PLEXUS Market Comments

Market Comments – August 27, 2020

NY futures continued to rise this week, as December added another 85 points to close at 65.37 cents.

December broke above its double-top resistance area at 65 cents this week and posted its highest close since late February. It is quite remarkable to see prices back at pre-Covid levels, despite the obvious drop in global mill use and a projected 55% rise in ROW stocks at the end of this season, compared to August 1, 2019.

But fundamentals are currently taking a backseat to investor psychology and money flows, as financial markets keep reminding us on a daily basis. We believe there are two main drivers behind these exuberant market moves, namely the Fed and passive investing.

The Fed has done a masterful job in assuring investors that it has everything under control and that it would act as a buyer of last resort if necessary, be it in the bond, high yield or stock market. Not only has that attracted scores of new, unsuspecting investors, but it has also scared away any potential short sellers.

Nasdaq short interest has been constantly declining despite record share prices and we are seeing the same in cotton, where large speculators are at their lowest outright short position in two years. It made sense for speculators to shy away from shorting during the bull market of 2018, but to sit on their hands in this fundamentally bearish environment can only be explained by a fear of the Fed's printing press.

While the lack of short selling removes overhead resistance, the massive flow of money into passive investments provides the fuel for markets to shoot higher. Index funds have removed the brain function from investing, as stocks are no longer rising as a result of sound analysis, but simply because a lot of money flows into index products that track the S&P 500 or Nasdaq 100 indexes. Investors are not really aware of what they are paying for, but stay committed as long as prices are headed north.

Cotton follows the same dynamics, as large spec shorts have dropped from 4.73 to just 1.17 million bales since April 21, when December traded at 55 cents, while index funds increased their net long from 5.34 to 7.35 million bales during the same time frame. In other words, these two forces added a total of 5.57 million bales in net buying, which is the main reason the futures market is trading ten cents higher.

The trade has been selling into this rising market in the belief that bearish fundamentals would eventually take over and prove them right. This might still happen at some point, but at the moment the trade is under water with its large basis-long position, as physical prices are not keeping pace with the rising futures market.

This is not the first time the futures market has taken on a life of its own, which is why ICE launched a 'World Cotton Contract' several years back that allowed for other growths besides US cotton to be delivered. While this contract may not have been perfect in its initial form, rather than improving on it and trying to make it work, the trade decided to ditch it.

We believe that if we had a viable futures contract that allowed for Indian and Brazilian cotton to be delivered, especially with a functional October delivery, we would have a more effective hedging tool. Based on the level of frustration we sense from mills with unfixed 'on-call' positions, we feel that the futures market is going to play a lesser role down the road, as some buyers and traders prefer to operate in a fixed price environment.

US export sales increased by 177,100 running bales for both marketing years, with Vietnam and China accounting for the lion's share. Shipments slowed to 287,700 RB, with China receiving 155,900 RB. Total commitments for the current season are now at 7.25 million statistical bales, of which a little over 1.0 million bales have so far been exported.

There are plenty of rumors about China Reserve buying, as China is apparently still intending to honor its 'Phase One' commitment. Some traders expect China to buy several million bales over the coming months, which would put a solid floor under the market.

So where do we go from here?

Two tropical systems caused the market to trade in typical 'buy the rumor – sell the fact' fashion this week, and now that the storms are gone without inflicting much harm, we might see prices pull back some more from here.

But the market is still lacking any significant selling pressure, as speculators have jumped on the bullish bandwagon and index funds are still seeing positive money flows. With China lurking as a buyer underneath, with 3.8 million bales in unfixed on-call sales on December and with the US dollar showing some weakness, it will take a significant change in perception to force prices lower.

By moving above the 65 cents resistance area the market has opened a new window to the upside and the impending crossover of the 50- over the 200-day moving average might lead to additional buying. We therefore believe that the market will continue to defy bearish fundamentals and is going to trade sideways to higher in the near future.

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