PLEXUS Market Comments

Market Comments – July 02, 2020

NY futures rallied this week, as December gained 325 points to close at 62.95 cents.

December closed today at its highest level since early March, when most of the world was still unaware of the impending pandemic. After open interest in futures and options had dropped to a multi-year low last week, speculators seem to have found a new liking to the cotton market.

A bullish Planted Acreage report, drought conditions in West Texas and December breaking out of a consolidation pattern sparked renewed interest from the speculative crowd, with rising volume and open interest validating the move.

The USDA Planted Acreage report came in at the lower end of expectations at 12.2 million acres. The Delta and Southeast were down 0.36 million acres each, while Texas dropped 0.7 million acres. If we were to pencil in a 16% abandonment, we would arrive at a harvested acreage of around 10.25 million acres, which at an 840-pound yield would give us a crop of around 17.94 million bales.

For reference, over the last 4 seasons the US harvested between 9.5 and 11.6 million acres, with the crop size ranging from 17.2 to 20.9 million bales. Therefore, an initial crop estimate of around 18.0 million bales seems to make sense. The question is whether a 1.5 million bale reduction in the US crop is reason enough to move the market substantially higher?

The US will start the new season with around 7.3 million bales in beginning stocks. Add to that a crop of 18.0 million for a total supply of 25.3 million bales. Current export sales amount to around 6.7 million bales (including carry-in) and domestic mills are expected to use 2.8 million bales, which would leave around 15.8 million bales for sale. Even if China were to take 4.0 million bales next season, which is still a big 'if' at this point, we would still have nearly 12 million bales looking for a home.

US export sales were once again all China and Vietnam last week. Out of a total of 318,200 running bales for both marketing years, China took 262.2k (82%) and Vietnam 50.2k (16%). The rest of the bunch bought just 5.8k bales (less than 2%). Shipments continued strong at 281,400 RB and are still on pace to make the 15.0 million bale USDA estimate.

Total commitments for the current season are now at 18.05 statistical bales, of which 13.35 million bales have so far been exported. New crop sales are at 3.6 million bales, plus a current carry-in of around 3.05 million bales, for a total of 6.65 million bales.

There is growing disconnect between NY futures and the physical market. While NY futures are rallying, physical prices seem to head in the other direction. Indian Shankar 6 is offered just above 60 cents landed Far East, without finding much buying interest. The same goes for Brazilian cotton, where Middling styles went for 57.50 cents FOB this week. These offering prices are in stark contrast to the A-index, which sits at 70.45 cents for current crop and at 72.60 cents for the forward A-index, which will take over on August 1.

These A-indexes look out of line considering that traders are trying to sell Middling style cotton of various origins about ten cents below without finding much buying interest.

The A-index plays an important role in the price discovery of US futures, because it determines the level of the AWP (Adjusted World Price). The AWP is simply a function of the A-index minus an adjustment factor to account for the cost to market plus a quality differential. The current adjustment factor is at 17.25 cents.

If we took the forward A-index of 72.60, minus the 17.25 cents adjustment, we would get a theoretical AWP of 55.35 cents on August 1. This would be more than three cents above the US government loan and therefore burden US stocks with carrying charges. Such a high AWP level would also justify the current level of the futures market.

However, the reality looks a lot different as we have already pointed out. ROW stocks are massive at around 69 million bales at the end of July and with new crop approaching fast, a lot of origins will desperately try to find homes for their cotton. The problem is that most mills are already covered until the end of the calendar year.

This should translate into further price pressure and while some origins are still dreaming of getting NY futures + traditional basis prices, they will soon have to join the game of musical chairs. In other words, we expect offering prices to head south and with them, the A-index. By the way, the forward A-index still doesn’t have an Indian quote in it, which seems odd, since there is more than enough cotton available from that origin.

So where do we go from here?

Speculators have taken the futures market hostage and may boost prices even higher given the current momentum and money flows. In doing so NY futures are divorcing themselves further from the cash market. Unfortunately, there is no way for the cash market to reign in futures prices until the next notice period rolls around, which won’t be until November.

However, if we are correct in our assumption that the A-index is currently much too high and will eventually have to come down to reflect the level of physical activity, then the "AWP – Futures" spread could extend to 17-18 cents from the current 13 cents and create an arbitrage opportunity.

While this looks like an interesting proposition, the market won't be able to act on it until November. In the meantime, speculators might push the market even higher, as trends and money flows are likely to dictate where the market is headed over the coming weeks and months. Therefore, anyone trying to hedge or short the market should only do so via puts or put spreads!

https://plexus-cotton.com