PLEXUS Market Comments

Market Comments – March 19, 2020

NY futures continued to slide this week, as May lost another 477 points to close at 54.93 cents.

As anticipated we saw a further erosion of cotton prices this week, along with a pronounced drop in global stock and commodity markets. The May contract has now lost over 18 cents or about 25% since posting a high of 73.08 cents a little over two months ago.

Meanwhile the Dow Jones is down 32% since posting a record high on February 12, while the CRB Commodity Index has fallen to its lowest level since 1972 and is now around 74% below its 2008 peak.

The global economy is grinding to a halt and the resulting supply and demand shocks are causing widespread financial pain in an already over-leveraged financial system. Many companies will face bankruptcy and scores of employees are being furloughed or laid off. Since there is no end to the crisis in sight yet, the situation is likely to worsen before it finally gets better.

If left to their own devices, economies around the globe would collapse into a depression, but authorities are going to do everything in their power to avoid this from happening. As stated last week, we expect central banks and governments to come to the rescue with unprecedented money printing and stimulus.

The Federal Reserve has already announced several money printing schemes in order to inject liquidity into a distressed credit system. Apart from buying vast amounts of government and mortgage bonds, it also pledged to unclog the commercial paper market and assist money-market mutual funds in meeting redemptions from investors.

These Fed actions will likely add up to several trillion US dollars over the coming weeks and months. We just witnessed the biggest ever weekly increase in the Fed balance sheet, as it grew by USD 356 billion. Over the last six months the Fed balance sheet has grown from USD 3.76 to 4.67 trillion dollars, and that's just the beginning.

We believe that over the coming months the Fed balance sheet could swell to over USD 10 trillion in an effort to shore up collapsing asset prices. Apart from government bonds, the Fed may be forced to intervene in the corporate bond and stock markets as well. In addition to that we are going to see massive government stimulus, which is simply deficit spending because there is no 'rainy day fund' to tap into. Most of this deficit spending will then have to be mopped up by the Fed as well.

The Fed is not alone in this effort, as the ECB (European Central Bank) announced a USD 818 billion program to buy public and private-sector assets, along with a USD 130 billion a month purchase program of eurozone debt. The Bank of England will buy USD 230 billion in government bonds and has cut interest rates to a record low.

As soon as financial markets get the message that the powers that be will do whatever it takes to reflate asset prices, market psychology will begin to shift. Instead of dumping assets, traders and investors will join central bankers in blowing asset bubbles up again.

While there will be a price to pay for all this massive money printing, current deflationary forces and the low velocity of money will likely mask the problem for many months or possibly years to come.

It is difficult to figure out what that means for the cotton market going forward. While a rise in nominal asset prices should lift cotton as well, the current fundamental picture looks awful. With many retailers closed and unable to take in new merchandise, there is a ripple effect throughout the entire supply chain. Many shipments will get delayed or cancelled and there is real demand destruction.

With people losing their income, even if only temporarily, and seeing their stock portfolios evaporate, they are more concerned about paying rent and putting food on the table than buying a new outfit or new bedsheets. Most retailers announced store closings until the end of March, but that seems to be wishful thinking, because the virus wave has yet to reach its peak. In other words, it will likely be many months before end-user demand is starting to normalize.

US exports sales were once again very strong at 436,400 running bales of Upland and Pima cotton for both marketing years, while shipments amounted to 385,200 running bales. For the current season we now have total commitments of 15.8 million statistical bales, of which 8.35 million bales have so far been exported. While these numbers look supportive, they don't really mean much given the current situation, because shippers are going to face delivery problems.

So where do we go from here?

Demand destruction is real, although it is still anyone's guess as to where the current level of mill use sits. Based on what happened during the financial crisis in 2008/09, we might see a drop of 12-14 million bales, possibly more. While there is also going to be some reduction in planted acreage, we don’t see production dropping nearly as much as demand, which would mean that already high ROW stock levels are going increase further.

However, US cotton is relatively cheap compared to other stocks around the globe, particularly in China and India, where 57% of the global ending stocks are located. Additionally we have the loan deficiency support kicking in, which should mitigate the need to get rid of inventories at any price, especially if the Fed is successful in backstopping financial markets. We are therefore cautiously optimistic that we are not far from a bottom, but if the carnage in the stock market continues, then all bets are off.

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