XINJIANG COTTON YARN PRODUCTION DECLINES

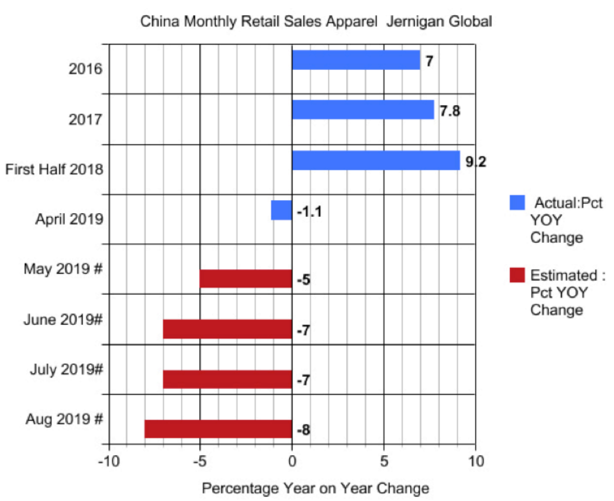
INDIAN PRE-MONSOON DROUGHT CAUSING ISSUES

AFRICAN FRANC ZONE BASIS EXTENDS PREMIUM

ICE FUTURES COLLAPSE UNDER WEIGHT OF CHINA WEAKNESS

JERNIGAN GLOBAL
KNOWLEDGE IS THE NEW CAPITAL

INDICATIONS SUGGEST CHINESE COTTON USE HAS FALLEN 20-30% AS THE RESULT OF TRADE WAR



Honeys apparel store chain, Shanghai

Very robust conditions were prevailing across the Chinese textile and apparel industrial complex, and companies were actively planning to expand capacity to meet the higher demand that was expected in the fourth quarter of 2018 and into 2019. This optimism was exhibited in strong forward demand for both cotton as well as polyester staple fiber. The time was May and June 2018, and it also was a time when China's leadership was showing excessive hubris on the world stage, as it relished its economic power and appeared to step outside the shadow of Deng Xiaoping. It appeared they expected the Trump administration to behave like the previous Obama, Bush, and Clinton administrations and buckle to China's demands, under the belief that the coupling of the two countries was just too secure, and that the US could never move its supply chains. After all, the strategy of supply chain accumulation had worked with China, the sole supplier in many key product groups, and China felt the Wall Street lobby would maintain the status quo. At first, the US demand was simple, an adjustment of the record trade deficit, and it appeared China would agree to increasing US purchases. However, they balked at the last minute, and the war was on. One year later we now know the key influencers in the Trump administration will not be moved as previous administrations, and they are not fearful of disrupting the US/China sourcing relationship. This may be remembered as the greatest intelligence failure on the part of the Chinese leadership in centuries.

As China dragged the trade negotiations out, new issue after new issue was put on the table and thus into the headlines, many of which had been kept quiet under the Obama administration. Despite all the discussion of the Xi/Trump relationship, China failed to honor its verbal commitments from the Argentine meeting in December 2018. At the same time, the Trump administration, which was the first US administration in years not heavily influenced by Wall Street interests, moved to inform all US companies and companies doing business in the US to move supply chains out of China, and urged them to relocate back to the US. As the Trump administration moved to place and leave tariffs on Chinese goods, US companies began to react by beginning the process of moving supply chains.

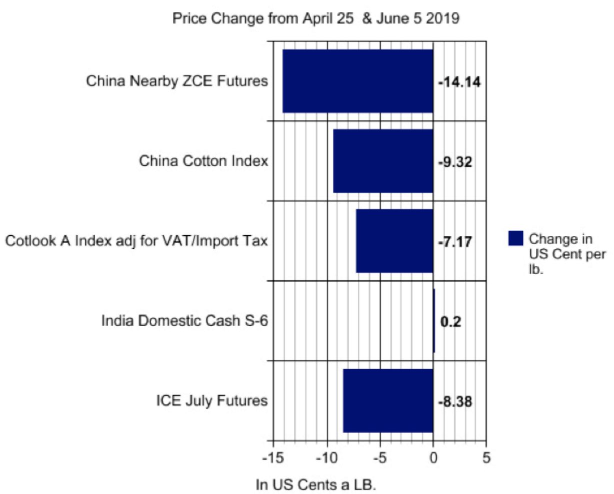
Moving supply chains is not a simple task, and would require ending the decades old policy of new fixed asset investment in China, cancelling orders and closing local plants. The Chinese side appeared to not understand that this would mean more than a disruption of export orders. The data suggest that the economic impact of these developments began to be felt in late October 2018. This was followed by some stability and optimism that a truce was coming and conditions would return to normal. Orders were weak but continued to flow at lower levels, and companies attempted to manage the weakness with the hope that normal conditions would return. Then came the complete breakdown of US/China talks, as China backtracked on its concessions. After this, the US was willing to force US companies to move the remainder of their sourcing out of China or face what could be permanent and possibly increasing tariffs. This meant US companies canceled orders and accelerated the movement of their supply chains. The move by the multinational firms also affected sourcing out of Europe. The human rights violations in Xinjiang began to garner more world headlines, impacting decisions to further move supply chains out of China. Last week, the Chinese leadership became concerned and held a top-level meeting with US Tech companies operating in China. They threatened them with retaliation if they stopped selling the needed US Technology to Chinese Companies or moved supply chains. Given the US law, this means that many more of these companies will eventually be forced to exit China.

