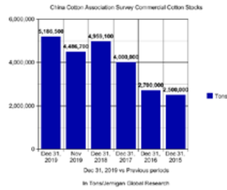

CHINESE UNSOLD COTTON STOCKS A BURDEN

CHINESE POLYESTER FIBER PRICES ARE A PROBLEM FOR PRICES

AFRICAN FRANC ZONE STYLES MOVE IN VOLUME AT FIRM BASIS

TRADE AGREEMENT LEAVES COTTON MARKET WITH LOTS OF QUESTIONS

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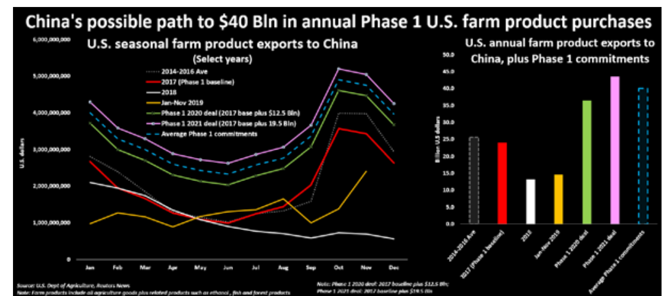
CHINA UNSOLD COMMERCIAL COTTON INVENTORY AT RECORD AS TRADE DEAL SIGNED

On Wednesday, the long expected and much anticipated signing of the trade deal between the US and China finally happened. The event appeared designed for maximum political value as more than 200 guests were packed into the room, which included Senators, US officials, business leaders, and others dignitaries. The event was anti-climactic, as the length of the ceremony caused many news networks to cut away before the Chinese side ever issued any comments or the agreement was signed. The delay was caused by a long list of self-congratulations from the US side that was likely viewed in bewilderment by the Chinese delegation. The events coincided with the key agriculture futures markets closing lower, unimpressed by the actual signing.

November soybeans closed sharply lower, losing 10 ¾ cents a bushel. Since December 2nd, November soybeans gained 6.5% at the peak but they have seen

a large portion of those gains erode. Hogs have been very bizarre, as they gained .675 a hundred-weight Wednesday but are only marginally higher since the deal was announced. Cotton has been the star performer, with ICE March soaring 12.4% as of Monday from the December 2nd low. However, it fell sharply Wednesday, losing 106 points in March and 55 points in Dec, well off the highs. Last week we commented on the bizarre behavior of the futures ahead of the signing. The market action is controlled by the Algorithmic Artificial Intelligence systems and now moves off key words in headlines or certain data points, which provides very weird price action. The rally in cotton had occurred despite not one known sizeable Chinese purchase of cotton. Thus, by Wednesday evening, Bloomberg led with a story that the 95 billion USD centerpiece of the trade deal was already in doubt. This was clearly a biased headline driven from the Bloomberg News Service, with their strong anti-Trump reporting in every story since its owner Mike Bloomberg announced his run for President.

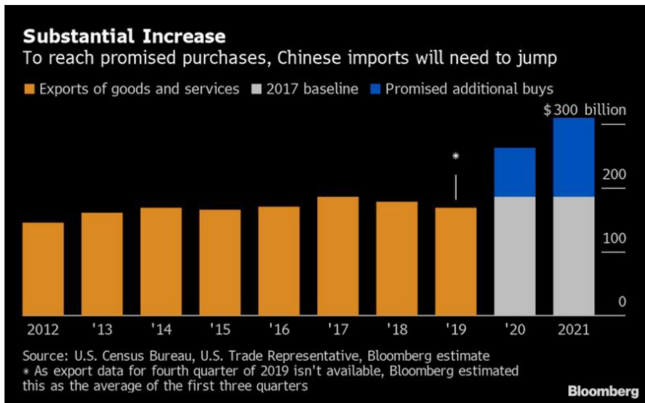
The US released the exact agreement signed but missing the confidential purchase target by commodity. The agreement contained details but did not do anything to quell the skeptics of the agreement or the belief that China would attempt to fulfill the agreement. As the buildup to Wednesday's signing of the China/USA trade deal got underway, it became clear that the markets had underestimated the agreement. We have pointed out several times our respect for US Trade Representative Robert Lighthizer and his seriousness as a negotiator. China, in the *South China Morning Post,* confirmed the size of the trade agreement they had agreed to, and it appeared to shock many that simply did not believe what the Trump team had communicated. Listening to a host of commentaries, it seemed to indicate that most simply are not qualified to comment on China, and they have no idea of the qualifications of the team of US trade negotiators. Many appear to have dismissed the importance of the trade agreement and what it may contain. It sounds as though the Trump Derangement Syndrome is alive and well on Wall Street. To begin with, China confirmed it would buy 200 billion USD in goods and services over the next two years, and it confirmed this included 75 billion USD of manufactured goods. *Bloomberg*, which has now assumed a very anti-administration view, was quick to point out the agreement could be in violation of the WTO across several fronts. *Bloomberg* has ignored the issue of any China WTO violation for most of the past 20 years. The news group is very active in China where it sells its services. After the agreement was signed, the EU trade commissioner announced the EU would review the agreement to see if it was WTO-compliant and would take action if needed. The size of the agriculture commitment again resulted in several reports of shock at the volume, even though Lighthizer had reported the details much earlier. The size of the agreement also triggered commentary on whether China can afford such purchases. The USDA has said it will now include expected China purchases from the Phase I trade deal in the February WASDE.



