PLEXUS Market Comments

Market Comments – Jun 04, 2020

NY futures resumed their rally this week, as July gained 243 points to close at 60.00 cents, while December advanced 204 points to close at 59.58 cents.

It was an eventful week, as short-covering boosted the July contract all the way up to a high of 61.15, before it pulled back to the 60 cents level. July dragged new crop values along, but December has so far not been able to crack the 60 cents barrier, as it posted a high of 59.80 this week.

The sharp drop in July open interest, which fell by 13.5k contracts over the last three sessions, clearly shows that this latest push was driven by short-covering and not by fresh buying. Overall open interest was down by 6.3k over the same three sessions, as some of the July positions were rolled to new crop.

The cornerstone of a healthy bull market is increasing volume combined with expanding open interest, which is the opposite of what we are seeing at the moment. This serves as a warning sign that this bull run may be on its last leg.

While the technical picture still looks constructive at this point, fundamentals present a mixed bag. On the one hand we have very weak export demand, but on the other hand there may be some trouble brewing in West Texas, as drought conditions are getting more pronounced. La Niña years typically get drier than normal weather in the central US and we are seeing early signs of this pattern.

US export sales slowed down considerably last week, as net new sales of Upland and Pima cotton amounted to just 8,900 running bales for all three marketing years combined. Shipments amounted to 240,000 RB, which was over 70k bales below the pace needed to make the current USDA estimate of 15.0 million statistical bales.

There were cancellations of 34,200 RB in ten markets that put a negative spin on this report. We keep hearing of quite a few contract renegotiations and cancellations, which will likely keep a lid on US export sales for the time being. Total commitments for the current season remain at around 17.3 million statistical bales, of which a little over 12.0 million bales have been exported. New crop sales are so far at 2.95 million statistical bales.

The CFTC spec/hedge report as of May 26 showed almost no changes, as speculators were 0.50 million bales net short, while the trade had a 5.44 million bales net short position. Index funds were on the long side with a 5.94 million bales net long position.

Interestingly, we are seeing a similar constellation across the Ag commodities sector. Whether it is wheat, soybeans, cocoa or sugar, large speculators and the trade own net short positions, while index funds are on the long side. This shows that active traders subscribe to a more pessimistic view on the market, while index funds, who are made up of passive investors, are using commodities as a diversification strategy and as an inflation hedge.

There is a growing disconnect between perception and reality when it comes to financial markets. Dismal fundamentals have taken a backseat to money flows, which have created some positive momentum in many of these assets and pushed prices to extreme levels. Yesterday the Nasdaq-100 index came within a few points of its all-time high set on

February 19, even though corporate earnings have been decimated since then.

It was quite astonishing to see how markets simply ignored the biggest riots in the US in over 50 years, which led to widespread looting and vandalism. This couldn't have come at a more inopportune time, because many retail stores and restaurants had just opened again after a long lockdown. Now many of these shops are boarded up and consumers are afraid to go out. This will only make a dire economic situation even worse and force many of these small businesses into insolvency.

While financial markets don't seem to care, the US dollar has come under pressure, as foreigners are starting to question the 'safe haven' status of the US. These riots have clearly tarnished the image of the US and as a result we could see some reallocation and repatriation of capital to Europe and Asia. Unfortunately we don't see an end to the current situation, especially with a contentious presidential election looming.

While a weaker dollar should in theory underpin financial assets denominated in US dollars, we would like to point out that in 2008 the US dollar index traded about 20% lower than now, which didn't stop the price of cotton from crashing to 36.70 cents during the financial crisis.

So where do we go from here?

The futures market has become the best buyer at 60 cents and as a result we have seen a rise in the certified stock, which we expect to grow further as we approach First Notice Day in about three weeks from now. There are a lot of current crop commitments being cancelled and some of that cotton will end up on the board.

This entire bull run has been predicated on China absorbing most if not all of the tenderable grades left in current crop, which has led to short-covering and forced prices higher. However, while China has shown up as a buyer recently, we have yet to see how much they are really taking and how many of these tenderable grades will be left over.

Even if July can pull off this bluff going into the notice period, we cannot see how December will sustain itself at current levels given the massive stocks around the globe and the clearly deteriorating economic environment. We feel that many traders erroneously believe that happy days are here again thanks to all the funny money the central banks and governments are handing out, but this won’t prevent the coming insolvency crisis, which will be deflationary. We still feel that December at 60 cents is a gift and that growers and owners of inventory should take out some downside protection via the options market!

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