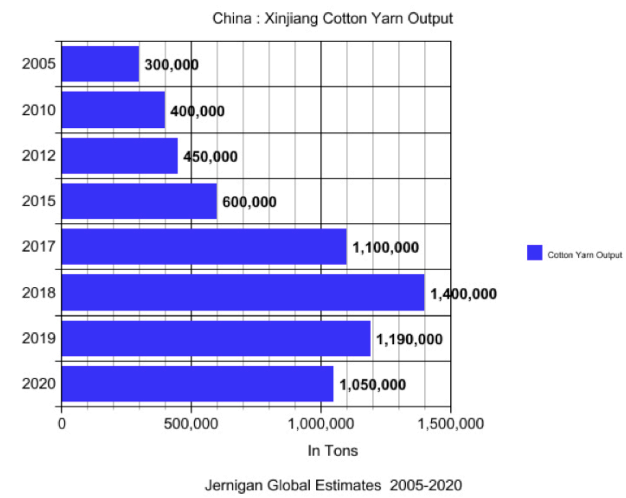
The sharp reduction in exports, first to the US and then Europe and other trade partners, occurred as domestic demand tuned weaker. The Chinese economic model – "build it and demand will follow" – has resulted in massive overcapacity in many industries, such as autos. Suddenly, auto sales started to fall sharply as market penetration topped out and the overcapacity increased supply. If supply increases say 25% and demand only grows 10%, there is a problem that cutting prices alone will not solve. Then came the Swine Flu epidemic in which China was forced to cull millions of hogs, impacting the agriculture sector and the food sector and increasing food inflation. All these events added to the weak labor market and wage stagnation.

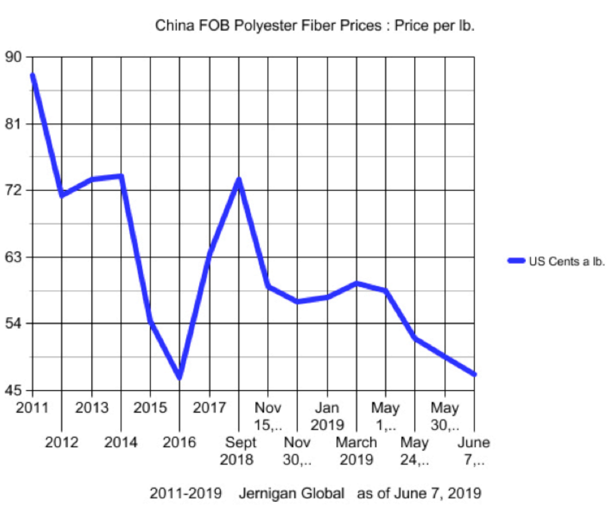
For industries such as textile and apparel, where demand has been expanding for decades both in export and domestic, no one was prepared for a downturn. The first wave of demand weakness, which hit in late October and is continuing, appeared to be export-focused only. The second wave of falling demand began in April and continues. It began with a further reduction in export orders, but it now includes a downturn in domestic orders. The entire supply chain, from the yarn spinner to apparel manufacturing, has reacted by rushing to unload all inventories, reducing operating capacity, and attempting to find demand at any price. During the past 30 days, the weakness has been almost nonstop and has spread to the domestic cotton sector. Today, China's ZCE cotton futures are an integral part of the cotton trade and the industrial commodity complex. Companies can hedge and trade cotton, cotton yarn, PTA, and MEG, along with many other industrial commodities. The price movement of these commodities is linked to the underlying commodity and not just speculation. The collapse in PTA futures occurred first and has continued. The ZCE cotton futures have also collapsed and have shown little willingness to follow ICE on the days it has posted gains. The lead ZCE September contract declined sharply last week, moving to new contract lows and also widening its discount to the Chinese Cash Cotton Index. By June 4th, the September contract had lost 19% from its recent highs, and was at a 10% discount to the cash index.

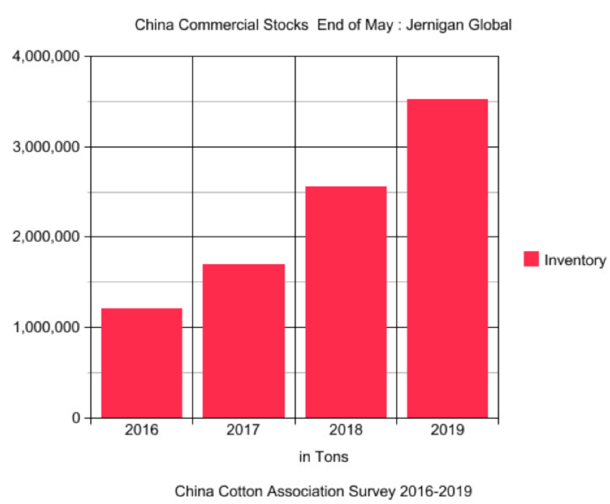
Even after this drop, warehouses in Xinjiang report poor demand for cotton, and ginners and traders holding the southern Xinjiang crop, which has some low strength and contamination issues. Demand has been very poor, even with discounts. At the end of May, the Chinese Cotton Association survey indicated that commercial inventories, not including spinners stocks or Reserve stocks, stood at 3,528,100 tons (16.2 million bales). This is one of the largest volumes for May since the survey started, and is 974,600 tons above last year. The Trade, PCC, ginners, and others holding such an inventory when prices are collapsing, could be creating a major financial issue for the industry. It is not clear how much of these stocks are hedged on the ZCE. It also means a major burden on ginners and others, as they arrange finance for new crop movement. As we have said before, the Reserve may choose to or is instructed to procure a portion of these stocks for the Reserve before imports.

