Trade Idea – Commodities
Upside potential for Cotton.
31st March 2016

Chinese inventory auction weighs on cotton price

- US cotton prices are currently hovering at seven year lows following a -8.7%* fall year to date. The decline comes after an announcement from China’s National Development and Reform Commission detailing plans to offload a portion of the nation’s vast cotton reserves, a move which risks further depressing import demand from the world’s largest consumer. Cotton prices have fallen 73% from a 2011 peak of over USc 200/lb as rapidly declining import demand from China and tough fibre competition from man-made materials (such as polyester) have pressured global prices (see Figure 1). However, at current depressed levels a tactical opportunity may be on the horizon. Chinese cotton auctions, like the one recently announced, have, in the past, fallen short of market expectations. If the upcoming stock sale disappoints then cotton prices could quickly become subject to a short covering rally, especially as speculative short cotton positions currently sit at record highs. In addition, there are some initial signs that the fundamental picture of the global cotton market may be improving, albeit by a small amount.

Figure 1

Chinese stocks climb as imports plunge.

Market awaits auction details

- Last year, a similar cotton auction held by the Chinese authorities failed to muster considerable buying interest as offered prices exceeded market levels, resulting in only 3.4% of the total stock on offer being sold. Details of the upcoming inventory sale remain unknown. Revelation of its size and speed will have considerable bearing on cotton prices in the near term. Should the auction fail to meet market expectations, cotton prices have potential to gain some upward momentum as speculators with short cotton positions are forced to hedge exposure. Similarly, risks lie to the downside if the opposite occurs,

*All figures quoted are sourced from Bloomberg unless stated otherwise.
however the market will be harder to surprise in this direction as negative implications from the auction have already been somewhat priced in.

• While fundamentals for cotton prices remain far from ideal, there are some small signs of improvement. Recent reports from the International Cotton Advisory Committee (ICAC) and the United States Department of Agriculture (USDA) show that global cotton stocks are set to fall by approximately 8% this year, the first decline in five years. The decline in ending stocks looks to be driven by falling production from China as domestic producers reduce output in response to ongoing price weakness.

Shorts near record levels

• Net speculative cotton positioning reached a 10 year low this month as short positions rose to an all-time high and speculative long positions retreated to a two year low (see Figure 2). The rapid accumulation of short positions leaves cotton prices vulnerable to a pullback, should an appropriate catalyst emerge. With the upcoming Chinese reserve auction at the forefront of market concerns, it has the most potential to be a cause of such a pullback.

Figure 2

Speculative shorts at record levels.

CFTC NYCE Cotton Speculative Net Positioning, 000's Contracts

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