PLEXUS Market Comments

Market Comments – July 25, 2019

NY futures rebounded this week, as December advanced 249 points to close at 64.19 cents.

The market has found some support this week and rallied up to the 64.70 resistance level twice, but has so far been unable to move past it. While this advance looks constructive on the chart, what we are missing is strong volume behind it, as the daily turnover averaged just under 18k futures contracts, although there has been increased activity in call options earlier in the week, which is encouraging.

It seems that specs have finally abated their relentless selling pressure, as last week's CFTC spec/hedge report showed that speculators and the trade were both net buyers between July 10-16, which is the first time this has happened since early March.

Speculators bought 0.01 million bales net to reduce their net short to 4.81 million bales, while the trade bought 0.41 million bales to cut its net short to just 0.70 million bales. Index Funds were the only net seller during that week, as they sold 0.42 million bales to reduce their net long to 5.51 million bales.

Speculators played a major role in forcing cotton prices to drop from 96 to 62 cents since June 2018, as they sold 17.1 million bales net over the last thirteen months and thereby greatly contributed to this bearish trend. However, we start to sense some nervousness among spec shorts, as they realize that history is not on their side, since every time they went several million bales net short, it would soon be followed by a massive short-covering rally.

Since 2006, when index funds started to emerge as passive holders of long positions in the futures market, speculators have owned net short positions exactly 20% of the time. The longest stretch they were continuously net short was between March and December of 2006, when they were committed to a net short position for 39 weeks.

Once speculators decide to cover, it typically triggers a big move in the other direction. The most dramatic one occurred when speculators went from a 4.5 million bales net short in March 2016 to a 12.4 million bales net long in February 2017, a swing of 16.9 million bales in just eleven months, which forced prices to move about 20 cents higher.

While there is usually a sudden bullish trigger that sets things in motion, it is also possible that the downtrend simply tires itself out over time and that some technical considerations prompt specs to cash in their shorts.

There are a few developments that could snap the market out of its bearish mood. The Chinese government has apparently allowed some companies to import certain Ag products without paying the retaliatory duty of 25%, among them soybeans, corn, sorghum, pork and cotton. Earlier this week the approval of 3 million tons of soybeans was reported and 50,000 tons of cotton was also mentioned. At this point it is not clear whether this was simply a gesture of goodwill ahead of the next round of trade talks or whether China is addressing its need for increased Ag imports over the coming years.

Over the last four seasons, from 2015/16 to 2018/19, China had a cumulative production deficit of 55.0 million bales according to USDA numbers, but imports only covered 24.4 million bales of it, while the balance was supplied from Reserve stocks. However, since government stocks have since been reduced to a strategically adequate level, we can assume that Chinese imports will slowly but surely rise to the level of China's annual production gap, which for the coming season is estimated at 12.75 million bales.

Speaking of imports, the US export sales report came in better than anticipated at 374,100 running bales of Upland and Pima cotton for all three marketing years. Vietnam was responsible for over 60% of the total, but there were still 15 other markets buying as well.

Shipments continued to be a bit slower than hoped for at 326,400 running bales.

Total commitments for the current season are now at 16.7 million statistical bales, of which 13.6 million bales have so far been shipped, with a little less than two weeks to go in the current marketing year. For the coming season there are so far 4.7 million bales on the books.

So where do we go from here?

It looks like the market has made at least a temporary bottom last week, when it posted back-to-back lows of 61.66 and 61.67 cents and then bounced. However, while some light short-covering and call options buying has given the market a lift, we need to see greater buy-side liquidity in order to generate some lasting upside momentum.

Speculators are aware of their record net short position and will be quick to cover if they are given a reason to do so. We already mentioned some potential triggers and the upcoming Fed meeting needs to be watched as well, because a dovish move might weaken the dollar, stoke inflation fears and provide a boost to commodities. The recent strength in precious metals seems to serve as an early warning sign.

The extreme weather we are witnessing is another reason not to get too cozy with a short position at these low levels. The jet stream has become a lot more wobbly in recent years and is meandering with greater amplitudes around the globe, which is causing these weather anomalies. While crops are generally looking fine at this point, there is still a lot of weather to negotiate before the crops are finally in.

Whether the market has already reached a turning point in this bear market or whether the final low is still ahead of us remains to be seen, but the long-term risk/reward scenario seems to shift in favor of the bulls. While speculators may be able to squeeze the market for a few more cents to the downside, they do so at the risk of suddenly getting wrong-footed by some bullish factors entering the scene.

https://plexus-cotton.com