Nonetheless, the Reserve's restocking alone would allow the agreement requirements to be met for the next two years.

The balance of the 2017 purchases was at dairy, 626.6 million USD, poultry 564.9 million, sugar 141.6 million, tobacco 170.246 million, and planting seed 135.9 million USD. The agreement is also to include the sale of processed foods, which have a much higher value and thus will impact the targets. Another area expected to show considerable growth in 2020 under any trade agreement is the exports of tree nuts, such as almonds. Shanghai JC Intelligence projects China could buy 2.5 billion USD of tree nuts annually under the agreement. China is projected to import 13.3 billion USD of tree nuts in 2020, which would reduce the volume of purchases required of other commodities.

SUMMARY

There has been much written about the agreement over the past week, and most of commentary has been linked to either anti-Trump or pro-Beijing views. Overall, after examining the statements by the trade representative, we have found that the agreement is a very big win for the US if it can be implemented. It goes a long way to correcting the imbalance in trade between the US and China. Focusing only on the sections relating to agriculture purchases, we find the targets ambitious but possible. Well-respected impartial analysis of the targets suggests the protein needs of China could exceed all expectations, which means the inclusion of processed foods. Such purchases would reduce the needed purchases in non-essential products such as cotton. Indications are that demand will play a role, and thus the individual commodity targets will have flexibility.

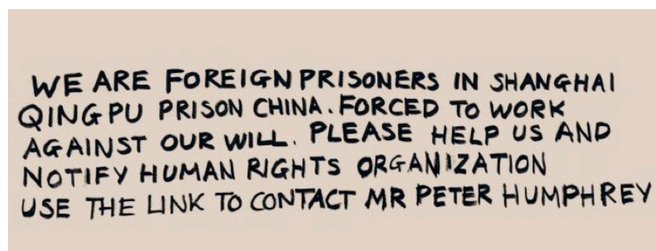
Second, the size of the agreement is not as daunting as it first appeared. The agreement is reasonable given

China's total agriculture purchases in the recent past. Shanghai JC Intelligence, a Chinese based consultant and research group, estimated purchases of 41.324 billion USD. Of that total, cotton was estimated at 1.567 billion USD, 800,000 tons or 3.6756 million bales. Their estimates compare to our own work, which pegs cotton purchases at 1.643 billion USD.

For cotton, the greatest impact could come in year two, when China could purchase more than four million bales in 2021, which would affect the 2020/2021 and 2021/2022 seasons. Few forward sales means all new business. Chinese cotton demand is weak and will likely remain soft for the next few years due to continued economic weakness and movement of the supply chains out of China. Nonetheless the Reserve restocking alone would allow the agreement requirements to be met for the next two years.

The hurdles for the agreement are many, but there is more and more evidence that China will sign and begin to implement the agreement. On Friday, it was reported that Henry Kissinger, the Secretary of State under President Nixon who helped open China to the US and has remained close to Beijing, has been shuttling between Washington and Beijing during the trade negotiation. He stated that Xi Jinping said he would much rather work with President Trump than the opposition Democrats, because he has placed less emphasis on human rights. At the same time, Chinese comment on their preserved negative views on the agreement has stopped. There is silence out of Beijing, and it is reported it will be signed in January. Human rights issues could still provide a stumbling block to the agreement. First, there is Hong Kong where no sign of compromise has emerged, and second, the Xinjiang concentration camps. Sometime in January a bill is likely to reach Trump's desk that will begin to penalize Chinese officials from Xinjiang. Second, the US law that prohibits the importation of any product made from slave or forced labor remains an issue for Chinese imports, especially textiles and apparel. It has also come to light that Uyghur families can sue Chinese interests in US courts for awards for damages incurred from Xinjiang imprisonment. Moreover, there has been some discussion of Uyghur families being able to sue companies importing product that can be linked to labor from the concentration camps. This past week *Bitter Winter* revealed photos of Chinese Christians being arrested and forced to work in apparel factories. These issues are not going away and will likely test the agreement and China's patience. The comments from Henry Kissinger suggest the Chinese may be starting to understand the seriousness of the human rights issues and the stress it is having on the US side.