Reuters

Before the signing, the US removed the currency manipulator designation on China. China has agreed to keep the RMB overvalued against the USD to prevent any trade advantage. The RMB has been appreciating against the USD since the agreement was announced, reaching 6.8843 by Tuesday. Most feel it is far overvalued and would fall sharply if freely floated. Jim Cramer, the well-respected CNBC analyst, on Wednesday morning said the "tariffs worked," to the shock of the many talking heads and economists. Cramer said the success of the tariffs was historical and also cited the agreement as having major shifts in intellectual property.

As the agreement details began to surface, it was clear it was much more substantial overall than anyone expected and has extensive detail. The agreement also has significant enforcement mechanisms that provide the US with the ability to introduce new tariffs without reciprocal action by China. The agriculture section called on China to import 12.5 billion USD worth of products above the 2017 base of 23.8 billion, or 36.3 billion USD, in 2020. Purchases in 2021 are required to increase to 19.5 billion above the base, or 43.3 billion USD. In addition, China also agreed to increase agriculture purchases five billion above these totals, if possible, based on demand. The agreement provided no indication of the requirements per commodity, but they did provide six major categories of imports, and one was cotton. The agreement also included requirements for purchases of manufactured products, energy, and services.

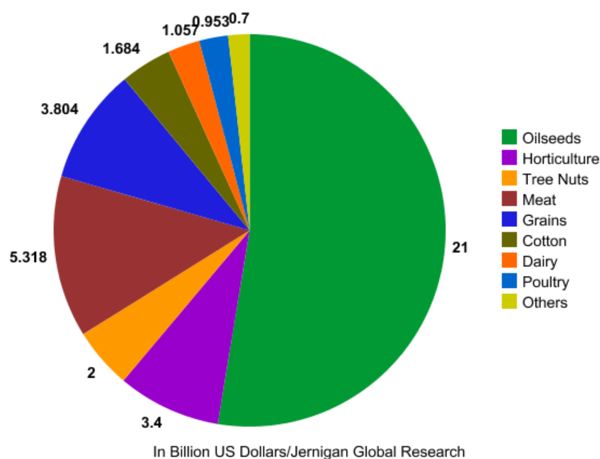


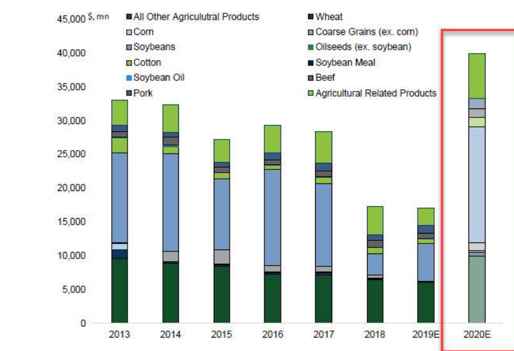
Li Hui, the Chinese Vice Premier who signed the agreement, said that the agriculture purchases would be driven by demand and would rise if and when increased demand was realized. This comment appeared to be all the anti-Trump traders and reporters needed to say this was evidence the purchases depended on demand. That is not what the agreement says. The base for 2020 of 36.3 billion USD is a hard target. A small asterisk says that China may increase purchases by five billion USD if increased demand occurred. The exact wording was "at the request of the United States, China will strive to purchase and import $5 billion per year of the U.S. agricultural products covered by this Chapter, in addition to the minimum amounts set forth herein." This clause allowed China to put the spin out that the purchases were based on demand.