The weaker demand is evident in the slower shipments of Xinjiang cotton to the eastern warehouses. September 2018 to May 2019 shipments of Xinjiang cotton to Eastern warehouses have totaled only 2,459,200 tons. This is less than half the 2018 crop. A review of the output data of the major spinners in Xinjiang may provide a clue to just how much cotton use has suffered. In summary, our findings suggest first quarter cotton yarn output in Xinjiang fell by 10%. However, second quarter cotton yarn output would appear headed for a 20-30% decrease. The driver is a slowdown in orders both domestic and export. The hope that new orders from the Belt and Road destinations would offset the lost US and European orders has proven to be false hope. As we have discussed, the Xinjiang camps pose a real threat to the Xinjiang and China's textile/apparel industry. Outside trade issues and the intertwining of the labor from the camps in the factories means Western Companies will be forced to cancel orders and pull out sourcing, unless it can be verified that their supply chains do not involve this labor. This risk was neither considered nor reviewed when the camps were established. The Camps have the attention of the US Congress, and bills are gaining momentum to punish those involved.







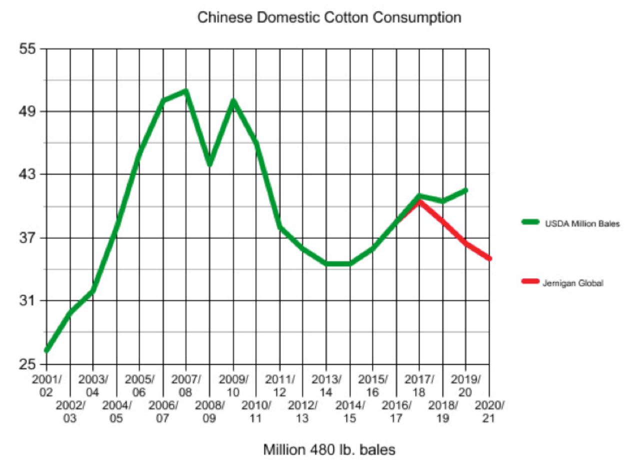


The collapse in cotton demand appears to have been minor in comparison to the decline that has occurred in the man-made fiber sector. The entire man-made fiber industrial complex has seen capacity surge since 2008, with new capacity coming online annually due to a never-ending increase in demand. The sector has been hit with a triple set of adversities. First is the weakness in industrial demand for polyester filament and other products, from a sharp downturn in the autos and other segments. Second is the decline in downstream fabric demand from the apparel sector, as export growth began to contract. And third is the downturn in domestic demand. The industry appears in a panic, with plants cutting production, suspending operations, cutting prices, and attempting to dump inventory. The fabric and twisting plants are the hardest hit. According to a survey, operating capacity in fabric mills in Zhejiang and Jiangsu have fallen to 65%, which is the lowest level in six years or more. Even with the lower operating levels, plants are building inventories. Upstream inventories at the polyester fiber plants are growing, and orders are getting scarce. China's overcapacity is such that when demand slows, even by small amounts, the end result can be catastrophic. An example can be found in the electric car industry, where the sector is in trouble with massive oversupply. China has 486 electric auto startups, an almost unbelievable statistic.

The raw material market is collapsing as the entire chain backs up. The over capacity and new plants coming online are not stopped or slowed without dramatic losses. Naphtha prices have fallen over 12% in a week, paraxylene is down 10%, and PTA is down 6% and still falling, while MEG has stabilized. But prices are already at nearly half the level of a year ago. Polyester 1.4 D 38 mm staple fiber fell to 47.20 US cents a lb. last week, placing it near the 2016 market lows. The decline has caused some recycled polyester plants to suspend operations.

The collapse in prices is having a ripple effect and impacting banks, as many companies will not be able to service outstanding loans. In a shocking revelation, Barclays released a survey of the major banks that have suspended issuing 2018 annual statements due to bad loans and other financial issues. The list included banks with total assets of 4.47 trillion RMB, or 747 billion USD. Baoshang Bank, which failed and was taken over by the CBC, was on the list and is being referred to as China's "Bear Stearns." The second bank on the list appears headed for the same fate. The Bank of Jinzhou in Liaoning has 723 billion RMB or 105 billion USD in assets. Its shares are suspended in Hong Kong, and its auditors, Ernst & Young Hua Ming, have resigned following its refusal to provide needed documents indicating how its loans were being serviced. Each bank takeover means a huge loss in assets and the end of credit for many companies. The Barclays research on this is a significant departure for some investment banks doing business in China. It had been disclosed recently that many investment banks and other financial institutions had internal unwritten rules not to publish any negative research on Chinese groups. With both Baoshang and Jinzhou listed, but with their shares no longer trading, investors are looking at large losses.