Chinese Christians in prison forced to sew apparel, source Bitter Winter, Dec 2019



WE ARE FOREIGN PRISONERS IN SHANGHAI QINGPU PRISON CHINA. FORCED TO WORK AGAINST OUR WILL. PLEASE HELP US AND NOTIFY HUMAN RIGHTS ORGANIZATION USE THE LINK TO CONTACT MR PETER HUMPHREY

This note was found in Christmas cards printed in China for UK deptartment store Tesco

The other issue impacting the trade agreement is its effect on trade diversion, the diversion of trade from other trading partners. A major article in the *South China Morning Post* discussed the situation on Friday. It asserted that China has the trade capacity to meet the terms of the trade deal, but it would require significant diversion of trade from other trading partners. It suggested Brazil and New Zealand would be two possible losers. As would be expected, Brazil could suffer losses in soybean and cotton exports, and New Zealand would see a decline in dairy and beef purchases. The impact on New Zealand remains yet to be determined, but Chinese companies have invested heavily in New Zealand, and the country has been overrun with Chinese influence to the point that it has been accused of becoming a Chinese colony. The Australian dairy industry has experienced heavy Chinese investment in 2019. China's dairy purchases from the US in 2017 were 626.23 million USD. China's dairy supply has become tainted. Thus, imported product is sought by consumers, especially in infant formula, which may make the US imports easy. The impact on Australia's agriculture is expected to be small given the drought-reduced production prospects, while the largest impact will be on Brazil.

As last week ended, the agreement appeared on track when President Trump announced he had a good call with Xi Jinping and that the signing of the agreement was being planned. He also said he discussed North Korea and Hong Kong with Xi.

ICE RALLY TRIGGERS CROP MOVEMENT IN BRAZIL AND US

The rally in ICE futures last week triggered the long awaited movement of the US crop from growers and movement from Brazilian growers. The movement continued the weekend, as ICE expanded its rally of Friday. US growers moved over 300,000 bales or more. Heavy volume also occurred on the Seam, with coop and marketing pool sales reaching more than 60,000 bales. The turnover was heavy enough to weaken the FOB basis somewhat in the Mid-South, where it remained weak by historical standards. This produced heavy scale up trade selling. Data from the BBM exchange in Brazil suggested that over the last two weeks an estimated 100,000 tons or 459,450 bales were sold. The BBM data through Friday showed active movement of 2019 crop and 2021 crop but only light movement of the 2020 crop. The lag in reporting may show much heavier movement. A successful US trade agreement would suggest a possible weakening of the Brazil 2020 and 2021 FOB basis.

Scattered other growths also traded at origin, which generated selling in ICE futures during the non-US trading hours.

ICE FUTURES CLOSE HIGHER AS MANAGED FUNDS MOVE TO NET LONG

The long-awaited movement by the Managed Funds to a net long position has finally occurred. As of Tuesday, December 17th, the Managed Funds reached 7,932 contracts net long. The Funds continued as buyers the remainder of the week and are likely near the 15,000-contract level net long. The Funds were triggered first by the trade headlines and then by the positive technical indicators. The Funds buying was met by aggressive Trade selling. The selling was very patient and avoided any hint of panic during the period when prices were collapsing. The net Trade short position has been at record lows for months, as producers and origin marketers avoided selling during the move below 65 cents. That selling has now begun to appear. A very large amount of the US and Brazilian 2020 crop remains to be sold.

The Trade's focus during the past week has been to understand the ramifications of the US/China trade agreement. The Trade's confidence in the agreement has increased during this period, and the research has shown that the Chinese purchase targets are reasonable. Much has been said of the agreement and the Trump administration's stimulus of the trade dispute. The argument that the trade imbalance does not matter also falls on deaf ears. By 2017, the US had imported 505.2 billion in goods from China versus total imports of 129.8 billion USD. Much has been said of the level of agriculture imports of 23.689 billion USD that year. That was a very miniscule amount against total agriculture imports that year of 131 billion USD and the trade imbalance with the US. It is clear from the data that Xi Jinping since taking office had already started the process of switching sourcing of agriculture products from the US. US agriculture exports peaked in 2013 at 29.350 billion USD. It was also clear China felt no need to address the imbalance or to source from the US, despite their hefty US export earnings which contribute heavily to the Chinese economy.

Thus, the move to push agriculture imports and other purchases of US goods to 200 billion USD is the first real adjustment since China joined the WTO. Once a deep analysis of the trade is completed, the Trump trade team will be shown to have done their homework and to have addressed a major injustice. For cotton, the injustice will continue, but the imbalance will improve, with any move back to the 1.2-1.6 billion USD mark in imports as trade in textile and apparel remains unbalanced, with cotton product imports over 13 billion and total textile and apparel imports of over 40 billion USD.

In summary, the new purchase target for cotton would equal 4.279 bales or 1.643 billion USD at an average CFR price of .80 cents a lb. The US currently has 1,577,300 running bales of upland and 14,000 Pima that has been sold to China and unshipped. Assuming this is shipped, under the new agreement it might be reasonable to expect additional possible purchases of just below 2.7 million bales. After adjusting for normal commercial purchases, Reserve purchases could easily absorb two million bales. Such new sales would offset at least a million plus bales of high priced 2018/2019 carry forward sales that have not been resolved and will be canceled or rolled into the next season. The remaining sales could be split between the 2019/2020 and 2020/2021 seasons because of the agreement.

