PLEXUS Market Comments

MARKET COMMENTS 24 Nov, 2022

Since our last report on November 10, March has backed off 166 points to close at 82.90 cents on Wednesday.

However, even though the March contract is not far from where it stood two weeks ago, it meandered in a wide range of over ten cents, between 89.92 and 79.30 cents. Open interest dropped nearly 40k contracts during this time frame to around 192k contracts before Wednesday's session, which was due to the December liquidation.

The December contract is now basically history, with just 703 lots remaining, not counting Wednesday's trading. Interestingly, the December contract managed to hold a small inversion over March, signaling that the US situation remains tight at this point, which is also reflected by the firm basis.

The back-to-back trade events in Las Vegas (ICA Dinner) and Miami (Cotton Summit) were a sobering affair, as they confirmed that mill demand is at a low ebb. While we already knew that mills were struggling, the situation appears to be worse than feared.

Most mills around the globe have been running 20 to 50% below their usual pace for the last 4-5 months, and while some are hopeful that things might improve in January, this is more hope than reality at this juncture. Many mills are sitting on 2-3 times their normal yarn and fabric inventories,

as consumer demand remains subdued, which weighs on the entire supply chain.

While cotton inventories as such are not too threatening, we need to add these extra yarn and fabric stocks back into the equation, since they are just raw cotton in a different form. Looked at it that way, there is more than enough cotton to go around!

It is difficult to see the light at the end of the tunnel at the moment. Consumers will have to start buying more cotton products for things to improve, but many of them have bought so much during the lockdown that they have no appetite to add more home textiles, towels and apparel at this point. Instead they spend money on inflated living expenses, like food, shelter, gas and utilities, and if there is money left over, they prefer to spend it on experiences, such as travel and eating out. It doesn't mean that they won't buy cotton products at all, but if they absorb let's say 10-15% less than usual, it would lower mill use by 12-18 million bales.

The WASDE doesn't reflect the right numbers yet and we should therefore expect a sizable downward revision in mill use over the coming months, which is bearish. The USDA has mill use still at 115 million bales, while Cotlook is at 108 million bales and the reality might even be lower than that. Unless we see either financial markets rally, the dollar weaken or consumer confidence rebound, it will be challenging for cotton to move much higher. Instead it becomes a question of how much lower we might have to go to uncover greater demand.

The CFTC spec/hedge report for the week of November 9-15, during which March moved sideways between 82.57 and 87.62 cents, showed a similar trend as the week before, with specs covering some shorts and adding new longs, while the trade liquidated a large amount of longs and shorts.

Speculators bought 0.36 million bales to reduce their net short to 1.1 million bales, while index funds were also net buyers, increasing their long by 0.29 to 7.17 million bales. The trade took the other side, selling 0.65 million bales to increase its net short to 6.06 million bales.

The recent rally was mainly caused by spec short-covering, after they had sold themselves into a "bear trap" as we headed towards convergence between cash and futures in the December delivery period. While speculators might eventually have to cover more shorts, the fact that December is now liquidated buys them another 3 months before they face the next reality check with the cash market. In other words, there is no urgent pressure for these spec shorts to get out.

So where do we go from here?

The lack of demand is clearly a problem at the moment and as such the WASDE doesn't reflect the right set of numbers in its balance sheet. While the supply side is now more or less known, the demand side is overstated by several million bales and will have to be adjusted lower over the coming months, which will have a bearish impact.

However, while demand is lousy and mills are not buying much at the moment, we are also seeing a refusal by growers to sell at these low levels, and the strong US basis reflects this. In other words, we have a standoff between buyers and sellers, with neither side willing to yield at the moment. This is keeping the market from making a big move to either side.

Sooner or later this stalemate will be broken and unless demand improves considerably over the coming months, we fear that it will be the growers who end up holding the short end of the stick. It could still take a while before supply pressure forces their hand, but it seems inevitable in the current environment.

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