JERNIGAN GLOBAL LOWERS CHINESE COTTON CONSUMPTION ESTIMATES



2001/02 to 2020/21 USDA/Jernigan Global Estimates

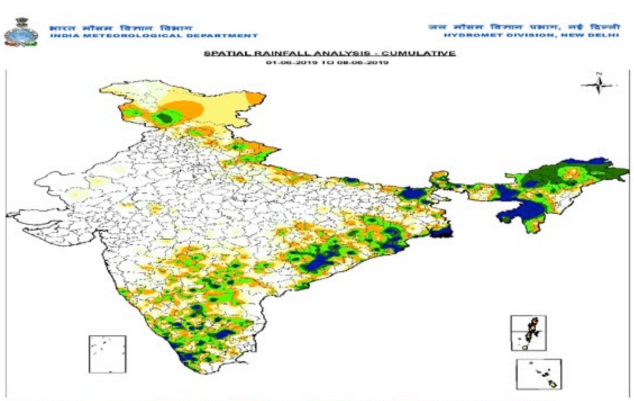
Amid these conditions, it is not clear at what price level stability will return to the polyester fiber market. The weakness is pulling cotton and Viscose fiber prices lower, and raises the risk of an even larger market share loss for cotton, as fabric mills attempt to find a way to return a margin. It also means that dumping of polyester fabric will be underway across Asia, impacting the entire region. The sharp collapse in polyester fiber prices and the need of companies to unload inventory at any price means cotton is again losing market share in the yarn and fabric market. The USDA currently estimates China's 2018/2019 cotton use will reach 40.5 million bales, and then further increase to 41.5 million bales in 2019/2020. We have revised our consumption estimate down to 38.5 million bales for 2018/2019, and down further to 36.5 million bales for 2019/2020. These downward revisions are conservative at a 5% reduction for each season, and could double given the reductions in yarn output we are hearing about. Moreover, the estimates could be further reduced if conditions show no improvement in a few months. The weakness in demand has slowed fresh cotton imports to a trickle and has reduced demand, even at the daily Reserve auctions.

The price spread between imported prices and local Chinese prices, as measured by the ZCE prices, has narrowed to near 900 points before VAT, 1% import taxes for the general import quota, and before any cost of the quota. When adjusted for these factors, the spread drops to less than 80 points. Overall, the sharp narrowing of the spread between imported prices and domestic prices will slow demand for imports. Cotton imports in the August-May period were up sharply from a year ago, which is one reason for the unsold domestic stocks. The volume of unsold domestic stocks also raises the risk that domestic prices could fall below imported prices if international prices stage any recovery. At the end of May, 207,000 tons of imported cotton were held at bonded warehouses.

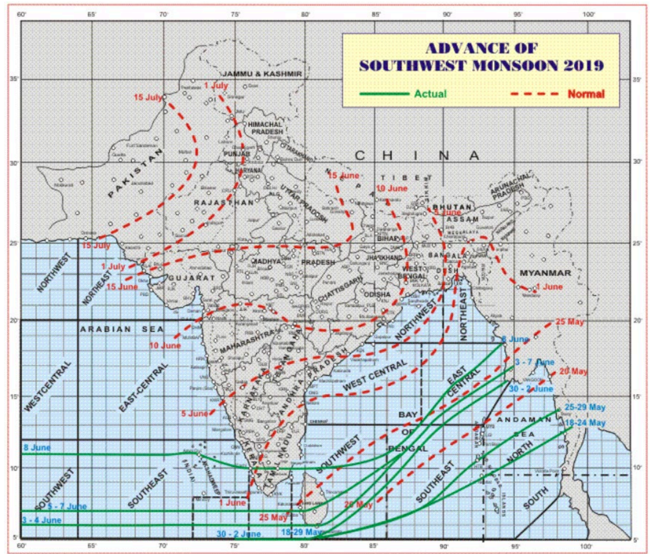
The collapse in the entire textile and apparel sector's price structure has created a serious problem for the Chinese cotton industry and also for the global industry. We fear that exporters will soon start dumping yarns and fabrics in the major consuming markets. The weakness also could impact cotton yarn demand. India's domestic cotton price levels are reducing the advantage of yarn imports. The nearby ZCE contract has dropped 14.14 cents a lb. between April 25th and June 5th, which compares to 9.32 cents a lb. in the China Cash Index. The Cotlook A index adjusted for VAT and import tax, has fallen 7.17 cents during the same period. The nearby ICE futures have dropped 8.34 cents. These declines compare to .20 cents a lb. increase in the Indian ex-gin price for S-6 1 1/8. This narrowing of the spreads risks a dramatic slowing in cotton yarn import demand from India and Pakistan. Another issue that may affect cotton fiber and yarn imports is a growing shortage of US Dollars. Reports surfaced last week that international banks had begun to restrict US dollar loans to Chinese banks. These reports coincided with reports that exporters are holding US dollars outside China in fear of devaluation, or that it will be too difficult to get the funds out of China if needed. In China, frequent users of USD have received notice that the Bank of China will provide a bonus for the conversion to RMB. These conditions may also halt any restocking of imports by the Reserve.

