ROSE ON COTTON – COTTON MARKET SURGES, BUT THERE ARE BEARISH SCENARIOS

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The ICE Dec cotton contract surged for the week, gaining 659 points finishing at 114.85, with the Dec – Mar spread inversion ballooning to 363. Dec posted a 905-point win for Oct. Last weekend our models predicted a finish on the week that was to be near unchanged to higher Vs the previous Friday's settlement, which proved to be correct. Still, we did not recommend trading this bias. Mar is now the *de facto* lead month by virtue of having the greatest open interest on the board. The rolling of the lead month this early is unusual.

Futures moved higher on continued strong export sales data for the week ending Oct 21 and the onset of poor harvest conditions across much of The Belt, which is significant in that Nov is normally a poor harvest month for many areas. This is especially true for the Mid-south. The market seemingly ignored slow US export shipment figures (with no relief in port bottlenecks in sight), poor domestic economic growth reports, and strengthening US currency, which seems linked to danger of the Biden administration's outrageous tax-and-spending legislation not being passed.

At any rate, should it pass, it will be much watered-down Vs its original version.

While we do not normally provide an in-depth analysis of likely market movements over the medium- to longer-term in this column, we are making an exception this week as we feel there are numerous items market participants should seriously consider.

With respect to strong demand for US cotton, it should be noted that Turkey and China (mostly) remain the only significant takers of our domestic crop. China can still, in general, land US cotton on its shores for 10 – 20 cents less than it can purchase cotton domestically. Turkey may well be the primary beneficiary of the boycott of Xinjiang cotton from brands and retailers based mostly in the western world. Demand has been effectively rationed across most locations simultaneously with a US having shipping/port crisis. We read one noted analyst that opined the slow shipment pace was bullish with the pipeline still needing much filling. We disagree, based on conversations with several individuals across the trade.

While the facts that the largest portion of this season's crop has been sold, mills have large on-call commitments, and minimal certificated stocks are all supportive factors for the cotton market, there are bearish scenarios to consider. First among these is the market's steep inversion (negative carry) which incentivizes merchants to move cotton to mills quickly. The US no longer has a domestic spinning industry large enough to allow merchants to incur carrying costs in anticipation of passing the costs along to domestic spinners at a flat price. Hence, the trade's ability (currently limited) to offshore cotton is crucial to its economic well-being. Further, amid shrinking projections of economic growth (domestically and worldwide), surging US inflation, and reductions in world cotton consumption, offshore sales cannot go unhedged as they are subject to cancellations or outright default.

We recognize that Commitments of Trader's data is fluid and dynamic, but if we were to take the trade's latest reported aggregate net short position as fixed for some time-period forward, the trade loses (or must maintain/increase margins on its futures hedges) nearly $80M for every cent the market moves higher (options and swap strategies are not applied here). So, the trade needs prices to move lower so that it can stop making margin calls/preparations, sell more cotton, stimulate consumption all along the value-add chain, and (most importantly) add carry into the market.

The trade can accomplish such by beginning to certificate new crop bales as they are made available within delivery point warehouses. Specs abhor certificated stocks on the same level as merchants do inversions and take sharp increases in stocks as a sign to liquidate. They do not want to own physical cotton. Increasing certificated stock is, in fact, the manifestation of the notion that a sale to the board is either the most profitable sale, the best risk aversion strategy, or both. Given that the certification of high-quality bales is now easier than ever to accomplish, certificated stock could increase notably effectively overnight. We expect to see an increase in cert stocks soon.

For the week ending Oct 24, the US crop was rated in 64% good, or better, condition, which is unchanged Vs the previous assay period. However, the condition of the crop in Texas was notably improved. That said, we believe that condition ratings are a moot point at this juncture. The US harvest was estimated at 35% complete, up 7 percentage points on the week and Vs the rolling 5-year average of 41%. While we expected greater progress, it should be noted that the harvesting of cotton is slow Vs that for grains.

On the production side, most of The Belt is expected to see mostly clear conditions, with only some light showers expected across the Mid-south and the southeastern states over the coming week. Temperatures are expected to plummet late in the week.

Regarding 2022 acreage in the US, which is currently a hot topic, many believe that cotton acreage will be up notably next year. We are not so certain; cotton is an expensive crop to grow and takes considerable energy inputs, especially when considering nitrogen fertilizer. While we think acreage may be up, we could see a larger increase in southern soybean acreage, which does not require such fertilizers. We had expected to see an increase in wheat acreage across the southern states, but a late crop and a wet fall seem to have made such unlikely.

Net export sales and shipments were lower Vs the previous assay period at approximately 367K and 66K RBs, respectively. The US is 57% committed and 13% shipped Vs the USDA's 15.5M bale export projection. Sales were again well ahead of the weekly pace required to meet the USDA's export target while shipments continue to woefully miss the mark. Sales are well ahead the average expected pace for this point of the season while shipments are near on par with the historical expectation. China and Turkey were responsible for 95% of 2021/22 new sales, while China bought all 20K RBs sold against 2022/23. Cancellations were negligible.

For the week ending Oct 28, the USDA classed approximately 934K running bales (RBs), of which almost 84% are deliverable against ICE contracts. The cumulative total for the season is now nearly 2.61 million RBs, with almost 86% tenderable. The pipeline continues to fill.

Internationally, the US and China are set for further bilateral trade talks as Phase One terms will need to be revisited by

Dec. Some believe this helped move the market higher last week. We hope that negotiations go better than nearly everything else has for the current administration and the nation's interests thereunder. We think that upward movement might have been more linked to the troubles the administration is having in legislating its historically expensive welfare and tax agenda.

For the week ending Oct 26, the trade reduced its futures only net short position against all active contracts to approximately 16.43M bales; large speculators reduced their aggregate net long position to just south of 7.75M bales. Managed money firms continue to keep their outright shorts at an alarmingly low level, and this could lead to quick (and potentially lasting) market breaks, especially if an increase in certificated stocks underlies a market break.

Producers who have read to this point have a lot to digest and consider and there are alternate scenarios being presented in other quarters. Regardless of whether one takes a bullish or bearish perspective going into the mid-to-long term, two things are crystal clear to us. First and foremost is that selling cotton over a dollar is a profitable win. Current prices are at historical highs, and represent a net return substantially above the cost of production. Secondly, 2022 crop prices in the 90s are an invitation to price 10-25% of new crop. The range between the most bullish and the most bearish realistic scenarios being presented for 2022 is substantial, but under any scenario, cotton sold for 90 cents is a winner.

For this week, the standard weekly technical analysis for and money flow into the Dec contract remain bullish, with the market now overbought. Harvest pressure, economic concerns, and (potentially) an increase in certificated stock could cause problems for the Dec and Mar contracts over the near- to medium-term. Index fund rolling continues over the coming week.

Have a great week!

Report Courtesy: Rose Commodity Group

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