Again, this is a serious agreement, and the US has left tariffs in place on 360 billion USD of Chinese goods, which will remain in place unless the year-one requirements are fulfilled. China also began to give in to US requirements on intellectual property. If the US brings a case of intellectual property theft, then it is up to the accused to prove it did not occur. The Chinese press appeared to ignore the extended press conference and put a win/win on the agreement.

One potential problem that was not addressed is the Chinese removal of all tariffs on US agriculture products, such as the 25% duty on cotton imports. New increased tariffs that had been announced were canceled, but the original tariffs remained in place. This means China will have to issue waivers and adjustments for commercial buyers. The exception may be the purchases by the large, state-owned Reserves. The Chinese and the US were silent on this feature. For the Chinese, this may have been a face-saver against the US tariffs that remain in place. However, this will affect normal commercial trade unless the Chinese address the issue. For example, the fact that the 25% duty remains in place on US cotton meant Chinese mills on Thursday were buyers of Brazilian cotton, not US. The lack of a universal withdrawal of these tariffs has raised major questions on the intentions of the Chinese.

The other issue that we discussed in previous issues regarding the impact of the trade agreement is that there are no milestones that have to be met on the calendar. It says only that the purchases have to be completed by the end of the year. The USDA weekly sales and shipment report will provide a regular monitoring tool. This is logical and gives Chinese buyers complete control over the timing of the purchases. China has used such buying power to its advantage many times over the past 20+ years. It will therefore be to China's advantage to stimulate as much worry and concern as possible among suppliers that it may or may not fulfill the agreement. As we have said before, Brazil has to export a set volume of cotton and soybeans in a set period as the next crop moves. If the Brazilian basis is a discount to US, Chinese buyers will buy Brazilian or offer the trader the same deal for US. As we have stated several times, the agreement does not create new demand but it only suggests that the US will have a certain share as long



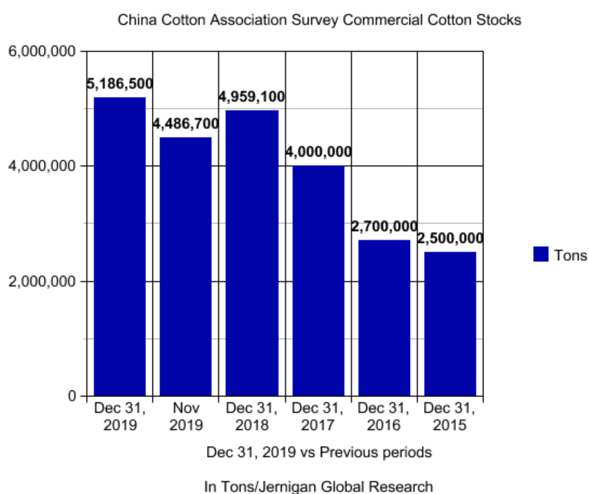


Source, ZeroHedge

as the US is competitive. Several parts of the agreement require the US products to be available at "commercial consideration," or China can ask for consultation. Leaving in place the import tariffs appears to give complete control of the buying process to the state to grant wavers and adjustments at will.

For cotton, the issue is demand. If, as implied, the Chinese have flexibility in the volume of commodities it buys, then cotton could be a loser in the agreement, as we have been discussing. The major commodities for which large demand is possible have both performed poorly. One factor that has received only limited discussion is the fact the agreement does not create additional demand. It just indicates the US will receive a larger percentage of world trade. The Chinese are insistent on the ambiguity on the volume of individual commodity purchases and the commentary that all purchases must be at competitive prices. It will be very late in 2020 before the US can check compliance on the purchases. That gives the Chinese the flexibility to wait until prices are depressed or basis weak to make the purchases. Again, the agreement does not increase demand, and the timing of demand could be changed if the purchase is for the Reserve. For example, if Brazil needs to export 10 million bales of cotton or 80 million tons of soybeans, the effort will be made to accomplish these sales regardless of Chinese demand levels.