INDIA FACES MAJOR DROUGHT BEFORE MONSOON ARRIVES AND SHORTAGE OF IRRIGATION WATER IN GUJARAT

India's states of Gujarat and Maharashtra are experiencing a major drought ahead of the arrival of the monsoon. A significant heat wave and a shortage of rainfall have resulted in a crisis in the central Indian states, and it is resulting in a serious depletion of soil moisture, a shortage of drinking water, and very limited water for irrigation. The southern cotton belt has also been impacted. The situation in Gujarat is extremely serious and is of great consequence to cotton, as it normally has the highest yield in India. The state has advanced irrigation schemes, but the systems have failed to reach many areas and also have failed to deliver the promised water supplies. About 20-25% of the Gujarat cotton crop is irrigated, but also requires additional rainfall. Gujarat is an arid state and requires significant monsoon rains for a successful crop and to provide needed drinking water. In 2012, the state launched a major irrigation scheme and the Narmada Dam, which was designed to supply 115 reservoirs in the important Saurashtra region alone. At the same time, Gujarat several years ago launched a drive for the establishment of major industries, including a sizable expansion in their textile and apparel sector. These industries require water and have been given priority over water for agriculture. The Kutch district of Gujarat has received no rainfall in all of 2019, which is 100% below normal, and all wells are dry. The Saurashtra area of Gujarat is the heartbeat of the State's cotton belt. So far in 2018/2019, 5,215,836 bales have been ginned from the area, down 26% from the previous year. 332,396 bales have been ginned from the Kutch district.



Dams in Gujarat are at only 10% of capacity. The giant Narmada Dam is nearly full, but, for the second season, none of this water is being allowed for irrigation. It is reserved for industry and drinking water. In the important districts of Saurashtra and Kutch, a significant shortage of



irrigation and drinking water is occurring. In Kutch, no water has been allocated for irrigation. The drought in 2018 and the continued dry winter have wells dry and water supplies gone. In Maharashtra, water supplies are very tight and drinking water in very short supply. The three major cotton-producing districts are 95% rain-grown, and these areas have no major rivers. All water comes from bore wells.

All attention is on the monsoon that has not yet arrived. Soil moisture profiles are extremely dry, and major rains are required to get this crop planted and emerged. At the moment, the monsoon has been delayed by a few days, but light rains have started in the south. The reelection of the Modi government has brought an announcement of expansion of the scheme to provide annual cash payments to small farmers. The number of farmers to be paid 6,000 Rupees a year (about 86 USD), was increased from 20 million to a total of 140 million farmers. The total scheme will cost approximately 12.5 billion USD. The lack of both land reform and a water infrastructure plan remain key inhibitors to agriculture income, along with extreme state intervention. Regarding cotton, yield remains the issue. In addition to the monsoon, the country's seed supply is inferior and needs the availability of the new traits and seed technology, which will remain unavailable until seed technology receives patent protection and proper payment.

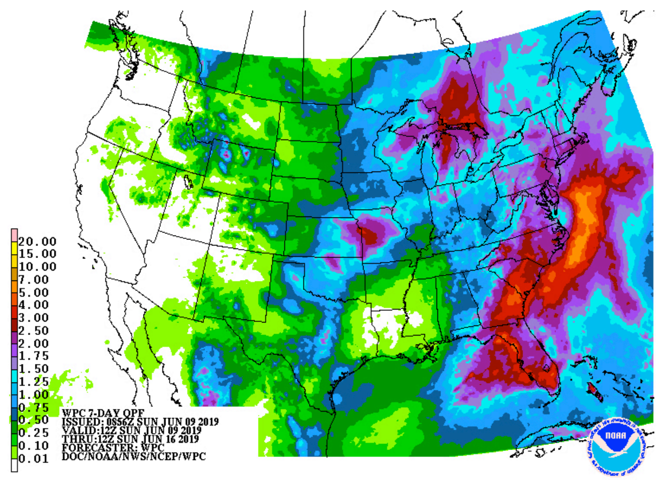
In the Northern Zone, where planting is near completion, growers have planted an estimated 1,281,400 hectares, which reflects a 140,976-hectare increase, with much of the expansion in Punjab. J-34 prices from this region have been very firm at a premium to S-6, recently 85-87 cents a lb., which has clearly stimulated farmer interest. Only a small amount of cotton has been planted in other regions, as growers await the arrival of the Monsoon.

The Cotton Association of India has left its crop estimate of 2018/2019 at 31.5 million 170 kg bales (24.6 million 480-lb. bales), with a carryover of only 1.3 million 170 kg bales (1.015 million 480-lb. bales). The CAI estimate has to be adjusted for the calendar difference, but is still far below the USDA's and US Agriculture Attaché's estimates. The USDA continues to overestimate Indian stocks by 5-6 million bales. Of course, the CAI estimate is far below the minimum stock levels required by mills and the pipeline. This suggests imports will continue to increase until near year-end. India was a buyer of 144,900 running bales of US upland during the week ending May 30th, and has now has purchased 1,061,400 running bales of upland for 2018/2019 shipment. We continue to feel that even if 2019/2020 cotton acreage expands, as some have estimated, production will remain inhibited by poor yields. The lack of any noticeable carryover means that any 2019/2020 shortfall would create new increased import demand.

