PLEXUS Market Comments

May 02, 2019

NY futures came under heavy pressure this week, as July fell 287 points to close at 75.45 cents/lb.

July broke through an 11-week uptrend line dating back to February 12, which triggered renewed spec selling. So far the trade hasn't been a strong enough buyer to halt the slide.

We are a bit surprised by how weak July has been acting this week, considering that around 90% of the US supply has already been committed. Frankly we did not expect July to break below 7600 support, because just a week ago May had found ready takers at that level during its notice period.

Last week we felt that due the tight US balance sheet and continued strong export demand July might actually lead the market higher, but the way things look now the opposite may be true, with a bearish new crop scenario pulling the board lower.

Crop expectations for the coming season seem to increase by the week, as there is now abundant moisture across the cotton belt, with only parts of the Southeast experiencing some dryness. This means that we could see below average abandonment numbers and above average yields this season, which could translate into a US crop of 23-24 million bales.

Globally we are seeing a similar picture, with India and Pakistan expecting much bigger crops, while China's output should be similar to this season. But the bottom line is that we might see a global crop of 125-126 million bales, which would likely outpace demand.

Speaking of demand, we expect global growth to slow down to a trickle during the second half of the year, despite efforts by central bankers to keep the party going. Even though financial markets have performed very well recently, with the S&P 500 reaching an all-time high this week, the real economy doesn't reflect this rosy scenario.

When we look at the PMI (Purchasing Managers' Index) data around the globe, we see a worrisome slowdown in economic activity. While the global PMI is at its lowest level since mid-2016, the Eurozone PMI is at a 6-year low and nearly every region of the globe is experiencing a slowdown in manufacturing and services.

In other words, we could face a scenario in which cotton production trends much higher while demand hits a wall, which is not a recipe for higher prices.

The stronger US dollar is another headwind for commodity prices. Not only does the US dollar have an interest rate advantage – the 2-year bond yield in Japan and the Eurozone is negative, while in the US it is +2.35% - but we believe that the US dollar is going to be the 'last man standing' in a crumbling global monetary system. Capital flight as well as safe haven and interest rates considerations are leading to more and more money being transferred to the US, which worsens the situation for emerging markets who need to service a massive amount of US dollar debt. We therefore believe that this self-reinforcing process is going to make the greenback even stronger over the coming years.

US export sales were labelled as 'disappointing' this morning, as they came in at 214,500 running bales of Upland and Pima cotton for both marketing years. However, we believe that these sales were quite strong considering how little is left for sale. Participation was good as well with 16 markets buying. Shipments of 302,900 RB remained behind the pace needed to reach 15.0 million statistical bales by the end of July.

Total commitments for this season have now reached around 14.9 million statistical bales, of which 9.15 million bales have so far been exported. New crop sales are at around 3.15 million statistical bales.

So where do we go from here?

Bearish new crop vibes and a stronger US dollar are weighing the market down and this is not likely to change anytime soon. Having said that, we still believe that July will eventually divorce itself from new crop, especially if these lower prices lead to stronger export sales.

Instead of rationing supplies, July is making sure that the remaining inventory gets cleaned out and this could make for a dangerous situation a few weeks down the road. For this reason we believe that the current July/Dec inversion of 103 points will grow larger by mid-June. As of last week there were still 3.9 million bales in on-call sales to fix on July and this should translate into decent support.

In short, we are friendly on July at the current level but feel that anyone with a long exposure to December should seek protection via bearish options strategies.

Report Courtesy: The Plexus Group

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