PLEXUS Market Comments

Market Comments – May 28, 2020

NY futures moved slightly lower this week, as July dropped 49 points to close at 57.57 cents, while December lost 116 points to close at 57.54 cents.

While the futures market continued to hold in the high 50s, the physical market had a weak appearance, which has put further pressure on the basis of Brazilian, WAF and Indian cotton.

China continues to dominate the narrative, but it seems to be more a fear of getting squeezed than a bullish outlook that is underpinning the futures market. Other than some apparent inquiries by the Reserve there is very little business going on, as shippers are still busy trying to sort out backlogged commitments.

It is still unclear what China’s motivations behind these US purchases are. Some traders believe that China wants to score political points by honoring the Phase 1 trade agreement, under which it obligated itself to buy large amounts of US Ag products. But if that is the case, then why does China burn its political capital by passing a new security law in Hong Kong, which effectively ends the autonomous status?

The Trump administration may announce new sanctions against China as early as tomorrow, which would put the two nations on a path towards a ‘Cold War’. Would China continue to buy US cotton, or honor existing commitments, if the December trade deal were to get supplanted by new sanctions? Needless to say there is a lot of uncertainty when it comes to China and this could start to weigh on the cotton market!

While the level of mill use is still anyone's guess, global production is a bit of a moving target as well. With La Niña likely to dominate this summer, the tropics will become a lot more active and there have already been two named storms before the start of the official hurricane season in June. Forecasters call for 14-20 tropical storms, of which 7-11 may reach hurricane strength. This could make for an interesting growing season in the US!

Another development to watch are the locust attacks on the Indian subcontinent and in East Africa. In India locust swarms are the worst in 27 years as they have migrated from Pakistan to Northern India, threatening to move south to cotton producing states like Gujarat and Maharashtra. There is no threat to cotton at the current time, but if the pest hangs around until cotton gets planted over the coming months, it could become a factor.

The strength of the US dollar plays an important role in forecast of commodity prices. The dollar index has recently weakened a bit, but at 98.50 it is still right in the middle of its 52-week range. Many analysts believe that the US dollar will strengthen, with some even expecting a significant rally. The bullish case is based on 'safe haven' considerations and on a global shortage of dollars, as foreign borrowers are scrambling to service trillions in dollar-denominated debt.

The counterargument is that foreigners own about 40 trillion dollars in US investments (versus 29 trillion the other way around), which they could sell in order to obtain liquidity. In order to avoid this from happening, the Federal Reserve has opened swap lines and repurchasing agreements with foreign central banks, which will allow them to get their hands on dollars without having to sell securities.

However, this won't work for countries with low foreign reserves, such as Turkey, South Africa or Indonesia, which may have to seek help from the IMF. We therefore feel that the odds for the US dollar to remain firm are high and that we could even see a strong appreciation against emerging market currencies, which are struggling to generate dollar income due to the global pandemic.

So where do we go from here?

Not much has changed since last week, as the fear of a July squeeze is still supporting the rest of the board. But fundamentals remain extremely weak and there is an abundance of cotton around the globe, which will sooner or later put pressure on physical prices. China is still the only game in town as far as US cotton goes, but with political tensions rising, the mood could suddenly turn negative.

There is a lot of optimism as the US and Europe are starting to open up again, but we need to understand that an overleveraged global economy was already heading for a recession before the virus arrived on the scene. This health crisis was simply the needle that pricked the bubble. Economies will recover, but from very low levels, and we believe that it will take two or three years before we are back to 2019 consumption levels.

China has given growers a gift by lifting the futures market into the high 50s and we would therefore use this opportunity to put on some downside protection via bearish options strategies in the December contract.

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