PLEXUS Market Comments

Market Comments – May 21, 2020

NY futures settled the week with minor gains, as July added 21 points to close at 58.06 cents, while December gained 94 points to close at 58.70 cents.

July came within 15 points of the 60 cents level yesterday, which is about the same price it commanded last September, when the cotton balance sheet looked a lot healthier than now. Spec short-covering is still the driving force, judging by the declining open interest in July. Over the last five sessions July OI has declined 4.5k contracts to 82.9k contracts. Tepid volume and a declining open interest are signalling that this bear market rally is running on empty.

China continued to dominate the headlines this week, as the bulls were happy to see further evidence of US sales to China, while the bears were focusing on rising trade tensions, which now include Australia as well. This week China slapped an 80% tariff on barley in retaliation for Australia pushing for a COVID-19 probe.

US export sales amounted to 249,700 running bales for both marketing years combined, with China accounting for 93% of it. Cancellations reduced the net amount for all other countries to just 16,900 RB, which goes to show that US cotton isn't attractive at the current level.

Shipments of 256,800 RB were still decent, but about 50k behind the pace needed to make the USDA export projection of 15.0 million statistical bales. With eleven weeks to go we believe that the final export number will fall 0.5 million bales short of the current estimate. Total commitments for this season are now at 17.3 million statistical bales, of which 11.5 million bales have so far been exported. Sales for the coming marketing year are currently at 2.75 million statistical bales.

At the moment China is the only game in town as far as US cotton is concerned and people in the know believe that as many as 4.5 million bales will be bought in the current round. So far around 1.3 million have been booked and if another 3+ million bales were added, it would mop up most of the available supply in tenderable grades, which is why the July contract has been so strong.

We are not sure what China's objective is for buying all this cotton, along with many other commodities. Is it an effort to ease trade tensions or to stock up before a possible currency depreciation? China is in a tough spot with its credit bubble of over USD 40 trillion and foreign exchange reserves getting tighter, especially with de-globalization on the horizon. We believe that China will eventually have to let the yuan slide, from the current 7.1 to possibly 8 or 9 yuan per dollar, which would not bode well for commodity prices.

The US stock market continues to move higher, with the tech-heavy Nasdaq-100 index coming to within 3% of its all-time high this week. The S&P 500 and the Dow Jones index are still limping a bit behind, but they too seem to ignore the global shutdown and the collapse in earnings. S&P 500 first quarter earnings were the lowest since 2009 and the second quarter is going to look even worse.

Interestingly it is not large speculators that are driving stock prices higher, but the retail crowd. The spec/hedge report for S&P 500 mini futures shows that large specs have a sizeable net short position, while it is a spike in small investor trading that has been chasing prices higher. With casinos and online sports betting closed, it seems that these gamblers have found a new outlet for their addiction.

We believe that this will sooner or later end in tears! Usually traders don’t like uncertainty, but right now it provides some cover for their actions. As long as central bankers and governments take care of people by providing financial lifelines and rosy outlooks, everyone remains hopeful. But there will be a day of reckoning, when the economic carnage of this crisis finally becomes visible.

So where do we go from here?

Despite all the buying by China we feel that this bear market rally is nearing its end. Maybe there will be a final push above 60 cents in July before the show ends, but producers and traders should seize the opportunity to put on bearish hedges in new crop futures.

While July may remain detached from the reality, we don’t think December will be able to do so as well, unless major crop problems were to develop. Basis levels for Indian and Brazilian cotton have already come under pressure, as physical prices refuse to follow the futures market higher.

Sooner or later US new crop prices will have to follow the lead of competitors in order to put sales on the books. The global supply overhang is simply too massive to construct a bullish case and the best we can hope for is a trading range in the 50s. But if retail demand disappoints down the road, as we believe it will, then new lows are not out of the question.

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