PLEXUS Market Comments

Market Comments – July 29, 2021

NY futures continued to move slightly higher, with December adding another 45 points to close at 90.31 cents.

December posted new intraday and settlement highs this week at 91.00 and 90.52 cents, respectively, as speculators and possibly index funds added more longs, while the trade expanded its net short position. Open interest was up another 10.2k to 247.6k contracts over the last five sessions, which is considerably higher than last year's 173.7k contracts and the 197.5k contracts we had on the same date two years ago.

The CFTC report of July 20 showed that speculators continued to add longs, as they expanded their net long by 0.48 to 7.06 million bales. Index funds on the other hand cut their net long by 0.20 to 8.33 million bales.

The trade was a seller as well, increasing its net short by 0.28 million bales to 15.40 million bales. While the trade net short appears large, there have been five seasons with bigger positions. The record was set in late February of 2008, when the trade net short reached 23.81 million bales, which set the stage for the epic short-covering rally that followed a week later.

Unfixed on-call sales continued to rise last week, up 0.11 million to 13.64 million bales, while unfixed on-call purchases went the other direction, dropping by 0.15 to 4.31 million bales. The net position therefore increased by 0.26 to 9.33 million bales.

The current constellation reminds us of early August 2018, when we had record unfixed on-call sales of 15.65 million bales, with the net on-call position amounting to 11.38 million bales in favor of sales. The December contract was trading right around 90 cents at that time, while the spec net long was at 9.7 million bales and the trade net short at 18.0 million bales.

The cotton balance sheet presented itself quite bullish back then, as global mill use was estimated at a record 127.6 million bales in the August 2018 WASDE report, well above global production of 120.53 million bales, while ending stocks were expected to fall 7.4 million to 77.10 million bales.

However, due to an economic slowdown and a sharp stock market correction in the 4th quarter we ended up with just 120.5 million bales in global mill use, or more than seven million bales below the August estimate. Global production went down two million bales to 118.5 million bales, while the US crop produced 18.4 million bales that season.

As a result of the 'risk off' move in financial markets, speculators started to sell and turned their 7.3 million bales net long into a 0.8 million bales net short position by the end of 2018, with the spot month dropping to 72 cents. Spec selling continued the following year and by August 2019 their net short had reached 5.4 million bales, with prices trading in the high-50s. In other words, within twelve months speculators had sold over 14 million bales net!

What this example from three years ago tells us is that speculators are the primary driver in the market. Their selling forced prices over 30 cents lower, despite the largest unfixed on-call sales position on record. When the market turns, support from these unfixed sales can quickly disappear, as mills pull or lower their scale-down buy orders.

US export sales came in about as expected last week, as 214,300 running bales of Upland and Pima cotton were added for all marketing years combined. There were 17 markets buying, while 21 destinations received shipments of 247,600 running bales.

For the current season we now have commitments of just under 17.5 million statistical bales, of which 15.75 million bales have so far been exported. With just 1.3 weeks of data left in the current marketing year, we will probably fall 100-150k bales short of the USDA export estimate of 16.4 million bales.

Meanwhile, new crop sales are currently at 3.25 million statistical bales. As pointed out before, we will likely start the new season next week with around 2.5 million fewer bales on the books compared to a year ago. Of note is that China has so far bought about a million bales less than last season.

While inflation expectations are still dominating the narrative, we are seeing conflicting signals such as falling bond yields all over the globe and a trillion dollars piling up in the reverse repo market, which are usually pointing to a slowing economy.

Backwardation in many commodities is another sign that inflation may be temporary due to supply bottlenecks, rather than a long-lasting phenomenon. For example, a barrel of crude oil costs over 73 dollars for September 2021 delivery, while a barrel for January 2025 delivery is about 17 dollars cheaper. Those who believe in runaway inflation should load up on future deliveries!

So where do we go from here?

Speculators continue to throw money at the long side, but scale-up trade selling is keeping the advance in check so far. As long as crops around the globe continue to perform well, it will be difficult to generate much upside momentum.

However, as long as speculators are happy being long, the downside is not really in play either, as there is still plenty of mill buying waiting underneath. But as the 2018/19-season has shown, we need to remain vigilant and keep an eye out for potential ‘risk off’ factors.

For now we maintain our outlook for a rangebound market, until we gain more clarity about the outcome of the crops and the path of the global economy.

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