PLEXUS Market Comments

Market Comments – February 27, 2020

NY futures collapsed this week, as May dropped 687 points to close at 62.50 cents.

Last week we felt that financial markets had been mispricing risk in regards to the coronavirus and would eventually have to pay more attention to it. Traders finally woke up to the economic fallout from this crisis, as panic selling triggered a massive selloff in stocks and commodities this week.

The VIX, or volatility index, which gauges fear in the market, shot up from a 16 reading last week to over 39 today, which indicates that there is some panic. Since 2008 there were only three other occasions with a higher VIX reading. Markets don't like uncertainty and right now we have plenty of it!

It is still difficult to assess how much of an economic impact this virus crisis is ultimately going to have. Although US stock markets posted record highs just a couple of weeks ago, the global economy didn't really mirror this optimism, as there have been signs of stress in many parts of the world for several months. The coronavirus may simply have helped to push some economies into recession.

What's clear is that containing the virus hasn't worked, as it has spread to almost 50 countries by now and infections will continue to grow. However, this new virus is not a death sentence and we will simply have to learn how to live with it. Many more people will get sick from it and a small percentage of the infected will die, but most will recover and go on with their lives. The world doesn't shut down when influenza kills half a million people a year either.

However, developed nations are generally better equipped to deal with the problem, while some emerging markets with poor healthcare systems will be dealt a more severe blow.

We feel that the biggest threat is not the virus itself, but the reaction to it, as economic activity has slowed considerably in many parts of the world. People travel less and don't go out, supply chains slow down or get disrupted, layoffs will follow and this is likely to create a negative feedback loop.

Unfortunately the cotton market, which looked quite constructive until last week, has been dragged down by this situation as well. While cotton fundamentals still seem somewhat supportive, the technical picture has deteriorated considerably after we broke through the 200-day moving average on Wednesday.

This was the last line of defense for the bulls and today's limit down comes therefore as no surprise. Remaining longs are throwing in the towel and specs are putting on new short positions. Also, a lot of decisions are no longer made by humans, but by so-called 'robo-advisors', which are automated digital platforms driven by algorithms. They are programmed to act on technical signals, such as long-term moving averages or momentum indicators.

Against this negative macro backdrop it doesn't seem to matter that US export sales continued to impress, as another 441,600 running bales of Upland and Pima cotton were added last week. There were 23 markets participating in the buying, which is a sign that US cotton is attractively priced and that there are not many other alternatives out there. Shipments continued to lag a little at 342,300 running bales.

For the current season we now have commitments of 14.5 million statistical bales, of which 7.0 million have so far been exported. While commitments of 17.5 million bales (14.5 export + 3.0 domestic) out of a total supply of 25.0 million bales look impressive, considering that we are still in February, there is growing concern that some of these sales might get cancelled if the economic situation were to worsen.

We are likely going to see reductions in global production and mill use, with the latter probably falling at a much steeper rate. The 2008 financial crisis saw global mill use drop from 123.8 million bales in 2007/08 to just 110.3 million bales in 2008/09, only to rebound to 119.5 million bales in the following season. We could see a similar path this time around, especially if a global recession were to result from this crisis.

So where do we go from here?

The cotton market is currently in freefall, along with financial markets, and it is still anyone's guess as to when this carnage will finally be over. The May contract has lost almost eight cents in just seven sessions and there is not much in the way of support until we reach the late August low of 58.84 cents.

Rather sooner than later we expect governments and central banks to come to the rescue with massive fiscal stimulus and more money printing. This week Hong Kong announced that every permanent resident over 18 will get HK$ 10,000 (US$ 1,284) to aid a population "overwhelmed by a heavy atmosphere". We expect similar 'helicopter money' drops in other parts of the world to follow.

This feeds right into our 'stagflation' narrative, as recessionary forces will be combated with massive money printing, with central bankers becoming buyers of last resort if necessary. This will ultimately reverse the price drop in nominal terms, although it may still take a while to overcome the current negative forces. Use options only to operate in this volatile environment!

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