Cotton Compass

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Monday, February 28, 2022

Arthur……or Martha? We have no idea.

	High	Low	Close	Change (week)	Change (month)
May 22	125.13	115.86	118.63	-2.53	+0.19
Jul 22	121.48	113.21	115.34	-2.79	-0.42

EXTREME uncertaintly reigned through the tail end of the week, as the market attempted to weigh the implications of Russia's invasion of Ukraine on global stability. Worst case and best case scenarios seemed to vaccilate throughout the Asian and US sessions on Thursday and Friday, with wild and unpredictable swings playing havoc with physical participant's sentiment and hedge strategies. Part of the volatility was no doubt driven by speculative participants further lightening their long positions.

The reality – and the market is telling us this - is that no-one has any idea what is happening, or how it will play out both for our own commodity, for the wider global economy, and for the "world order" – whatever that is. The worst case…which we are loathe to even suggest let alone print…is that Russian territorial ambitions do not stop at Ukraine, and that China seizes the opportunity with an incursion into Taiwan – perhaps even as a premeditated divide and concur strategy. Lets hope and pray (to whoever you choose) that this is not the case, and that a best case scenario (whatever that looks like) plays out from here.

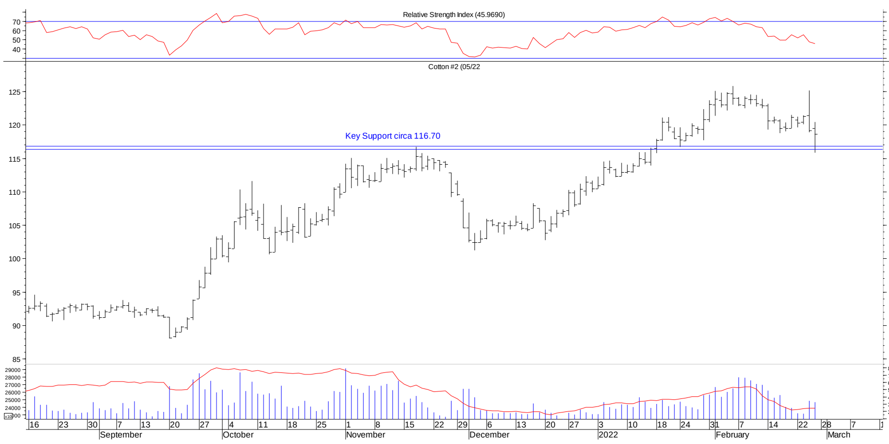
Needless to say, cotton wasn't the only whippy market, with global stock markets trading wildly, while wheat managed to carve out sequential limit up and limit down days on Thursday and Friday. We've attempted to illustrate this with 5 day charts on Page 3.

US Export Sales were, perhaps, the bright spot for the cotton market this week…..although you couldn't really tell from the market's reaction on Friday. Net sales (including Pima) for 2021/22 totaled 252,100 bales and for 2022/23 218,200 bales, while actual shipments (including Pima) were a marketing year high of 394,100 bales. The shipments number remains our key focus…..and ultimately could prove a double edged sword. The US needs to ship 400,000 bales plus to meet USDA export targets and keep their domestic balance sheet manageable…..but ultimately this moves stock from origin to destination….which potentially deflates the "artificial demand bubble" that we believe has been inflating price for the last 12 months.

The USDA Outlook Forum on Friday pegged US area at 12.7 million planted acres – up 13.2% from last year, with a potential production total of 18.2 million bales. This was well above the National Cotton Council (12.035 million acres) 10 days earlier, which suggested production of 17.3 million bales using 10 year average abandonment and 5 year average yields. As per last weeks report, using NCC's numbers we came in at 16.3 million bales.

Looking at market relative markets, in the last 12 months, CME Dec corn and Nov soybeans are up 18.7% (going from the "12 month low" to Friday's close), with ICE Dec cotton up 38.4% using the same methodology. Whilst we are comfortable that cost of production considerations do not particularly favour cotton – a straight price comparison with competing crops probably compensates to an extent.

Technically, we have had the drop into the suggested 116-117 cent zone (with the market bouncing hard from Friday's low of 115.86 on the May). However, with so much outside market and geopolitical volatility we have no real confidence in this bounce yet. The next week – and the broad 116-117 cent zone feels pivotal.



