Thompson on Cotton: Fundamentals Large and in Charge

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Short of being caught on the dark side of the moon, it was difficult to miss last week's market excitement. December cotton futures rallied for over a two-cent gain on the week. Of course, this was no major feat as it has been equaled many times before. However, it was a milestone because it broke long-standing resistance at 89 cents setting both a contract record close and intraday settlement high of 89.93 and 89.95, respectively.

More importantly, the strength of this breakout was a play on fundamentals, not on the whim of some outside influence. As we entered the week, the focus was on USDA's July Supply and Demand numbers and fears of escalating inflation. The latter appears legit as the consumer price index rose 5.4 percent from last year, the fastest pace in 13 years. It was also reported 47 percent of the businesses in the U.S. raised their prices last month, the largest percentage since 1981.

Despite this, retail spending increased in June by 0.6 percent, with clothing store sales up over 2.5 percent. Still drunk on stimulus money and lower debt, consumers are content to continue their buying binge. The resulting increase in global cotton consumption on top of already tight inventories makes meeting this demand very difficult. Simply put, it’s a recipe for higher prices.

The WASDE report was reflective of this as USDA increased world mill use to 123 million bales. This is quite bullish considering last year’s mill use was 118.5 million and the previous season totaled only 103 million bales.

Domestically, the numbers were slightly more bearish. U.S. production was raised to 17.8 million bales, an increase of 800,000 bales from a month ago. Despite per acre yields being lowered, a significant reduction in abandonment led to this larger crop estimate. We think the crop is as big as it is going to get as the lateness of it and adverse field conditions will serve to suppress yields in many locations.

Spec traders and fund managers seem to maintain this same sentiment, steadily adding to their long position fueling this breakout while helping move prices from 85 to 90 cents. With additional buying power at their disposal, they will be closely monitoring the supply/demand situation over the next several weeks as things unfold.

Weekly export sales, a strong indicator of demand, were less than stellar this week, but the Fourth of July holiday may have been a contributing factor. Combined current and new crop sales totaled 157,270 bales, down 33 percent from last week. In addition, shipments of 189,340 fell below the weekly level required to meet the current crop export estimate by July 31.

Of some concern, current sales for the next marketing year total 2.8 million bales versus 3.5 million bales this same time last year. But don’t get alarmed yet. We think the lack of available unsold inventory may be more the reason for this rather than a lack of demand. Nonetheless, this bears watching going forward.

The most recent crop conditions report shows improvement as that rated good to excellent increased from 52 percent to 56 percent for the week versus 44 percent at this time last year. In our opinion, this is very misleading for we do not think it fully accounts for the lateness of this crop.

One must not overlook the percentage of the crop currently setting bolls compared to last year. It is 17 percent vs. 30 percent in Alabama, 10 percent vs. 26 percent in Mississippi, and 23 percent vs. 31 percent in Georgia. Thus, it is felt the crop is as big as its going to get.

With a 17.8 million bale crop posing little threat to the market at current demand levels, anything smaller will be viewed as bullish.

Where to from here? Grower selling will certainly constitute resistance at ninety cents. As of Friday, they were 626 December contracts being offered at 90 which is three times what one would historically see. Nevertheless, cotton fundamentals are the strongest they have been in sometime.

Therefore, look for resistance at this level to be broken in much shorter time than was 89 cents. If the market can find its way to close above 90, look for a two to three cent run as charts will entice technical traders and specs to the buy side.

Always keep in mind that at these lofty levels you are ever closer to an overbought condition versus an oversold one. Therefore, continued positive news will be required as a bull must be fed daily.