US CROP POTENTIAL SHRINKING AMID EXCESSIVE WET PATTERN

The US 2019 cotton season has been extremely unusual, as has the entire spring planting period for the Midwest and central US. Corn and soybean planting has been delayed, along with cotton. For both corn and cotton the excessive moisture has prevailed through the first major planting date deadlines for crop insurance. Cotton growers across West Texas, Oklahoma, and Kansas have some of the best moisture profiles on record, but storm after storm has either delayed planting or has caused several attempts at replanting, which have largely failed. This has forced growers in the high yielding 1-N crop district north of Lubbock, which has already passed its crop insurance deadlines, to either except insurance and then possibly plant milo, or face increased risk from lower crop insurance and a shorter growing season. Low mike is a real concern and threat when planting is late due to the normal frost dates. Irrigated growers with attractive historical yields will likely choose prevented acreage, while dryland decisions will be made on a case-by-case basis. The insurance coverage has a total average price, after cottonseed support, of near 82 cents for dryland growers with 75% coverage. A 550 yield will provide only about 338.25 USD per acre. However, if the grower goes ahead and plants and is hit by low mike, the discount can be heavy and could reach 10-20 cents. In 2017, The 1-N crop district produced 2.323 million bales, and 1.825 million in 2018. This district historically has much smaller abandonment than the 1-S, due to the high percentage of irrigated acreage.

One of the most surprising aspects of the season has been the number of flooded fields with irrigation pivots. The insurance deadlines have passed for this region. Original planting intentions were likely near 1.55 million acres. Losses, late switch to corn, and prevented acreage could reach 500-750,000 acres. This area is much higher yielding than the southern districts, which could translate into a loss of 925,000 to 1.4 million bales below earlier potential. Planting intentions in the 1-S or southern high plains was near 3.0 million acres. The region contains many large blocks



of dryland acreage. The district also has a longer planting window. Many of the southernmost regions have received much less moisture, and actually need rain. A massive dust storm, or Haboob, covered the southern plains Wednesday afternoon and evening, causing major losses to newly planted cotton. The size of the loss could reach hundreds of thousands of acres.

In the Mid-South, growers rushed to plant before June 3rd. By that date, over 90% of the intended acreage in Louisiana, Arkansas, and Tennessee was planted. Mississippi was only 77% planted and Missouri 78% planted. Additional rain moved in last week, and around 250,000 acres may have experienced prevented planting, which included flooded fields. Missouri has been hit hard by flooding, with both soybean and corn planting delayed. The Southeastern belt, which has suffered from heat and drought, received beneficial rains late last week.

In its last WASDE, the USDA carried the US crop at 22 million bales from planted acreage of 13.780 million acres, and harvested acreage of 12.540 million, with an average yield of 842 lbs., below both 2017 and 2018 levels. Overall, lower planted acreage and harvested acreage, along with a higher average yield, suggests that the US crop has been reduced below the larger crop estimates. The possibility for a much higher average yield, however, is still maintaining production near 21.5 million bales. The USDA first yield survey will be important given all the uncertainly.

RECORD HARVEST UNDERWAY IN BRAZIL'S BAHIA REGION

Weather has been perfect for the start of the 2019 Bahia harvest. CONAB has average yields at 1,770 kg per hectare (8.13 bales), which remains below the record 8.68 achieved last year. Bahia growers planted a record 332,000 hectares to cotton in 2019. Western Bahia is drawing additional investment amid an agriculture boom, as cotton and soybeans from the region move to China. For soybeans, the ability to ship out of the northern ports has been a boom. But for cotton, until the northern ports expand to handle containers and arrange service from the shipping lines, it still means shipment by road to the southern ports. If the ability were achieved to move cotton from the north, it would increase profitability for growers. Growers are hoping for a repeat of the excellent quality of the 2018 crop. Yields in Mato Grosso are expected to reach 7.58 bales a hectare by CONAB. However, IMEA has the Mato Grosso crop reaching a yield of 7.988 bales a hectare from 1,072,476 hectares, with a total production of 1,846,033 tons (8.481 million bales). The harvest is also gaining momentum in Goais, which now has a top-notch classing office.

158,933 hectares of the Mato Grosso crop was full season with harvest about to begin in July, while the balance of the crop is second crop after soybeans. The record 2019 crop will tax the total infrastructure of the cotton belt from ginning to shipments. China is likely to be the designation for much of the crop. 2018 crop shipments were strong in April at 71,800 tons, and while this was up sharply from a year ago, it was below the level needed to meet shipment targets. From July 2019 through June 2020 Brazil will need to average 137,500 tons of export shipments a month, which has never been done before. Chinese exporters are expanding their networks in Brazil and handling more and more volume.