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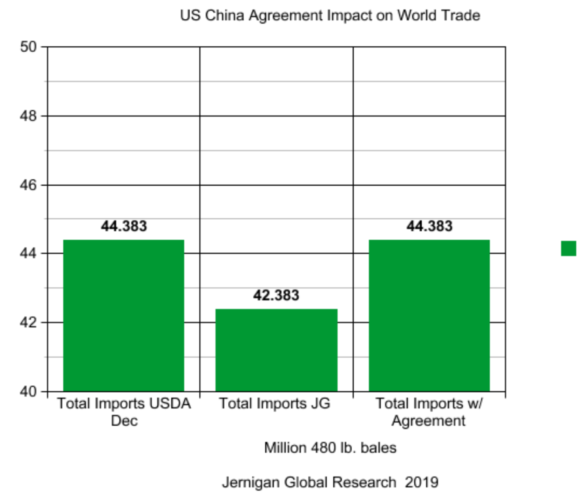

The Market is now attempting to test the 70-72.50 level in March. For this to be accomplished, the Managed Funds will need to move to a net 25,000 -50,000 contract net long position level, which remains an open question. While US export prospects will improve under the new US/China trade agreement, its impact overall in boosting global cotton consumption remains a bit in doubt. ZCE cotton futures have shown no excitement for the agreement, and it reflects cotton demand in China. The May contract closed at 13,400 RMB a ton (86.70 cents), and that is very near the level of the Cotlook A Index adjusted for China after VAT. In addition, certificated stocks for possible delivery against the contract increased last week by 119,800 tons, and total delivery stocks are at 1,010,240 tons, which illustrates the poor level of demand as ginners continue to sell ZCE to find a home for their cotton. These record stocks for possible delivery suggest extremely poor demand for domestic cotton. The Reserve purchase scheme has not resulted in any volume purchases due to the extreme quality requirements.

Our concern remains the weak domestic cotton demand in China, which will increase as supply chains pull out of China. The human rights issues will not go away. China has a Xinjiang problem, and its supply chains have been infected by it. Credit issues are expanding, with more USD debt defaults pending. The China/US agreement has the potential to bring trade back to some normalcy. It also could impact basis levels if Brazil and others are forced to find a non-Chinese supply chain. For now, the market is attempting to move higher under a speculative influence. The US faces the burden to export 16-18 million bales. It should be noted that these levels are near or at a record if reached. To reach that goal it will take much more than 4.279 million bales that is a moving target and not driven by real demand. The need for such exports will have a major impact on world trade. At the same time, Brazil will need to move another record crop to export in 2020/2021. A signed trade agreement and a start to Chinese purchases may create some excitement, and memories of the post-June 2018 period when Futures were in the 90s.

It should be remembered that those prices were driven by much larger Chinese and Global cotton demand, and a Supply Chain, especially a Chinese supply chain full of confidence and willingness to extend forward coverage. China's actions since that time – the violation of the 1987 Hong Kong Handover Agreement, the revealing of the Xinjiang Concentration camps that have provided labor to the textile industry, and now photos of Chinese Christians being forced to sew apparel for Chinese Companies, have changed everything. Brands and retailers want out of China for business not directed at the domestic market. This may not be in the headlines, but it's the goal. The liability is just too great. For now, the moves are limited by the lack of capacity and expertise in other markets. The demand over time has a way of solving such problems. The agreement reached with China appears to be close to the same proposed by the US in 2018 before the official dispute began. Unfortunately for cotton demand and the Chinese export industry, the agreement from the Chinese side has come too late to stop the exodus.

This clouds the outlook for prices. In the near term, a rally into the 70/72.50 nearby is possible and seems logical if an agreement is signed and has started to be implemented. However, any delays or failures will have major negative impacts. The US/China relationship continues to have major issues. Hong Kong police abuse is expanding, as are human rights abuses. Action by the US is required by law. Secondly, the Xinjiang problem and the Christian persecution may not be a major Trump agenda, but Congress is moving quickly to force actions. Then Taiwan awaits, with a major group of Senators last week pressing for the US to start a Free Trade Agreement with Taiwan that would anger China. Then you have China's continued attempt to increase influence in the US, Australia, and others that is drawing anger. Canada has been overrun by Chinese influence and has asked the US to not sign the trade agreement until several major Canadian citizens being held hostage by China are released. Thus, Canada appears to be seeking US help with China's aggression against the US ally. It's the Holiday season, and the rhetoric is slowing for a week. However, the hurdles for the agreement will increase in the New Year.

For the cotton Industry, this means prices are entering a time of increased movement based on this agreement but limited by overall cotton demand.

Merry Christmas and Happy Holidays

To our Friends Around The World

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