PLEXUS Market Comments

Market Comments – May 30, 2019

NY futures continued to recover during this holiday-shortened week, as July gained 186 points to close at 69.34 cents, while December gained 149 points to close at 68.32 cents.

Since posting an intraday low of 64.50 on May 14, July has been able to move nearly 500 points higher in a short-term uptrend channel, although the primary trend remains bearish. July has maintained its leadership role this week, as it has moved up 186 points, while December (up 149 points) and March (up 138 points) were lagging behind.

We were quite amazed when we saw the latest CFTC report, as it showed that speculators continued to dig themselves deeper into a hole, even though the market had already started to reverse. From May 15-21, when the market traded between 6579 and 6824, speculators sold another 1.31 million bales net to increase their net short to 4.11 million bales net. This was just 0.38 million bales shy of the record 4.49 million net short set in March 2016.

Index funds continued to be net sellers as well, cutting their net long by 0.14 million bales to just 6.71 million bales. The trade was once again a strong net buyer, reducing its net short by 1.45 million bales to just 2.60 million bales net. This too marked the lowest trade net short position since March 2016.

It is quite remarkable to see speculators adding to their net short position even though the market was already turning around. In just 3 weeks, specs and index funds have sold nearly seven million bales net and the outright spec short position (large funds + non-reportable) has more than doubled to 8.85 million bales.

Most of these specs shorts are concentrated in the July, while the trade and index funds share the long side. With the July notice period just a little over 3 weeks away, there will likely be a showdown between trade longs and specs shorts. The index fund long will simply get rolled into December according to a fixed schedule.

While speculators are able to dominate market action between delivery periods thanks to their monetary power, they can’t convert money into cotton and this moves the advantage to the trade as we approach the notice period. With current crop supplies basically sold out and with the certified stock at just 83k bales, some of these spec shorts might find themselves trapped. However, it all depends on whether trade longs are willing to force the issue

While July has potentially bullish dynamics over the coming weeks, the opposite is true for December and March. With just a 2.6 million bales net short the trade is under-hedged and will need to increase its new crop short considerably over the coming months.

Although new crop has been struggling to get into, as well as out of the ground due to stormy weather in Texas and a heat wave in the Southeast, sooner or later this US crop will be on its way and whoever owns it will need more downside protection. The same goes for some of the foreign crops that are typically hedged with US futures and options. In other words, we estimate that the trade net short will have to grow to at least 12-15 million bales over the coming months.

Not only do we feel that there will be plenty of supply in the coming season, but demand seems to be struggling. Shares of apparel retailers got hammered in May due to disappointing earnings and cautious forward guidance. For example, PVC group lost 25% in May, while Abercrombie & Fitch was down nearly 40%. The global economy is clearly slowing down as consumers are struggling with debt and we therefore don't share the USDA's optimistic view on mill use.

The government shows mill use for the current season at 122.71 million bales, which is basically the same as last year's 122.77 million bales. But for the coming season the USDA is increasing its mill use number to 125.93 million bales, a jump of 3.22 million bales

(+2.62%). Cotlook is probably closer to the truth with 122.60 million bales for next season. Based on the evidence we are currently seeing we would be lucky to keep mill use near 123 million, but we are afraid that even that will be a challenge in the current economic environment.

So where do we go from here?

We still believe that a short-covering rally in July is on the cards, but with December and March pulling in the other direction, it remains to be seen whether July can detach itself to force a bigger inversion.

Once July is off the board the focus will shift back to the supply/demand situation of the coming season, which we view as bearish at this point in time. Only production problems or some unexpected vigour on the demand side - maybe because of a US/China trade agreement - would alter our perception. But unless speculators move to a sizeable net long position and thereby provide the liquidity for the trade to increase its short hedges, we feel that new crop values will eventually slip to new lows.

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