PLEXUS Market Comments

MAY 14, 2020

NY futures rallied this week, as July jumped 246 points to close at 57.85 cents, while December advanced 81 points to close at 57.76 cents.

Spot futures continued to move in the opposite direction of the physical market, as fears of China cornering tenderable grades with the help of merchants has short sellers moving out of harm's way. It is rather amazing to see the July contract trade at a 2-month high after the USDA released one of its most depressing supply/demand reports in many years on Tuesday.

The WASDE report came in at the bearish end of expectations, as global mill use was lowered to 105.00 million bales for the current season, while global production remains elevated at 122.67 million bales. This means that we have an estimated production surplus of 17.67 million bales this season.

As a result we are seeing a steep increase in ending stocks by the end of July, with US stocks going up 2.25 million year-on-year to 7.10 million bales, while ROW ending stocks are rising 16.28 million bales to a record 60.92 million bales and global ending stocks are at 97.16 million bales.

The 2020/21-season sees a further increase in stocks, despite an overly optimistic global mill use number of 116.46 million bales, which would be the 3rd highest mill use in the last 10 seasons! We don't know what econometric model the USDA is using, but it is telling us that global mill use will basically be back to normal starting in August. There is just no way this is going to happen in our opinion!

Despite this optimistic outlook on demand, stocks in the US would still go up by 0.6 million bales y-o-y to 7.7 million bales, while ROW ending stocks are expected to rise by another 4.39 million to 65.31 million bales and global ending stocks are projected at 99.43 million bales.

ROW stocks are really the big burden that will weigh on prices, as they are nearly double what they were four years ago, going from 33.45 to 65.31 million bales. While India with 19.71 million bales in stocks and the US with 7.70 million bales enjoy some government assistance, it still leaves around 38 million bales of inventory that has to be carried by producers, merchants or mills. The cotton market will therefore resemble a game of musical chairs next season as these bales are trying to find a home.

Indian prices have already been offered at steep discounts lately and we expect prices to come under further pressure. This is being reflected by the A-index, where Indian medium grades are currently quoted 800 points cheaper than the corresponding US quote. US prices are artificially held up by the July squeeze, which has dragged new crop values higher as well, even though the July/Dec spread has started to invert this week.

US exports sales were again quite strong last week at 329,600 running bales of Upland and Pima cotton for both marketing years, with China accounting for 266,200 RB or 81% of the total. Shipments dropped off from last week at 249,600 RB, but remained relatively strong considering the circumstances.

For the current season we now have commitments of 17.15 million statistical bales, of which 11.25 million bales have so far been exported. China accounts for 1.64 million RB of the outstanding commitments this season, which is 1.0 million bales more than a year ago

The fact that the CC-index has basically been flat-lined for the last eight weeks shows that the recent purchases by China have not been made because there is a need for cotton. Instead they were either an attempt to honor the trade deal and/or an opportunity to scalp the market for some trading profits.

So where do we go from here?

We continue to believe that the market is way too optimistic about the return of demand. Central banks and governments have been plugging holes with trillions of dollars of new funding, but it won't be enough to stave off a solvency crisis down the road. A lot of companies will eventually go bankrupt and scores of people will remain unemployed, while many scared consumers are going to bolster their savings rather than spending money on discretionary items like apparel.

Once the July squeeze is over, the futures market will have to face reality again. There is simply too much cotton looking for a home for prices to sustain these lofty levels. While the US is caught in a bubble, competitors will try to get some sales on the books at discounted prices, although not many mills are in a buying mood. Sooner or later this will lead to a price war and force values lower.

The July contract has turned into a crapshoot and we would therefore avoid it altogether. Use puts or put spreads in December to establish some downside protection!

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