ICE and ZCE futures experienced a major bull market prior to the signing of the agreement, even though demand from Chinese mills had been weak. China's ZCE May futures surged 14.4% since December 4th, gaining 11.93 cents a lb., while March ICE gained 12.4%, or 7.94 cents in the same period. In both markets the speculative sector drove the gains. Confidence outside of China has improved, but China's internal demand for cotton is quite weak. The certificated stocks that can be delivered against the ZCE



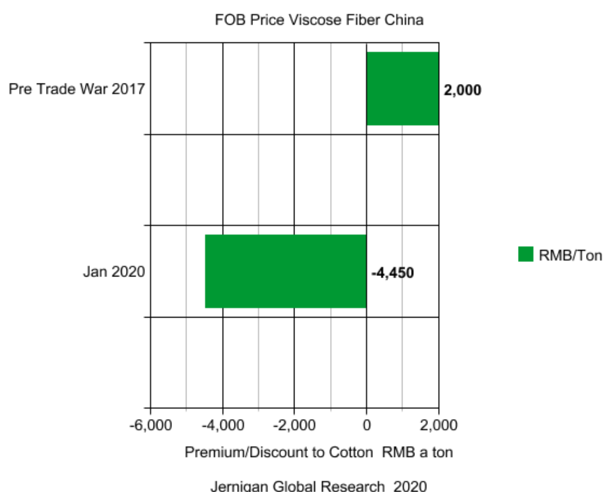
contract have moved to new records daily, reaching 6.31 million bales, which reflected a large increase for the week. The May contract closed the week at 14,005 or 92.60 cents, losing 440 RMB a ton or 2.91 cents a lb. last week.

The China Cotton Association (CCA) conducts a monthly survey of all commercial cotton stocks held outside of the Reserve and spinners' inventories. The survey for the period ending December 31st showed a record 5,186,500 tons or 23.507 million bales, up 689,800 tons from a month earlier, and up 227,400 tons from a year ago, a record for the survey. It also compares to stocks of only 2.5 MMT in the same period in 2015. To put the size of these unsold stocks in perspective, the 2019/2020 total Chinese cotton crop was 5.625 MMT, of which 5.050 MMT came from Xinjiang. Of those stocks, 4,236,500 tons were in Xinjiang warehouses, 729,000 MT in Eastern warehouses, and 220,000 tons was imported cotton held in bonded warehouses. At the end of December, mill inventories, also measured by the CCA, stood at 735,500 tons, down from year-ago levels of 870,200 tons. The CCA Planting intentions survey showed that growers plan to plant 7.5% less acreage to cotton in 2020/2021.

This level of commercial unsold stocks raises the question as to why. We suspect the first answer is that consumption by Xinjiang-based spinners has fallen by 25-35% or more, about 2.4 million bales. Brands and retailers have told their Chinese suppliers they want to avoid any chance that Xinjiang slave labor-produced goods are in their supply chains. Chinese spinners operating in the region also have been told to keep a low profile, and some have shuttered operations that were easily accessible. This is one reason why unsold stocks of Xinjiang cotton are at record levels. The second feature is capital restraint that forces spinners to carry less inventory, as that survey showed. Thirdly, demand from the domestic retail market is weak, with the economy believed to be growing at only 1-2%, and much of the data is now unreliable as that growth level is covered up. By mid-week, the Cotlook A Index adjusted for VAT, and import tax remained at a premium to the cash index and small discount to May ZCE futures. Thus, no price incentive existed for imports outside quota considerations. Mills attempt to use all allocated import quotas for fear unused quotas will affect future allocations.

The January ZCE cotton futures expired on January 15th, and it should be noted the price collapsed to 13,265 RMB a ton for a one-day loss of 510 RMB or 3.31 cents a lb. It also compared to the CC Cash Cotton

Index that day of 13,949 RMB. The collapse reflected the record certificated stocks and the very poor physical demand. This is not a surprise considering the run up in prices was speculative and not based on demand. ZCE PTA futures have also fallen sharply from the recent highs, losing 4% since January 6th. PTA is one of the raw materials for plastic and polyester. Viscose Fiber cash prices have fallen to a new record low of 61-62 cents a lb. The weakness in Viscose fiber is remarkable, as it is now at a 29 cents a lb. discount to cotton versus a ten cent a lb. discount in November 2018. In RMB per ton terms, before the trade war began in 2017, Viscose traded at a 2,000 RMB a ton premium to cotton. Today it is at a 4450 RMB ton discount to cotton. Viscose spinners are reported to be operating at a negative margin, and many spinners have turned to polyester yarns.



