Plexus Cotton Limited Market Report

PLEXUS
COTTON LIMITED

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NY futures rallied past the 2 dollar mark this week, as March surged another 1644 points to close at 204.02 cents, while December advanced just 189 points to close at 133.39 cents.

The current situation in the futures market is akin to someone shouting fire in a crowded theater. A series of limit-up moves over the past few days culminated in today's explosive session, as frightened and panic-stricken shorts were stampeding towards the exit, no matter how great the cost.

With the futures market locked the limit (+700 points) and options trading halted after it had reached double-limit up (+1400 points), the only way out was via spreads and as a result the March/December spread traded as high as 87.34 cents, while the May/December was going for as much as 82.65 cents. This put prices paid for March at over 220 cents, while May was fetching more than 215 cents!

To put this into some perspective, the spot month has now more than tripled in price since this rally started about 7 months ago. On July 20 of last year the December 2010 contract had settled at 73.01 cents, while its successor is currently seeing trades in excess of 220 cents!

As of this morning there were still 13'427 lots open in the March contract, with just today's and tomorrow's session left to get out of harms way before First Notice Day. Based on today's trading volume in March we estimate that there are still around 5'000 contracts open, but most of those should be cleared out by tomorrow afternoon.

So far the Certified Stock of around 200'000 bales (including bales under review) has played only a minor role in this short-covering drama. As long as a massive short position existed, with hardly any cash cotton available for delivery, the relatively small amount of Certified Stock was no obstacle for this runaway bull market. Also, until a couple of weeks ago the futures market was not really overvalued compared to cash cotton, which made the Certified Stock attractive to potential takers. However, with March trading at more than 220 cents today (based on spreads) and with the inversion on the board increasing, the 200'000 bales of Certified Stock could turn into a stumbling block for the bulls after all, at least temporarily.

The bulls will counter that the market is so strapped for cash cotton that the Certified Stock will be snapped up regardless of the price. Today's US export sales report certainly lends credence to this notion, since it was once again exceptionally strong considering how little cotton remains available. For the week that ended on February 10, sales of Upland and Pima cotton totaled 299'200 running bales for both marketing years, with 24 markets participating. Total commitments for the current marketing year now amount to 15.4 million statistical bales, of which about 6.8 million have so far been exported. For the 2011/12 season total commitments amount to 3.3 million statistical bales so far, which is about ten times more than a year ago.

When we look at the latest US balance sheet from a purely statistical point of view, we are already in a deficit situation, which will only keep increasing over the coming months. Total supply in the current season amounted to 21.3 million bales, of which 3.6 million bales are going to domestic mills and 15.4 million have so far been sold for export. This leaves theoretically 2.3 million bales, but since there are already 3.3 million bales in export commitments for shipment August onwards on the books, there is a statistical deficit of 1.0 million bales. If we further add 3.8 million bales in domestic mill requirements for the coming season, the deficit grows to 4.8 million bales. Now let's say that the US is going to sell another 5 million bales until September, or about 160'000 running bales a week, and new crop commitments (domestic and export) could swell to nearly 10 million bales before the bulk of the US crop gets harvested. This means that even if the US crop turns out to be a lot bigger in the coming season, it may take quite a while before any crop pressure is going to be felt.

So where do we go from here? The market is currently fueled by panic short covering in the March contract and to some degree also in May and July, as bears struggle to keep up with margin calls and increasing margin requirements. We therefore should expect to see at least another limit up or two. Once March has been liquidated, it remains to be seen whether there is still enough fuel in the tank to keep this parabolic move going. While anything is possible in an out-of-control market like this, we anticipate that the May and July shorts will temporarily stop chasing prices, while longs are likely to book some profits, which should lead to a short-term momentum shift and hence a correction. However, since the shorts have just witnessed what can happen to procrastinators, we expect any correction to be relatively shallow, since aggressive short covering will likely be waiting not too far below. As of last week there were still over 2.0 million bales in unfixed on-call sales on May and nearly 4.0 million bales on July, which should provide plenty of support underneath the market.

Best Regards

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