AUSTRALIAN CASH MARKET

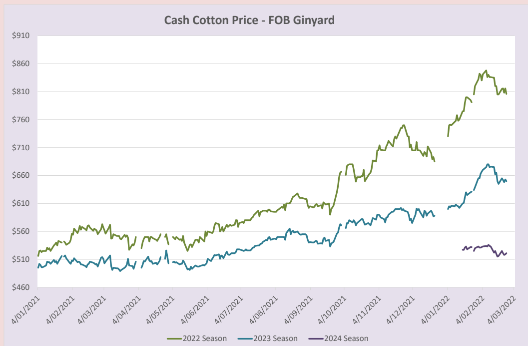
	A$/bale Close	High Weekly	Low Weekly	Change this wk
2022	$806	$816	$806	+$1
2023	$650	$655	$648	+$5
2024	$521	$525	$518	+$5

2022 Crop

Cash markets were moderately – but not heavily - active, with growers justifiably uncertain over the medium term geopolitical risks to this market. We suspect if it wasn't for the large rain event in Northern NSW/Southern QLD that grower sales appetite may have been stronger. That said, several of those with more 'room to move' on sales opted to add to positions while price held above $800/bale (which it did for April-August throughout the week). This move looks vindicated for now, with cash markets likely to open today closer to $790 than $800/bale.

Looking forward: The situation – from our point of view – is that no one knows how commodity futures, equities and currency markets will play out as the current situation unfolds. The only thing we do know is that as a grower you don't get too many shots at circa $800/bale cotton in your lifetime.

Production-wise: Whilst we suspect the heavy rain and cloudy weather of recent days has knocked the cream out of yields (particularly for those crops with a heavier fruit load) – we still believe we could be in for a surprise to the upside in terms of average yields. See Page 3.



Price Outlooks 2022 Crop:

Outlook this week: A$800 - 880/bale

Outlook 1-2 months: A$680-820/bale

2023 & 2024 Crop: 2023 was steady…with mostly smalls trading at $650+ throughout the week.

Hedging Model: No changes

2022 Crop Hedging Model		
Prodn Guess	Sales	Orders
5000 bales – 85% sold @ $635.94 average	500 @ $550 250 @ $575 500 @ $575 1000 @ $595 500 @ $625 500 @ $655 500 @ $720 500 @ $803	
2023 Crop Hedging Model		
5000 bales – 40% sold @ $600	500 @ $550 500 @ $580 500 @ $600 500 @ $670	

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EXPORT MARKET SUMMARY

CONSUMERS, quite understandably, were sidelined for much of last week as the disturbing Russian/Ukraine events took hold. No doubt, there are also some uncertainties surrounding how it could impact the geopolitical situation closer to Asia. That said, with inventories (at destination) still generally tight – and logistics issues likely to get worse, not better, as this crisis unfolds, the stage remains set for exagerrated demand signals unless we face a serious global economic slide….and there is definitely still fill in spot business for prompt slots being done on a daily basis – crisis, or no crisis. For context, low grade recaps (prompt shipment) are trading at more than 1000 on CFR Asia for March/April.

Inflation Rates in Consuming Countries:

Emerging country inflation remains on the rise – particularly in local currency terms (due to relative appreciation of the USD). This situation is most obvious in Turkey, and arguably insulates exporters from the challenges facing their respective domestic economies

	Local Currency	USD
Bangladesh	5.86%	4.80%
China	0.90%	1.91%
India	7.30%	5.15%
Indonesia	2.20%	0.16%
Pakistan	13.00%	2.83%
Philippines	3.00%	-3.18%
Thailand	3.23%	-7.09%
Turkey	48.69%	-19.71%
Vietnam	1.94%	3.98%

***Estimated offer US c/lb (C&F Main Asian Ports, 1-1/8", 3.5-4.9 NCL)**
Note – add 400-600pts for subcontinent markets

Origin	Offer Nearby	Offer Deferred	Eg Sales
Aus SM, 37	+1450 (N) J/A	+1400 (N) A/S	
Aus M, 37			
US 31-3-36 GC	+1600 (H) A/M	+1600 (K) J/J	
US 31-4 36 GC			
US 41-4 36 GC			
Brazilian M, 36	+1650 (H) M/A	+1500 (Z) O/N	
Fr W Afr (s), 36	+1550 (K) A/M		
****PSF**	55.24 US c/lb	+2.42 (week)	+0.49 (month)
Yarn 32Ne-China	4.71US $/kg	-0.01 (week)	+0.19 (month)
Yarn 40Ne-China	5.21 US$/kg	0.00 (week)	+0.10 (month)
Yarn 30Ne-India	4.79 US$/kg	0.00 (week)	-0.03 (month)
Yarn 40Ne-Paki	5.33 US$/kg	0.00 (week)	+0.13 (month)

