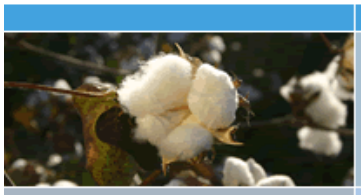

Plexus Cotton Limited Market Report

PLEXUS
COTTON LIMITED

February 3rd 2011

NY futures ended a volatile week with slight gains, as March advanced 247 points to close at 171.86 cents, while December added 220 points to close at 116.06 cents.

The market had another rollercoaster ride over the past five sessions, as March first dipped to 164.51 cents last Friday, then rallied nearly 18 cents straight to a high of 181.22 cents this morning, only to drop 10 cents in the final few hours to close the session at 171.86 cents.

In order to make some sense of this volatile market, we need to take a closer look at what is driving it. When we look at the latest net futures and options positions as reported by the CFTC, we have Index Funds at 4.28 million bales net long, Hedge Funds and other speculators at 5.88 million bales net long and the trade with a 10.16 million bales net short. Although the CFTC report does not specify which months these positions are held in, we can safely assume that the majority is in current crop March, May and July futures.

Most of the trade shorts are either hedging physical cotton or were put on by merchants in order to lock in the price of on-call sales to mills. As of last week there were still 7.9 million bales of unfixed on-call sales based on March, May and July futures. The trade does not really have any other choice but to get out of its net short position in current crop futures by June 24th, because rolling it forward is prohibitive when there is a 44 cents inversion to December and merchants wouldn't allow mills to extend their fixations past the July contract anyway. In other words, the trade has a lot of buying to do over the next 4-1/2 months.

While trade shorts will be forced to cover, Index and Hedge Funds don't have to do anything unless they want to. With this massive inversion they may actually decide to stay long and simply roll their positions profitably from one futures month to the next. In order for the longs to give-up this lucrative set-up, the shorts will have to offer a price they can't refuse. This week's strong rally provided such an incentive, as some specs decided to cash in this morning, setting a steep correction in motion. It may have been a combination of factors that caused some of these spec longs to square up, like the high price itself, overbought 'technical' readings, a stronger dollar, the exchange and CFTC starting to scrutinize positions and uncertainty ahead of tomorrow's acreage report.

Although this correction may have further to go, we are of the opinion that this is simply another correction in a bullish trend and not a trend reversal. We have seen this kind of "two steps forward - one step back" action before and have no reason to believe that the overall pattern has changed. As long as physical prices continue to hold up as well as they are (A-index set a record at 205.05 cents today) and we are seeing 20 markets on the US export sales report competing for the little cotton that remains available, we have to assume that this bull market has some life left in it.

A trend like this typically doesn't end on a whim but with a big firework finale, brought about by massive short-covering. So far we have seen nothing of the sort, as open interest has actually increased over the last few weeks and unfixed on-call fixations in current crop remain stubbornly high near 8 million bales. Only once most of this sizeable trade short position has been liquidated will there be some confidence that a top is finally in place. Until that is the case, the shorts should welcome any correction as an opportunity to get out of trouble.

Best Regards

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