PLEXUS Market Comments

February 15, 2019

Market Comments – February 14, 2019

NY futures continued to slip this week, as May, which is now considered to be the lead month, dropped 221 points to close at 71.71 cents/lb.

A significantly lower mill use number in the WASDE report and higher than expected planting intentions were behind the market's weakness, as spot futures dropped to their lowest level in 15 months. The last time the market had closed below the 70 cents level was on November 17, 2017.

The WASDE report didn't contain any major surprises, but finally addressed the weakness in demand by taking mill use down by 1.99 million bales to 123.64 million bales. This means that the USDA is now 4.3 million bales below its high estimate of 127.94 million bales back in September. However, despite this sizable cut the USDA may still find itself behind the curve, since the market is signaling that mill use may not even measure up to the 122.58 million bales of last season.

In other words, the global supply gap this season may actually be a lot smaller than the 5.19 million bales the USDA is currently projecting. Our estimate is in the region of 3.0-3.5 million bales only. While China has a supply gap of 13.0 million bales this season, the rest of the world (ROW) has a surplus of

7.81 million bales according to the USDA, or closer to 10 million bales if we count with a lower mill use number.

Even though Chinese imports are trending higher this season at 7.5 million bales, it still won't be enough to stop ROW inventories from increasing. The current WASDE shows ROW stocks at 43.13 million bales, but this number might actually be above 45 million bales if we are right on mill use. By comparison, ROW stocks were at 43.03 million bales at the beginning of this season and just 34.48 million bales a year earlier.

Not only is there enough cotton in the pipeline for the remainder of this season, but production is shaping up to be quite a bit larger in the coming season. Last weekend the NCC Planting Intentions came out at 14.45 million acres, which pegs early US crop estimates at around 23 million bales.

Brazil, who is now the second largest exporter after the US, is also looking at a sharp increase in production, with the latest local estimate showing a crop of around 11.8 million statistical bales, which compares to 9.2 million bales a year ago. Since Brazil has demonstrated its ability to ship close to a million bales in a single month, it should alleviate any supply concerns during summer months.

Today's export sales report for the week of Dec 28 – Jan 3 was again quite strong at 319,800 running bales for both marketing years. This means that total commitments were already at 11.7 million statistical bales at the beginning of the calendar year, with seven months to go in the marketing year. Shipments were still lagging a bit at 3.85 million statistical bales. On Friday, February 22nd, the USDA will publish export sales for all six weeks between January 4 and February 14, which could add up to an impressive number!

The latest available CFTC spec/hedge report for the week of January 8-15 showed a familiar picture, with specs extending their net short position by 0.14 million bales to 1.26 million bales, while the trade bought 0.64 million bales to reduce its net short to just 5.85 million bales. Index funds reduced their net long by 0.50 million bales to 7.10 million bales.

We don't quite know what to make of this small net short position by the trade, which is the lowest since April 2016. A year earlier the trade still carried a net short position of 18.72 million bales, at a time when the cotton balance sheet didn't look much different from now.

In a way the trade has been forced to reduce its net short, because speculators sold 13.49 million bales since the beginning of June. Since the futures market is a 'zero sum' game, the trade had no other choice but to assume the role of scale-down buyer.

However, this raises concerns that the trade may have overplayed its hand? A trade net short of 5.85 million bales didn't even hedge the net on-call position of 6.18 million bales at the time (10.69 million in unfixed on-call sales vs 4.51 million in unfixed on-call purchases), let alone all the unsold inventory. It certainly looks like the trade has been under-hedged recently.

This raises important questions as we head into the planting season. From a risk-management point of view the trade will almost certainly have to increase its current net short in order to cover unsold inventory, new crop plantings and on-call positions. If that were the case, then speculators would have to turn into net buyers to facilitate trade selling, but with the chart still in a bearish trend channel, what will change speculators' minds?

So where do we go from here?

Recent reports seemed to tell the market “don’t worry, the pipeline is flush with cotton throughout the season and there is a lot more on the way next season”. This has increased outright pressure and also forced more carry into the market.

Since we believe that the trade is currently under-hedged and therefore needs to increase its net short position over the coming months, the question is what will it take to turn specs into net buyers. Maybe a US/China trade agreement would do the trick or a batch of strong export reports on February 22nd might help, but unless some bullish catalyst is found, the market will likely continue to drift lower and spreads will continue to widen.

Therefore, while some bullish spikes can’t be ruled out, we feel that the market will remain on the defensive as we head into the planting season.