In April, China was the top destination for cotton export shipments at 24,171 tons, which brought total 2018 crop shipments to China to 373,803 tons. The other major destinations were Indonesia, Bangladesh, Turkey, Vietnam, Malaysia, Thailand, and South Korea. The prospect of a record crop that has to move to export ASAP is keeping CFR Asia offering levels very aggressive. The most aggressive merchant offers are 875 points on for a Strict Middling 1 1/8 for October-March shipment, and 800 points for a Middling 1 1/8. SLM 1 1/8 offers extend down to 700 point on, which continues to make this type popular in many markets. The same basis levels are applied to 2020 crop offers extending into March 2021 shipment. Thus, Brazilian cotton offers spinners a steady basis for shipment all the way through the first half of 2021. For markets such as Bangladesh and Indonesia, this is at major discounts to the few Australian offers. US offers are competitive, but only thru May 2020. The ESALQ Index of a 41-4-35 landed Sao Paulo has increased its premium to ICE ahead of the crop movement at 72.92 US cents a lb. The Real has continued to rebound against the USD and ended the week near 3.86.

The aggressive Brazilian basis is driven by the fact there is no warehouse storage, and the large volume of crop input finance barter that has the input suppliers needing to convert to cash quickly. We expect to see new interest in warehouse storage soon. Also, major investment is needed in the development of the northern ports to service cotton and to arrange shipping line service. Warehouse storage at the southern ports would be quite expensive. The withdrawal of Chinese import demand has come at a crucial time, with movement of the 2019 crop about to accelerate. If Chinese import demand continues weak in August and forward period, the CFR basis could come under more pressure as exporters attempt to stimulate movement.

GREEK GROWERS EXPAND COTTON ACREAGE

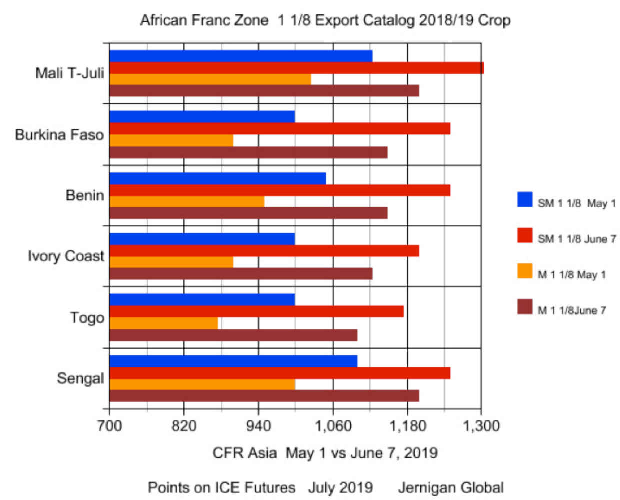
Planting of the Greek crop is complete, and the acreage planted to cotton has expanded 10-12% as growers continue to improve quality and yields. Planted acreage in Karditsa is believed to have increased by 20% to 50,000 hectares, while expanding 12% in Larisa and Thessalinki. Acreage in Serres has increased 13% to 28,000 hectares. Some replanting was required after recent heavy rains. Both Greek and Spanish new crop is well reflected in merchant offering portfolios, and basis levels are at large premiums to Brazilian, which has limited buying interest. Earlier in 2019, a notable volume of Greek moved off to China at competitive basis levels. Turkish April imports included a volume of Greek styles. It remains unclear if the increased Greek acreage will impact EU subsidies, which have a production limit.

Greek exports remain focused on Turkey, Indonesia, Egypt, Vietnam, and China. The slower offtake in Turkey this season resulted in some aggressive basis offers of SLM 1 1/8, attracting buyers in Pakistan and other markets.

AFRICAN FRANC ZONE SUPPLIES VERY TIGHT AT FIRM BASIS

Supplies of African Franc Zone 2018/2019 crop better grades are now quite tight, with very firm basis levels prevailing. The crop has been taken up by Indian, Bangladeshi, and other mills amid the tightness in long staple Strict Middling grades. The basis levels have been surprising considering that spinner have been willing to pay for a handpicked cotton. The Cotton Made in Africa program has been successful in creating pull through demand from European retailers and brands. A few offers of the much in demand Cameroon Plebe or Bola/s 1 5/32 are still in circulation, but at basis levels, which reflect sizable premiums at 1400 points or higher on July. Even the more widely available Middling 1 1/8 types are offered at 1150-1200 points on July. A record 2019/2020 crop is expected, but you could not tell it by the CFR basis levels of some major shippers, which have introduced the full catalog of offers near the same level, or at only a slight discount, as old crop.

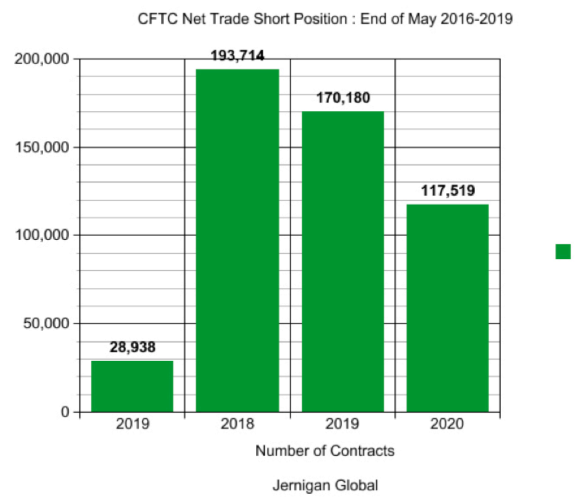
If the 2019/2020 production reaches the early estimates for the region of six million bales, the basis is likely to weaken. However, much of this will depend on the quality of the 2019 US and Brazilian crops. The premium of the West African basis to US and Brazilian machine-picked is currently considered excessive, especially considering the contamination issues for some of the regions. Another feature being discussed is the sustainability issues surrounding the continued planting of non-BT cotton, which increases spraying and pesticide use. US, Brazilian, and Australian cotton has reduced pesticide use dramatically in recent years, which is becoming important to some brands.



