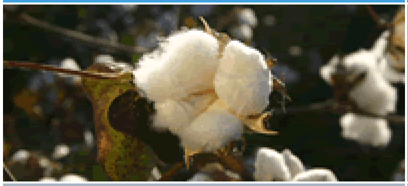

# Plexus Cotton Limited Market Report

PLEXUS
COTTON LIMITED

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NY futures continued to collapse this week, with December losing another 1451 points to close at 119.39 cents, while March surrendered 1256 points to close at 116.59 cents.

It is hard to believe that in a matter of just ten sessions the December contract has dropped nearly 48 cents, falling from an intra-day high of 157.23 cents on November 10 to a synthetic low of 109.25 cents on November 23. Interestingly, the market held right around the synthetic high of the March 2008 bull market, which was also at around 109 cents.

It was a combination of factors that contributed to this brutal sell-off. From a fundamental point of view the market was clearly getting too rich at 157 cents, since it translated into physical prices in excess of 175 cents, a level at which mills are unable to operate profitably.

With futures prices disconnecting from reality, the market had become a bubble in search of a needle. It found it in the form of macro-economic developments that prompted some hedge funds to cash in their long positions. First there was China's determination to reign in commodity speculators and to combat inflation. Then there was renewed fear of an escalating debt crisis in Europe, which has led to a strengthening US dollar and as if that wasn't enough, we now have North Korea threatening to destabilize Asia.

After running up by nearly 50 cents and then giving it all back in a matter of just over a month, it has become quite difficult to gauge what cotton is really worth today. Basis levels are all over the place and at premiums we have never experienced before. This week US MOT high grades still sold at 28 cents above NY futures for nearby shipment, which is almost 20 cents more than the traditional basis. It is astonishing that mills continue to pay this kind of premium when they could buy more or less the same quality 13-14 cents cheaper in New York. Then there is the ongoing steep inversion between March, May and July, which has not narrowed at all during this selloff and is contradicting this bearish move.

The December notice period serves as an opportunity to figure out what cotton is worth these days. Although it may initially have been viewed as a negative sign that a major Memphis merchant decided to tender 49'300 bales, this isn't necessarily true. Unlike in previous years it makes a lot of sense to put cotton on the board and then take it back in March, May or July at a huge discount. And this season the risk of getting inferior bales back is basically non-existent, because nearly all of the certified stock consists of current crop. At the same time it makes sense from a taker's point of view as well, since certified cotton is, as we have pointed out above, the cheapest cash cotton available right now. Based on where the December has been trading over the past few days and considering what mills are still willing to pay for physical cotton at the moment, it seems that 115-120 cents represents about 'fair value'.

So where do we go from here? The short-term trend is still pointing lower, although Wednesday's session offered hope that some sort of a bottom is within reach. Physical prices still hold the key to this market in our opinion. If they continue to hold up as well as they have been this week, then the futures market will sooner or later have to turn back up. One positive in this regard is that the US crop is over 85% committed at the grower and merchant level, which means that there is relatively little pressure to get the balance sold. This would be different if the crop was only 40% or 50% committed, because merchants would be much more aggressive to push sales than they are now.

Developments on the macro front may continue to spook hedge funds and the clamp down on speculators in China could cause prices to come under additional pressure over the coming sessions. However, we need to bear in mind that consumers in China are probably not going to buy fewer jeans and T-shirts because of these government measures and that the drop in cotton prices is likely to mitigate the anticipated demand destruction, which should be bullish in the long run. Also, with inflation flaring up all over the globe while central bankers keep interest rates artificially low, real interest rates are dropping deeper into the negative, which is bullish for commodities.

In summary, we believe that the market has value at current levels but we can't rule out further downside pressure from the spec sector in the short term.

Best Regards

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