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Cotton Is Set for ‘Epic Showdown’ Between Hedge Funds and Mills
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By Marvin G. Perez

(Bloomberg) -- Hedge funds are abundantly optimistic about cotton prices. But just as the excitement escalates, farmers are gearing up to increase plantings in the U.S., the world’s top exporter.

Cotton has been the recent star of the crop world, with prices heading for a third straightly monthly gain. The advance was underpinned by demand that’s poised to increase to the highest since 2008. That captured the attention of investors, who have piled into speculative wagers that futures will keep climbing. But it’s also caught the eye of American farmers who are in the midst of making planting decisions at a time when grain prices have stayed historically low.

U.S. cotton plantings this year will probably reach the highest since 2011, a Bloomberg survey showed. The rising acreage could be why commercial traders such as textile mills have taken the opposite approach of hedge funds and are holding a huge short position, or bets on falling prices.

“The market is setting up for another epic showdown between speculative longs and trade shorts, and at this point it is still anybody’s guess who will prevail,” said Peter Egli, the Chicago-based director of risk management for Plexus Cotton Ltd.

“This could turn into a drawn-out process, with prices moving in a narrow band for another two or three months before a final blow.”

Net-Long Holdings

In the week ended Jan. 23, money managers held a cotton net-long position, or the difference between bets on a price increase and wagers on a decline, of 108,162 futures and options, according to U.S. Commodity Futures Trading Commission data released Friday. That’s just shy of the record 108,778 from a week earlier, data going back to 2006 show.

On ICE Futures U.S., cotton prices jumped about 17 percent since the end of June. The rally was helped by declining global stockpiles as demand stayed high. Crop-quality issues have also curbed short-term supplies in India and Pakistan, while a weaker dollar improved prospects for American exports.

“The economy is rallying and cotton has been certainly going along with it,” Oliver Kinsey, a New York-based portfolio manager for Ballymena Advisors LLC, said in a telephone interview. “Yes, there’s demand, but cotton is not some blockbuster bull market.”

While investor buying helped push open interest, or contracts outstanding, to a record, commercial traders loaded up on short positions, indicated by open on-call contracts representing unhedged sales. Since the shorts must be closed by buying a long contract, several analysts have said in recent weeks that the confluence of the two big holdings leaves the market vulnerable to big price swings.

Rising Acres

Adding to the uncertainty: rising U.S. plantings. In the 12 months starting Aug. 1, sowings may rise 4.8 percent from a year earlier to 13.2 million acres of cotton, according to the average of 10 traders and analysts surveyed by Bloomberg.

Cotton is performing "slightly better than last year" when compared with other crops such as corn and soybeans, said Jon Devine, economist at Cary, North Carolina-based researcher Cotton Inc. Strong yields in many growing areas last year may also encourage farmers to favor the fiber, he said.

Still, it's not a done deal for bears. Even with bigger plantings, output could still drop because weather issues can affect productivity. In any case, cotton traders can probably count on more volatility in the coming months.

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