ICE FUTURES: DECEMBER FUTURES INFLUENCED BY COLLAPSE IN CHINESE TEXTILE MARKET

ICE futures encountered weakness last week despite the excessive wet pattern that continues in the Texas High Plains and other issues associated with the US crop. ICE 2019/2020 futures face several major headwinds, which is offsetting the crop concerns. First, the collapse in the Chinese domestic textile and cotton market has serious ramifications for global trade and the global balance sheet. For several weeks, we have been discussing the collapse in Chinese man-made fiber prices. The decline has seen all parts of the supply chain fall sharply, with polyester fiber prices near the 2016 record lows. Demand has turned weak from exporters and from the domestic market. The overcapacity of the sector has accelerated the negative aspect of the downturn in demand. The entire Chinese market and the man-made fiber industry, as well as the textile market, were built on ever-increasing demand, with no one ever envisioning a downturn. Cotton has also been impacted, as there are indications that cotton yarn production by many of the major mill groups in Xinjiang and in the East has been curtailed.

We have lowered our estimates of Chinese domestic consumption by two million bales below the USDA estimates for 2018/2019, and four million bales below the very optimistic USDA estimate for 2019/2020. Even these estimates may prove too high given the cutbacks in output in an attempt to balance supply. The weakness will reduce import demand. Secondly, the collapse in China's cotton prices has erased the premium of the domestic market to the international market, after prices are adjusted for VAT and import tax. This of course reduces the incentive for spinners to import. The collapse in domestic cotton prices is being driven by the collapse in the textile market, and also by the oversupply of old crop cotton in commercial inventories outside of spinners and the Reserve. The commercial sector is carrying one of its largest unsold inventories on record for the end of May. Demand for these stocks is low even after the break. The much weaker physical demand is also evident in the sharply reduced offtake at the Reserve auctions.



Our fear is that these conditions will, first, cause new import demand to be very slow for the remainder of 2019. Secondly, the Reserve may focus its restocking on the domestic stocks to relieve the burden on the commercial sector instead of imports. Without new Chinese demand from the domestic industry or from the Reserve, Brazil faces a major burden reaching its export goals. This, in turn, would enhance the competition between the US and Brazil to meet each exporter's targets, which means a further basis and price war. The downturn in consumption we fear could reduce cotton yarn import demand. The Indian shipments are at risk because of price. This would, of course, affect the Indian balance sheet, since the cotton yarn could not likely be diverted to other markets. Finally, we fear that the Chinese market condition will result in the dumping of polyester staple fiber and man-made fiber apparel products in markets around the world, thus disrupting trade.

Outside the Chinese influences, the record Brazilian crop is beginning to move. Without problems, the movement of this crop will make it more difficult for the US forward sales to increase. At the same time, the Trade is holding one of the smallest short positions on record, which means the commercial sector needs to hedge futures. This provides a ready volume of selling on any rally. This selling showed up in the COT report ending May 4th when the Trade was a net seller of 1,706 contracts. The record Speculative short has been focused on the July contract that has pushed the July/Dec spread to near 200 points. However, on Friday the spread collapsed back to flat, and the technical condition of the market turned very negative. As time goes on, the Funds will want to get their short position moved into the December and forward contracts. The COT report showed a net reduction in the Managed Funds' shorts that confirmed that the early rally was Funds short covering. After Tuesday, the Managed Funds appeared to be again adding new shorts.

Against these negatives, the problems with the US crop are not causing buyers to have concern. The USDA forecasts 2019/2020 exports for the US at 17 million bales, which is impossible without Chinese demand or a major crop disaster by a major producer. This alters the balance sheet. This means a 15.0-million bale export is a more realistic goal, but even this is difficult. A US crop reduced to 20.0-21.0 million bales still leaves adequate stocks. The collapse of the Chinese markets is causing the support, which was evident at 65 cents, to erode and be reduced. And today the size of the US crop, very much a moving target, is simply unknown.

On Friday, July collapsed. The limit was a bit shocking. As of Tuesday, the trade only had a small net long in July. The collapse could be linked to the cancellation of export sales to China or to some other high-price sale that triggered some new shorts. The other possibility is that a large managed fund long liquidated. While the MF are net short July, they still had a 23,255-contract long position. Friday was a day of heavy speculative and Algo system selling across the entire agriculture complex. This appeared linked to fears that the announced tariffs on exports to Mexico would be put in place on Monday. Late Friday, the US and Mexico reached an agreement for Mexico to halt the flow of illegals across the country and to the US border. This allowed the tariffs to be avoided for now. This should ease selling on Monday. However, for cotton, the problem remains the Chinese market.

Friday's action created an outside range in Dec and suggests the market may be breaking down. A close below 65.26 would suggest a test of the 60-cent area. Amid this environment we continue negative toward prices.

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