PLEXUS Market Comments

Market Comments – February 18, 2021

NY futures extended their rally during this holiday-shortened week, as May added 243 points to close at 90.30 cents, while new crop December was up 130 points to 85.08 cents.

May settled above 90 cents today and was the first spot month to do so since July 2018. In the twelve sessions since February 2nd the spot month has now gained nearly 900 points, as the rally continues unabated.

What’s remarkable is that open interest has basically stayed the same at 247k contracts, even though we liquidated around 90k contracts in March during that time frame. By comparison, last year’s open interest declined about 56k contracts during the same period.

The most recent CFTC report showed that speculators and index funds were adding new longs when the market broke through resistance, while the trade was apparently still willing to extend its net short position.

During the week of February 3-9, which covers the move from around 82 to 88 cents, speculators added 1.61 million bales net to boost their net long to 8.48 million bales, while index funds increased their net long by 0.25 million bales to 7.79 million bales. Those positions are by no means extremes, as both camps have held net longs in excess of 12 million bales, although not at the same time.

The trade was a strong seller into the rally, as it added 1.86 million bales to its already big net short position, which grew to 16.27 million bales. We have to go all the way back to August 2018 to find a larger exposure.

We understand that from a traditional point of view it makes sense for the trade to load up on 'cheap' basis-long positions. This week international merchants purchased several hundred thousand bales in India, since the CCI didn't follow the lead of New York futures. This meant that Indian high grades could be procured at around 86-87 cents break-even, CIF China, which resulted in a very attractive basis.

However, hedging foreign cotton by going short US cotton, which is almost sold out this season, sounds like a risky bet to us. In other words, it remains to be seen whether adding to an already sizeable basis-long proves to be an opportunity or a liability. If speculators and index funds continued to hog the long side of the market and we get a short squeeze, then these 'attractive' basis positions might get a lot more attractive.

As pointed out last week, the trade short is so large because mills and merchants acted on bearish opinions by not fixing on-call contracts and/or adding basis-longs over many months. As of today all of these shorts are under water and it remains to be seen whether the physical side of these transactions will ultimately compensate them for the losses in New York.

As the stubbornly high open interest was already alluding to, the unfixed on-call position didn't make a lot of progress last week. Unfixed on-call sales in current crop dropped by just 0.43 million to 7.38 million bales, while unfixed on-call purchases were down 0.19 to 1.40 million bales. The net difference between the two still amounts to 5.98 million bales of buying power.

Just how much bullish potential some participants see in the current market can be gleaned from the large open interest in out-of-the-money call options. Yesterday there were over 12,500 calls with strike prices between 100 and 130 cents open in May, July and December combined.

And they are not cheap, as the July 100 calls settled at 317 points, while the December 130 calls were at 115 points. An at-the-money call option in July is nearly 600 points, which makes it costly for trade shorts to protect against upside exposure.

Recent classing data suggests that we won't quite get to the 14.95 million bales the USDA estimates. So far there have been around 14.45 million bales reported and we feel that the final number will be around 14.70 million bales, which would make an already tight US balance sheet even tighter.

According to our calculation we estimate that there are only about 3.8-4.0 million bales still looking for a home in the US. Export sales will start to slow down from here, both as a result of lower availability and price rationing.

So where do we go from here?

The March liquidation was orderly, as the trade kicked the can down the road, hoping for an eventual break to cover its short. Sure, there are still four months for the trade to deal with its position, but what worries us is that it keeps getting bigger, as 'cheap' basis offers lure more shorts into the market.

By amassing such a big position, the trade has put itself at the mercy of speculators and index funds. The latter is seeing strong inflows, as commodity ETFs are becoming an interesting asset in the inflation narrative. Large specs have currently no reason to cash in their positions and it would take a substantial drop in the market to start flushing them out, since the primary uptrend looks quite powerful at the moment.

There is always the possibility for an outside event to force speculators into selling, like a selloff in the stock market, a rally in the US dollar or an unexpected turn for the worse in the pandemic. Maybe we will enter another period of consolidation, because the trade doesn’t need to act at the moment and speculators probably won’t chase the market higher after this steep runup, but sooner or later the shorts will have to find a way out, otherwise it might lead to another squeeze like in early 2008.

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