*Offers estimated based know/est levels Friday Asian business hours adjusted for futures
** PSF = Polyester Staple Fibre (1.4 D / 38mm) ex works China
*** Yarn (India) = 30Ne 100% Cotton Combed, ring spun knitting yarn (ex work)
**** Yarn (China) = 40Ne combed cotton yarn (Qiangqing Market (Zhejiang))
*****Yarn (Pakistan) = 40Ne combed cotton yarn (C&F Main Asian ports)

AUSSIE BID/OFFER SPREAD

The chart right attempts to illustrate the spread between the bid for Australian cotton (Middling 1-1/8" ex ginyard Central Valleys) vs the offer (SM 1-5/32" CFR Main SE Asian ports). The chart is not perfect, given that for the purposes of the data the basis for the best "bid" is based off an April-August delivery window (and/or the spot market in between crop years), whereas we use the cheapest basis for the most active nearby offer period to calculate the sell side. Whilst it's not perfect, it is illustrative.

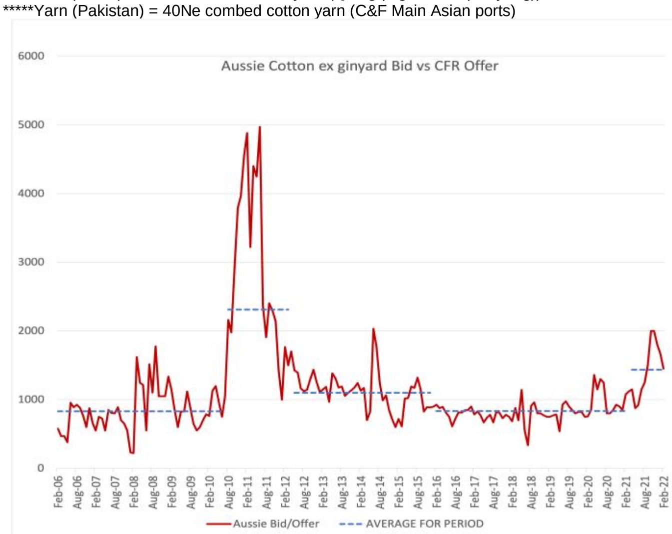
What does this tell us: In the 16 years we have kept this data set, the long term average bid/offer spread has been 1155pts. If we ignore the October 2010 to June 2011 extremes, that average falls to 975 pts. *We calculate the current bid/offer spread at about 1450pts (depending on timing)*….so clearly, we are at an historically wide spread right now.

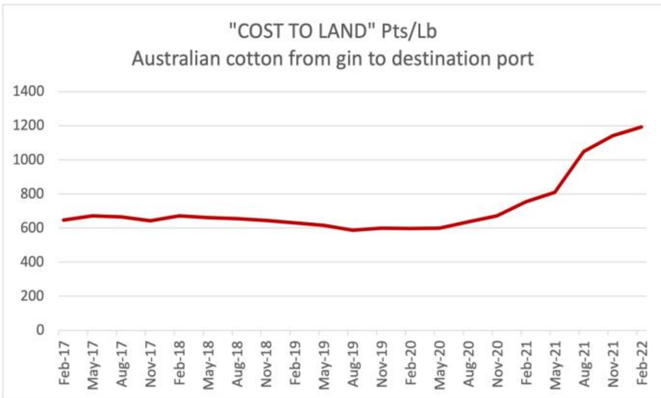
Why? Essentially, the bid/offer spread in the chart right is made up of the merchant's costs to move a bale from the gin to the final destination port plus a margin. Part of the reason for the current wide spread is clearly to do with risk/reward….and part of it is to do with costs.

Risk: High volatility, high prices and the steep market invert we are currently experiencing increase risk to the merchant – including margin and default risk – and spread risk if they get the timing of their hedges wrong. Higher risk trading should logically generate higher potential reward.

Costs: It should come as no surprise to anyone that the cost of moving a bale of cotton from gin to final destination port has increased over the last two years. In large part, this is due to rising cost of container freight (see page 3) – but domestic trucking costs and warehousing fees are also on the rise – and it is worth remembering that a chunk of a merchants costings (eg selling agent commissions and insurance) are based on a percentage of the sale value…..which means those costs go up as the price of raw cotton moves higher. Throw in some currency fluctuations, and overall, our estimates suggest at commercial rates the "Cost to Land" from ginyard to main S-E Asian destinations has increased from about 600pts/lb in early 2020 to around 1200pts/lb today.

Overall then, it appears despite the historically wide "bid/offer" spread, the paper margin for a merchant has not increased much – if at all - over the last 12-18 months. Clearly, the current unusually wide divergence in individual merchant bids reflects their respective pricing of risk going forward.





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OCEAN FREIGHT…..just how bad is it really?

