Thompson on Cotton: Does Downside Risk Outweigh Upside Potential?

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Advancing 174 points, December cotton futures closed the week at 94.84 finding itself within two cents of the contract high of 96.71. Though trading activity was much less volatile than that of the previous week, a host of uncertainties remain.

The current market resembles a mountain climber who has been scaling a steep, precipitous slope with ease but is now struggling to breathe as air becomes thinner, terrain rougher, and ominous storm clouds start to immerse him. Climbing higher requires every hand hold be meticulously placed to safeguard a potential fall.

The darkest clouds center around demand concerns. Due to the resurgence in Covid cases, renewed business restrictions are being imposed, especially in major textile producing countries of the Far East. Subsequent labor shortages are interrupting transportation and creating logistical disruptions giving an appearance of lower demand.

The spread in polyester prices versus that of cotton is narrowing ever closer to the inflection point that could trigger a switch to man-made fibers. Consumer spending in July barely met expectations increasing only 0.3 percent when compared to June. One must think consumer confidence is being shaken not only by Covid but also by a bewildered Administration and the uncertain aftermath of botched evacuation attempts in the Middle East.

However, all is not negative. Fed Chairman Powell stated Friday he does not see a rise in interest rates soon for its still felt inflationary pressures are temporary. This was welcomed news to all markets.

Combined current and new crop exports sales were respectable exceeding 300,000 bales for the week. Most notable was over half these purchases came from Western hemisphere countries. This was likely the result of Covid issues in the Far East causing transportation snarls and factory closures.

The USDA raised their crop outlook for the fourth consecutive week with 71 percent rated good to excellent. This is quite impressive considering the ten-year average is only 47 percent. Even more extraordinary, Texas is rated 70 percent good to excellent when the ten-year average for the state is a mere 33 percent.

There is no doubt these numbers will decline as Hurricane Ida made landfall on the Louisiana coast yesterday as a strong Category 4 hurricane with sustained winds over 150 miles an hour. Once inland, the path is projected to move through the heart of cotton production in the Midsouth with possibly Category 2 winds still prevailing.

The Managed Funds (Spec community) will be watching all the above closely. Keep in mind that cotton prices follow in direct correlation to their net long position, as seen in the accompanying chart. The August 28 COT report showed the Funds increased their net long position to 8.4 million bales.

The record high was 12.3 million bales in February of 2017 thus potential buying power remains.

Conversely, the trade net short position now stands at 17.1 million bales providing firm support. The last time the net long-net short spread was this large was in February 2018. This was when the US/China trade war erupted to be followed by Covid which sent prices from 93 cents to 48 cents as the Funds liquidated their long position from 12.4 million bales to a net short of 2.8 million bales in the span of six months.

Currently the situation is somewhat different, though Covid still threatens. More imposing today, we are dealing with its repercussions, the likes of which has us sailing in uncharted waters.

Where to from here? History indicates each time the managed funds have accumulated a net long position of 10 million bales or more, a steep liquidation followed within six months.

In the short term, the tug war of between unfixed on call sales and the specs sizeable net long position should keep the market in place. It’s even possible prices will move slightly higher as we approach harvest. Nonetheless, at these lofty levels spec traders can be easily spooked. Thus, it’s conceivable the downside risk is greater than any upside potential at these heights.