For cotton, the problem is that, overall, Chinese cotton demand is weak and import demand outside the annual TRQ quota is very limited. The lack of a removal of the 25% import duty adds to the drama and uncertainty of US sales. The total agreement has a lot of skeptics and will likely face WTO challenges from the EU and Brazil. The US side achieved from China the most detailed agreement yet, but even then there were lots of wiggle-room clauses that could endanger the purchase part of the agreement. Discussion of the agreement has suggested it has large potential in the financial services sector for US banks and finance companies. The opening is occurring at a time of great risk. Confidence might be taken from the effort put forth by Liu He, the Vice Premier who negotiated the agreement, and the effort that his team made to spin the deal as positive on the Chinese side. Taoran Notes, the social media blog that is believed written by someone who travels with Liu, posted last week for the first time in two months. First, the initial translation said there would be complaints regardless of what was in the agreement. Second, since it seems both sides are unhappy about a few aspects of the agreement, it may be a deal that will work. The agreement does appear to be a big win for Liu He and his reformers versus the hardliners that stopped several earlier agreements. Missing from the agreement was any discussion of the human rights issues that overhang the agreement.

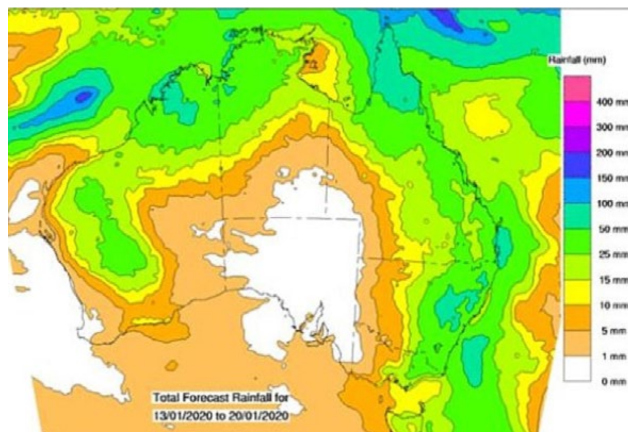
For the cotton industry it's clear there is confusion as to what the agreement means, and there should be since a lot of unanswered questions remain. The market needs the Chinese textile industry to reach stability and to a return of confidence in forward orders. Conditions after business returns following the Chinese New Year celebration and holiday will be very important. Many spinners are waiting until then to restock. Many downstream mills have already announced extended closures around the holiday period. Another factor hurting cotton is the cheap price of polyester and additional capacity that will come online after the holiday. Currently, the price of cotton is twice as expensive as polyester. Polyester is 40% cheaper than Viscose fiber. Such price ratios are having an impact on the demand of both fibers.

AUSTRALIA: HOPE RETURNS AS RAINS ARRIVE

Farm paddock, Central NSW – Last week, 2020

The global media headlines during the past two weeks were dominated by Australia for its record brush fires and the failure of the country to manage climate change. The Financial Times went so far as to say "Australia is no longer the Lucky Country." Australia earned that title for its climate and near recession-proof economy. With only 25 million people, no one talks about the fact that Australia's impact on the global climate is minor. Other than the use of coal for power, it has very limited impact. Nonetheless, the Labor Party and left-wing activists, along with the press, have violently attacked the government for its climate change stance. The facts pointed to the drought's intensity being caused by a spike in the IOD Index, as we discussed several week ago. They now indicates the index has fallen sharply, which suggested a change was occurring. The index is now collapsing, which is a very positive sign. A CSIRO brush fire scientist blamed the fires on 30 years of misguided Green ideology. The scientist reported that, as a result, forest fuel conditions had reached levels that are the most dangerous in many years.