Pretty bad as it turns out. The table right represents the results of a survey we conducted of merchants regarding the freight rates they are seeing to various key destinations for Australian cotton. The survey was conducted prior to the Russian invasion of Ukraine – which likely won't have helped the situation. It should be noted that it is our assumption that the "dearest rates" noted in the table were for larger volume shipments – whereas the cheapest rates are more likely for smaller, spot opportunities. Regardless, the numbers speak for themselves considering that just a few short years ago, cotton could be shipped to most key Asian markets at less than US$500/40'. That said, to put things in perspective – for a grower (considering each 40' container holds 110 bales of cotton), every US$100/40' increase "only" equates to about A$1.25/bale. So even a US$1000/40' (A$12.25/bale) increase is hardly a biggie considering day to day market swings can easily equate to A$15/bale or more. Rather, the risk here sits squarely on the merchant trying to run a 'cost plus' operation on relatively slim margins in what is largely a forward market.

Since COVID induced bottlenecks really started to bite about 18 months ago, our survey suggested that on average, merchants believed freight rates to China had increased 275%, to North Asia (eg Korea/Taiwan) had increased 325%, to South East Asia (eg Vietnam/Thailand/Indonesia) had increased 400%, and to the Subcontinent had increased 840%. There were some pretty wide variations in these estimates.

Confidence in their ability to source containers and services was unsurprisingly greatest for Chinese, North Asian and South East Asian markets (mostly in that order), whereas there was very little confidence for the Indian Subcontinent and Turkish/European markets.

Going Forward, approximately 40% of merchants felt the situation would improve going into third quarter 2022, about 40% thought it would be similar, and 20% thought it would get worse.

Other Considerations: The reality is that with large crops of everything on the East Coast (winter and summer) there is plenty of 'seasonal' competition for port and container capacity. Whilst most grain will be shipped in 20' equipment, there is potential that some sorghum will go out in 40's – and certainly some cottonseed. With those two products destined mostly for Chinese markets, shipping lines will be keen to reposition those containers where they need them.

Merchants are also concerned that now shipping lines have a 'taste' of what they can charge for shipping, they are unlikely to relinquish ground on rates without a fight. Furthermore, the potential logistics implications surrounding the Russian/Ukraine conflict – and rising energy prices cannot be ignored. Tricky times.

Table – "All In" Ocean Freight Rates – merchant survey

	Cheapest	Dearest	Average
Jakarta	US$1200/40'	US$3500/40'	$2142/40'
Ho Chi Minh	US$1200/40'	US$3000/40'	$2058/40'
Busan	US$1200/40'	US$2500/40'	$1742/40'
Bangkok	US$1200/40'	US$2800/40'	$2025/40'
Keelung	US$1200/40'	US$2500/40'	$1833/40'
Mersin	US$6000/40'	US$9000/40'	$7286/40'
Mumbai	US$7000/40'	US$9000/40'	$7667/40'
Karachi	US$7500/40'	US$9000/40'	$8200/40'
Chittagong	US$7000/40'	US$9500/40'	$8333/40'
Shanghai	US$800/40'	US$1350/40'	$1167/40'

CROP SURVEY

For the first time in several years, we ran an agronomist/industry representative survey last week to try to help clarify yields in our crop model. The survey results are encouraging, and are suggest the crop is broadly in line with previous "average to slightly above average" seasons. It does not, at this stage suggest "gin busting" yields, but we believe it does now point toward a 5.2 million bale (plus) crop. It should be noted that, in the past, late February surveys have tended to be conservative – particularly on dryland yields. It should also be noted that the survey will not have taken into account the impact of the East Coast deluge late last week. We will publish a crop update next week utilising this data.

Irrigated	**Very Poor (<6.25b/ha)**	**Poor (6.26-8 b/ha)**	**Satisfactory (8.1-10 b/ha)**	**Good (10.1-12.5 b/ha)**	**Excellent (>12.5 b/ha)**
	0.2%	2.0%	22.4%	42.0%	33.3%
Dryland	Very Poor (<1.25 b/ha)	Poor (1.26-2.5 b/ha)	Satisfactory (2.6-3.75 b/ha)	Good (3.76-6.25 b/ha)	Excellent (>6.25 b/ha)
	0.0%	5.2%	32.4%	57.7%	4.7%

OUTSIDE MARKET VOLATILITY

What a week. These 5 day charts (30 minute bars) are just an attempt to illustrate the wild, unpredictable swings experienced elsewhere.

Chart 1: Dow Jones Industrial Average – 1 Week

Chart 2: Chicago SRW Wheat (May contract) – 1 week