PLEXUS Market Comments

MARKET COMMENTS – SEPTEMBER 30, 2021

NY futures exploded to the upside this week, as December rallied 1,334 points to close at 105.80 cents. The Dec/March inversion widened from 96 to 192 points.

Last week's selloff to the 89 cents level proved to be nothing more than a head fake, as the market quickly transitioned into a slingshot move, with spot futures rallying to their highest level in over a decade. Over the last eight sessions the December contract powered ahead 1678 points, with the overall volume totaling a massive 369.8k contracts.

It all seemed to originate in Xinjiang, where seed cotton prices were bid up ahead of the crop movement, which seemed to spark speculative buying in the Zhengzhou futures market that turned into a feedback loop with ICE futures. Over the last five sessions the ZCE January contract has rallied 2,520 yuan/ton, which equates to 1770 points/lb. It settled today at 19,680 yuan/ton or around 138.50 cents/lb. This wide spread between the two futures markets has offered ample arbitrage opportunities for savvy traders.

Chinese authorities are now trying to cap this advance by issuing additional import quotas and by extending Reserve auction sales, which have so far totaled around 2.9 million statistical bales. The government also seems to wag the finger at speculators and it might eventually take measures to rein them in, like it has done in other markets.

But this could backfire, because it might be interpreted as an admission that there is a cotton shortage. Some analysts are already drawing comparisons to the 2010/11-season, when prices rallied to over two dollars. Rumors about a short crop in Xinjiang and the strong US export sales to China have added fuel to these fears.

However, according to local sources the Xinjiang crop is doing fine, with a bumper crop of 5.2 million tons expected, which would be slightly higher than last year despite acreage being about one percent lower. We also don't expect China to chase foreign growths at any price. While it made sense for China to refill its reserve in the low 90s, we expect sales to slow at current levels.

US export sales were about as strong as expected, as 588,300 running bales of Upland and Pima cotton were added, with China taking 420,300 running bales. In total there were 16 markets buying, while shipments of 175,600 RB went to 18 destinations.

For the current season we now have commitments of 7.65 million statistical bales, of which just 1.6 million bales have been shipped so far. This is still quite a bit behind last season, when we had 8.5 million bales sold and 2.3 million bales shipped.

So far this advance has been orderly and we have yet to see a limit up close. We can't even label this a 'short-covering' rally because open interest has expanded by 26.6k contracts to 289.4k contracts since last Thursday. While some shorts may have covered, new shorts have come in to replace them as the market rallied, while on the buy side we suspect strong spec and index fund buying.

Last week's CFTC spec/hedge report showed a 1.92 million bale drop in the spec net long position to 7.74 million bales, which was the result of a technical break to 89 cents. But since then, speculators have come back with a vengeance and it will be interesting to see how many longs they have added when the new report comes out tomorrow.

In the last five years the spec net long has moved above the 12 million bale level twice, so there is still a lot of room for this position to increase, especially with the chart and strong momentum providing a good reason to add exposure. Since the Index Fund net long position is also at a relatively high level at 8.2 million bales, it will take a rather substantial trade net short to offset these two big longs.

So far trade shorts have refused to cut and run, since the sharp rise in open interest suggests that the trade is willing to fight this onslaught of speculative buying. While this may give hope to the bear camp, because merchants and mills are obviously not seeing a good enough reason to bail just yet, there lies great danger in this massive short exposure.

In 2010 we also saw open interest rise from around 175k to 240k contracts between August and early November (roll period and Dec options expiration), with prices shooting up from around 83 to 151 cents during that time frame. Then we got a nearly 40 cents collapse in prices and a 45k drop in open interest over the following two weeks, before prices started to rally to new highs and open interest climbed again as well. It took until the second quarter of 2011 until the shorts finally capitulated.

In a market that's devoid of keen sellers, as speculators and index funds see no reason to cash in at this point, it doesn't take a lot of short covering to keep the uptrend going. Even a relatively small number of fixations can push prices up in a market that doesn't have ready sellers.

The latest CFTC on-call report is cause for concern, because it shows that mills missed an opportunity to greatly reduce their exposure when prices dipped below 90 cents. As of last Friday, when the market was already back at 96 cents, there were still 4.24 million bales in December on-call sales open, down just 0.70 million bales, while the overall on-call sales position had 15.14 million bales open, down a measly 0.69 million from the week before.

So where do we go from here?

While China has brought great uncertainty to the market and there might be some fundamental reasons for prices to move higher, this has clearly turned into a showdown between spec longs and trade shorts.

Mills feel trapped with their massive unfixed on-call position, but have for the most part refused to pay up to get out of their predicament. Many of them have also been knocked out of "Accumulator" strategies, which has left them once again unprotected. This means that there is still a lot of potential fuel for this rally to continue.

However, the market has gone parabolic over the last eight sessions and will probably need to take a breather at some point. The Chinese 'National Day Golden Week', during which the ZCE futures market will be closed from October 1-7, couldn't come soon enough, because it might give traders a reprieve from this panic-like ratcheting up of Chinese and US futures.

We expect that dips will be eagerly bought by desperate shorts, while there is no telling when this rocket finally runs out of fuel.

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