The dramatic change in forecast follows a long history of major droughts ending when press coverage reached excessive levels, with many forecasting dire conditions ahead. The change also follows commentary from several meteorologists citing the performance of the Indian Ocean Dipole Index as the driver behind the heat and drought. They also stated that the conditions to the north of Australia were impacting North American weather, where a much warmer than normal winter was occurring in many areas.



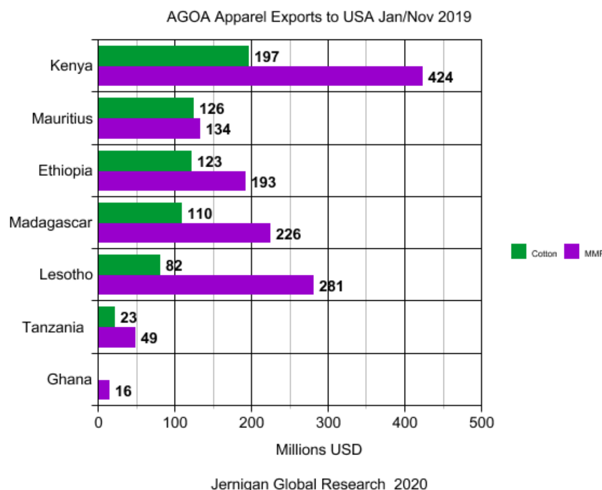
This forecast suddenly changed last week, with the forecast becoming wet for much of Queensland, New South Wales, and Victoria. The forecast has many areas likely to receive 50 mm or more. The change did not occur before more towns ran out of water. Stanthorpe, Queensland ran out of water on January 13th, and water is now being trucked from Connolly Dam. This was the community that was discussed as having its aquifer water sold to a Chinese company. The rains arrived as forecast, and by Thursday flooding was reported across several areas, as heavy rains drenched the parched soils and some dams began to see some inflows after being near bone dry. The rains came too late to impact 2020 dryland crop but have provided a very welcome boost for the rural areas. The drop in the Indian Dipole Index has raised hopes it is the start of a major renewal of water resources.

In Queensland, the rains through Saturday were concentrated on the Eastern Darling Downs, where up to 200 MM has fallen at some farm locations. Oakey reported 73MM, Toowoomba 34MM, and Stanthorpe 86MM. The South Coast/Moreton area, which is not cotton country, received 100-200MM as well. In New South Wales, the Northern Rivers, which is not cotton country, received 100-200MM. The Cotton belt the area near Forbes and Parkes received 37-76 MM or more. Moree officially received 56MM, and many areas has received 25MM or more. Flooded paddocks and streams were common, bringing joy to the region. Additional rains are possible through Tuesday.

SUB-SAHARA AFRICA NOW TENTH LARGEST SUPPLIER OF COTTON PRODUCTS TO USA

The apparel supply chains are moving out of China. However, much of the movement is in only cut and sew, with fabric manufacturing, a much more difficult process to move out of China, remaining. China's apparel exports are weaker but not its fabric exports. December textile exports were up 11.4% to over 11 billion USD. China is the main fabric exporter to many of the cut and sew centers. One of those is the Sub-Sahara region of Africa, where many of the exporters enjoy duty free entry into the US under AGOA trade benefits. Ethiopia is emerging as a powerhouse in the region, and its top investor and trading partner is China. Approximately one third of all imports come from China, and it was the top supplier of fabric. Its exports to the US will exceed 200 million USD of apparel in 2019. The top supplier is Kenya, which has become a major supplier to the US with January-November exports reaching 424.12 million USD, up 16.12%. Lesotho is the second largest supplier at 281.326 million USD, and Madagascar has increased US exports to 226.182 million USD.

These strong exports are not contributing to any real increase in cotton use, with cotton fabric imports providing the raw material. Kenya, the largest supplier, will consume a mere 40,000 bales, with 25,000 bales grown locally. Kenya's textile sector is small and dominated by old equipment. This compares to the robust cut and sew industry that has expanded because of the AGOA duty free access to the US. The fabric is supplied by China, Taiwan, India, and Pakistan. Lesotho will consume an estimated 90,000 bales of cotton imported from East Africa. It has benefited from Taiwan investment and has a complete supply chain, including denim. Madagascar has one spinning mill and uses only 20,000 bales, importing most of its fabric. Mauritius also has an active cotton-spinning sector and uses 120,000 bales annually. It has a major textile and apparel industry and is also a major supplier to Europe.



