PLEXUS Market Comments

January 02, 2020

NY futures continued to push higher over the holiday period, as March gained another 169 points since our last report on December 20, closing today at 69.27 points.

The market continued to advance over the holidays and got within 26 points of the 70 cents mark this week, as speculators continued to exit shorts and added new longs.

The latest available CFTC report of December 24 showed speculators 1.23 million bales net long, while index funds had a 6.95 million bales net long position. The trade was the only net short in the market with 8.18 million bales.

This means that since the beginning of August speculators have gone from a 5.36 million bales net short to a 1.23 million net long position, which amounts to 6.59 million bales of net buying. The market has responded accordingly by rising from around 57 cents to nearly 70 cents.

The trade, which had been considerably under-hedged going into harvest, has used the market's strength to rectify the situation and increased its net short from 0.15 to 8.18 million bales between August 6 and December 24. This means that the trade now has a similar net short as a year ago, when it amounted to 8.36 million bales. Even the price is nearly the same, as the spot month traded at around 72 cents twelve months ago.

However, while the mood was quite depressed a year back, we now have financial markets in full ‘risk on’ mode again, after the Federal Reserve has kindly refilled the monetary punch bowl. Three rate cuts and another round of QE have inspired investors to go all in, which boosted the S&P 500 index to a 29% yearly gain. Basically all financial assets ended with gains in 2019 and as long as the monetary spigot remains open, there is no reason to believe that the current trend is going to end anytime soon.

When we look back at the last decade, it is quite mind-boggling how much US government debt has grown. Ten years ago the US federal debt amounted to USD 12.31 trillion, while it stood at USD 23.11 trillion at the end of 2019. That’s an increase of USD 10.8 trillion! In other words, in just one decade the US has nearly doubled the debt it had accumulated in the prior 243 years, between 1776 and 2019.

The situation looks quite similar in other parts of the world. Central banks, along with irresponsible governments, have been the enablers of this massive debt expansion, as the combined balance sheet of the six major central banks (US, EU, China, Japan, UK and Switzerland) has grown from around USD 5 trillion to USD 20 trillion between 2006 and 2019. What was supposed to be a stop-gap measure to prevent a global financial meltdown in 2008 has turned into a permanent fixture in the financial markets, with promises of endless monetary support going forward.

There are several takeaways from the above in regards to the cotton market. From a bullish point of view the fact that markets are now back in full ‘risk on’ mode will likely fuel further spec buying, against which the trade may not have enough left to sell at this stage of the season.

Then there is the positive wealth effect these asset bubbles create. Global stock markets have added more than USD 17 trillion in total value, with the total surpassing USD 85 trillion at the end of 2019. This means that consumers may be inclined to spend more, which could translate into stronger demand for cotton. A stronger than expected Christmas shopping season bears witness to that.

Over the long run this unfettered monetary expansion will act as the proverbial tide that lifts all the boats, meaning that nominal prices of just about everything will likely go up as the value of currencies is being diluted. While commodities have been laggards, they are starting to catch up, led by precious metals.

Meanwhile global bond markets have reached USD 117 trillion in 2019, with government debt making up about 47% of this amount. Interestingly, about USD 12 trillion have sub-zero yields, which is acting in favor of US treasuries, where the whole yield curve is still positive, ranging from 1.5% overnight to 2.4% on the 30-year bond. This should keep foreign demand for US debt instruments strong, which in turn should underpin the US dollar as foreign investors will have to convert their currencies into greenbacks in order to buy US assets.

So where do we go from here?

Speculative buying has forced the cotton market higher and with the exuberant mood prevailing in the financial world there is no end to this buying spree in sight. It therefore seems to be only a matter of time until the market moves past the 70 cents level.

From a fundamental point of view the market seems to be more than fairly priced at the current level, but stronger demand could tip the scales in favor of the bulls going forward. Also, US export sales are well advanced at nearly 12 million statistical bales, which reduces the need for short hedging.

The more we move forward in the calendar, the less there is a need for the trade to short current crop futures. New crop plantings are more likely to be hedged in December futures. Since speculators are buying in the front, it could therefore lead to a lack of sell-side liquidity, which would force prices higher. While the market may do some back and filling along the way, we expect values to move into the low-70s over the coming weeks.

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