PLEXUS Market Comments

May 09, 2019

NY futures continued their free fall this week, as July dropped another 522 points to close at 70.23 cents/lb.

July came under heavy pressure from spec and trade selling this week, breaking through important support levels without much opposition. Since closing near 79 cents on April 17, July has lost nearly 900 points in just 15 sessions.

The market went into full blown panic mode after President Trump surprised traders with a "Twitter Bomb" on Sunday afternoon, threatening to increase existing tariffs from 10% to 25% on 200 billion dollars of Chinese goods and to levy a 25% tariff on an additional 325 billion dollars of goods that haven't been taxed so far.

If these tariffs go into effect on Friday, China will likely retaliate and that's what has the cotton market so rattled at the moment. China still has 0.81 million bales of current crop and 1.40 million bales for August onwards on the books, and traders fear that these US sales might get cancelled if a trade war breaks out.

If this were to happen, we would go from a tight supply scenario in US current crop to one of excess inventory, which is why the July/Dec inversion has faded away this week and instead started to put carry on the board. Since last Friday the July/Dec spread has gone from an inversion of 123 points to 34 points carry, a swing of 157 points. Needless to say that this has caught many traders on the wrong foot.

US export sales were actually quite good last week, but the market considered this to be old and irrelevant news in light of current developments. Total sales amounted to 300,100 running bales of Upland and Pima cotton for both marketing years, while shipments improved to 403,700 running bales. Participation continued to broad-based with 17 markets buying. Commitments for the current season reached 15.1 million statistical bales, of which 9.6 million have so far been exported. For the coming season there are 3.2 million bales on the books.

As if the China trade dispute wasn't enough of a headache, tomorrow the market will also have to digest a potentially bearish WASDE report. The May report gives us a first look at new crop numbers and as pointed out last week, we could see quite a jump in production, while mill use struggles to keep pace.

The last three months rank as the second wettest on record all the way from Texas to the Atlantic coast. In other words, there is more than enough moisture to get crops up and running and we therefore expect an above average output in the US. If the US makes 5 million bales more than last season and the Indian Subcontinent, Brazil plus some other origins produce a combined 5-6 million bales more, we could end up with the largest global production on record. In other words, we might surpass the 127.43 million bales of the 2011/12-season.

We don't expect the USDA to show any record numbers just yet, since they probably want to see some evidence first, but the potential exists and the market knows it. Since we don't expect demand to keep pace with production next season, global ending stocks are likely to rise. In case of a trade war with China this would be bad news for the US, since China would likely shun US cotton and source from other origins, which would force the US into the role of residual supplier.

So where do we go from here?

At the moment there is no telling where this falling knife is finally going to stick. The chart looks awful but momentum indicators are in "extreme oversold" territory. This means that a sharp rebound could come at any time, but some positive news is needed to trigger it.

Markets don't like uncertainty and at the moment there is plenty of it. With the trade deal hanging in the balance and a potentially bearish WASDE report looming tomorrow, buyers are still in hiding. If a trade war can be avoided and China remains as a buyer of US cotton, then July is too cheap and will rebound.

However, if trade talks break down and tariffs go into effect, it could freeze up an already slowing global economy and this would be bad news for cotton. Not only would China shy away from US cotton, but we would also see a slowdown in global demand. Hopefully cooler heads will prevail!

Report Courtesy: The Plexus Group

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