AFRICAN FRANC ZONE STYLES MOVE TO SPINNERS DESPITE BASIS PREMIUM

Last week, African Franc Zone styles sold both from merchants to spinners and from local selling organizations to merchants. The crop is rapidly being ginned, and the selling organizations need to finish sales. Prices are at their seasonal highs. Despite the record crop moving, both the FOB basis for origin sellers and the CFR Asia basis levels have been maintained in recent weeks, which has been conducive for trade. Bangladesh and other spinners are again taking up these styles despite the CFR basis levels. The levels are well off their peak but still overpriced vs. US and Brazilian styles and are at record premiums to Indian cotton. Cameroon Plebe 1 5/32 styles remain offered at 1400 points on March and May, and a USA Memphis Eastern Green Card 31-3-37 at 1300 points on. This discount is shocking. First, the origin is select, from the Memphis Territory only. Second, Green Card means HVI data for each bale, no contamination, and sustainability features with the US Cotton Trust Protocol or BCI an option. The other 1 5/32 African Franc Zone styles are offered at 1300 points on March and May. Indian S-6 1 5/32 is offered at 500 on March, which is an 800-point discount to the West African offer. The Mali Juli/s 1 1/8 offers are at 1225 points on compared to a Memphis/Eastern Green Card 31-3-36 at 1250 points on.

Bangladesh was the top market for West African cotton shipped out of the Ivory Coast in 2019 at 67,490 tons. It also took volume from the other crops. India and Vietnam were the next largest destinations. West African styles also continue to be popular in Thailand. Turkey was a very big market in 2017/2018 but sales have slowed sharply in 2018/2019 and 2019/2020 due to the development of the basis premium.

The region continues to be plagued by low yields. Mali's average yields are expected to be near only 400 kilograms a hectare or 1.84 bales, and Benin will reach close to 475 kilograms or 2.1816 bales per hectare. The yield levels are caused by the lack of BT cottonseeds. The spinning quality of the cotton is good, but the low yields are keeping farmers' income limited, causing local governments and marketing organizations to maintain high seed cotton prices. This is causing debt problems.

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TRADE DEAL ALLOWS NEW PIMA EXPORT SALES TO CHINA

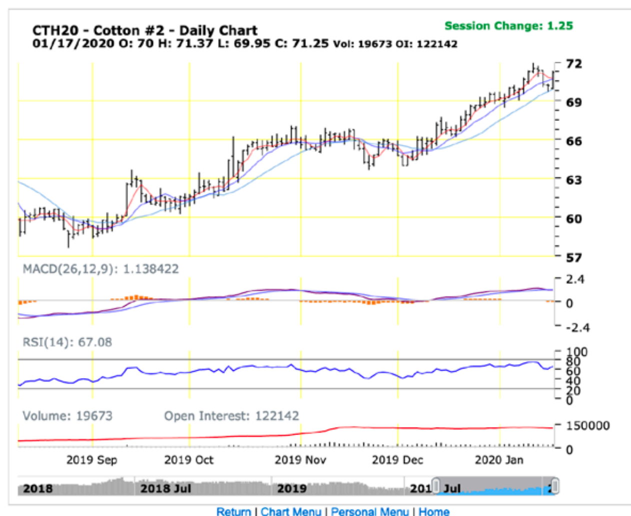
The largest sale of US Pima to China since the trade war started has occurred, with sales of 13,200 bales. Total US Pima sales in the latest week reached 34,300 running bales, the largest sales since the week ending February 14, 2019, when sales reached 42,275 bales. India was the second largest buyer at 8,000 bales, Vietnam 6,400 bales, Pakistan 4,300 bales, and Turkey 1,500 bales. Total Pima export sales have reached 388,100 running bales, down from 467,200 running bales a year ago. Upland sales were also brisk at a net 232,900 running bales. Vietnam was the top buyer at 71,600 running bales. Vietnam has imported a total of 510,625 tons or 2,346,066 bales August–December, which reflects a decline from 567,025 tons a year ago. Imports of US and Brazilian cotton are up from a year ago, and these growths are replacing Australian cotton. Imports from Australia have reached only 17,153 tons compared to 110,102 tons a year earlier. Imports from India are also down sharply. Pakistan was the second largest buyer at 34,800 running bales, and Turkey purchased 29,500 running bales and was also active last week as a buyer of US styles.

US export shipments picked up to 301,700 running bales of upland and 7,700 of Pima. This was far below the average needed to meet the USDA target. If shipments average near this level, exports will fall near 3.0 million bales below the USDA target of 16.5 million bales. Shipments now must average 393,466 running bales a week the remainder of the season, or US exports will be reduced. 24,700 running bales were shipped to China. Attention will now focus on any indication of the large outstanding sales to China beginning to ship.

ICE FUTURES CLOSE NEAR UNCHANGED FOR WEEK

US equity prices hit a new all-time record high. The Chinese RMB surged against the USD, reaching 6.8598 following China's agreeing to keep its currency overpriced against the USD. It has gained 4.56% against the USD since the trade deal was announced, and it has also added to exporters woes. At the same time, the Chinese CSI-300 Equity Index has gained over 3.4% in January.

The China/US trade deal is signed, and the issue is that US cotton remains subject to a 25% tariff unless exemptions or adjustments are made. Then there is the issue of need, and, as we discussed in detail earlier, China is awash in unsold cotton. Unsold commercial inventories outside the Reserve and spinners' stocks are 5,186,500 tons, which compares to the 2019/2020 domestic crop of 5,625,000 tons or 25.844 million bales. More than six million bales of this inventory have been certificated for delivery against the ZCE futures. The January contract expired last week sharply lower as this weight impacted the market. The Reserve effort to buy Xinjiang new crop has been very slow due to the high quality restrictions it put on purchases. This has been unusual. Many outside China expect that China needs to restock its Reserve stocks. Rabobank has forecast that China will import 12 million bales in 2020/2021 as the restocking begins. That is a possibility, but for the remainder of the 2019/2020 season it is import demand that is a concern. The level of unsold stocks in China is a sizeable burden in that it is not held by the Reserve. The Jan ZCE contract expired at



13,265 RMB a ton (87.84 cents), which means some ginners or traders delivered stocks at that price. This represents a big discount to the speculative boosted distant futures contract. It was also at a discount to the Cotlook A Index adjusted for VAT and import tax, and a nearly 4 cent discount to the cheapest Middling 1 1/8 E/MOT US landed price after VAT. The agreement says China has 12 months to choose the time to meet their commitments. For cotton, we speculate that 1.4-1.6 billion USD has been set as a target, but we know it can be adjusted based on other purchases. The

outstanding 2019/2020 sales reflect nearly 600 million in sales, which means the needed sales for cotton would then drop sharply.

We suspect one reason farmers and bulls have been disappointed over the market action to the trade agreement is the flexibility given to China, understanding why it was granted, and the lack of any creation of actual new demand. We heard another trader refer to the agreement as equal to China being granted a call option on US exports. The price of that option is nothing if used, and new tariffs and trade friction if it chooses to let the option expire. For those attempting to trade these markets, its back to again attempting to gauge Chinese demand.

Chinese mills did enter the market using their 2020 TRQ quota. Brazil was the featured growth along with some other growths. These mills purchased Brazilian because of preference and uncertainly over tariff waivers. Brazilian and US Type offers are near the same basis, so the purchase was not based on price.

Non-Chinese mill demand was moderate last week, with Bangladesh, Turkey, Taiwan, Indonesia, and Vietnam all in the market with US, Brazilian, and African Franc Zone styles moving. This business appeared to help the market during the price weakness. Bangladesh appeared to be volume buyers of West African last week. It appears that mills that used to pay a premium for the high grade Central Asian styles have replaced these with African Franc Zone styles.

The price strength came from new Fund buying, either as Managed Funds or Index Funds. The size of the new allocations of Index Funds long has been a major source of the price strength. The Managed Funds net long position is now at what is considered a first step in building a net long position. This means they have additional buying power. The March ICE contract ended the week with a small six-point loss, while the Chinese ZCE May contract closed 2.90 cents a lb. lower for the week. The market has reached our first upside target range, which extended up to 72.50. Additional gains are possible if the funds extend their net long toward 50,000 contracts. All attention will be focused on China, its actions around the US tariffs, etc. Overall, we are turning cautious, as the Cotlook A expands its rally near a 50% premium to the average polyester staple fiber price.

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