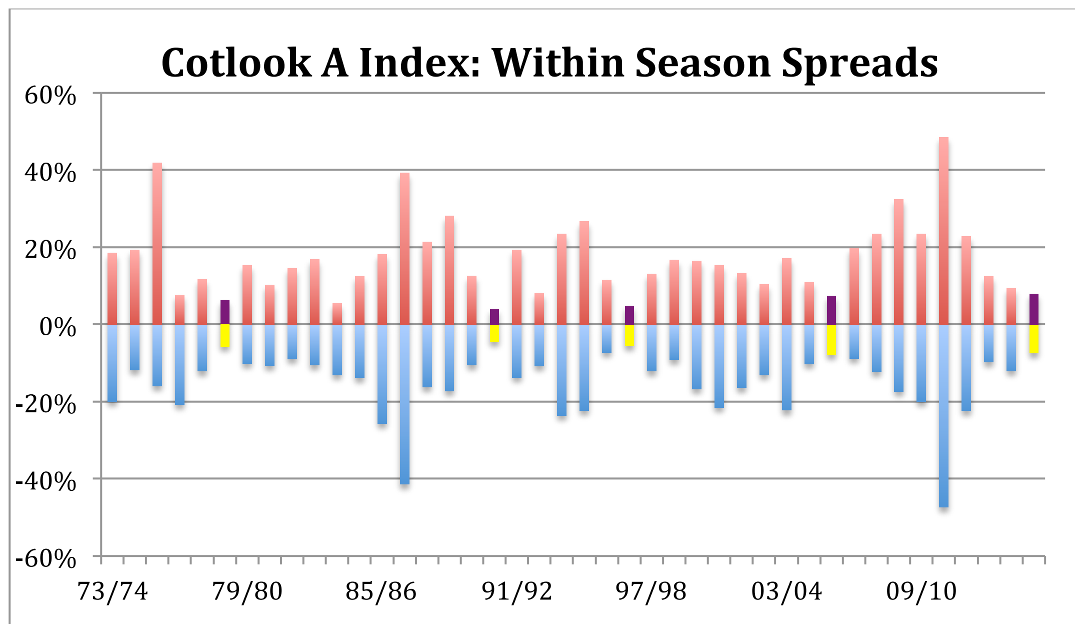
Tough Times for Speculators/Tough Times for Cotton

There is an adage: “Be careful for what you wish; you may get it.”

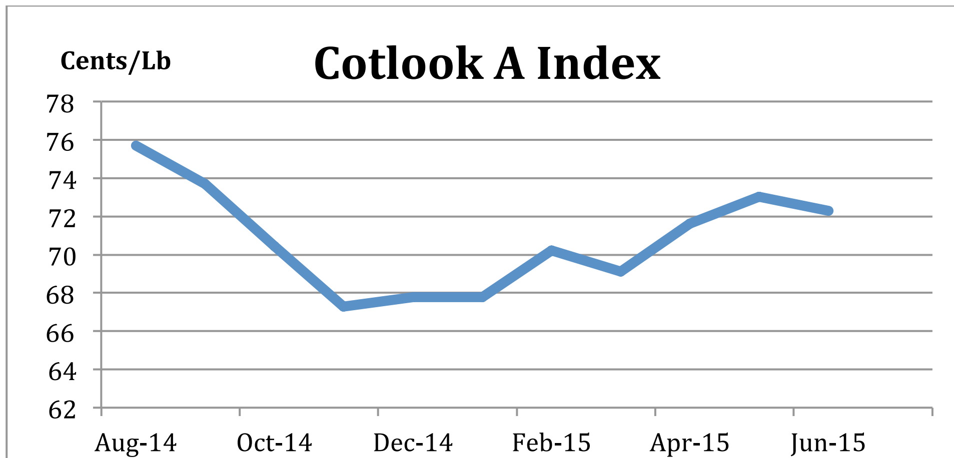
The world cotton industry is experiencing price stability rarely seen, and while some segments may appreciate the tranquility, the industry as a whole will suffer. This may seem counter intuitive as most government officials and many market participants decry price volatility. However, the current stability in prices is not the result of a natural balance between cotton supply and demand. Rather, the current situation results from management of reserve stocks by the governments of China and India.

Stable Prices

With approximately six weeks to go in the current season, the 2014/15 Cotlook A Index has averaged 70.5 cents per pound. The highest quote of the season was 76.15 cents in September and the lowest was 65.3 cents in January. As a percentage of the average, the highest quote was 8% above and the lowest was 7% below, for a total spread of 15 percent of the average this season. Since 1973/74, the average within-season spread between the highest and lowest Cotlook A Indexes has been 32%, and the highest was 96% during 2010/11. In the 42 seasons beginning with 1973/74, the 2014/15 within-season spread of 15% between the highest and lowest quotes will be tied for the 4th lowest.



Furthermore, the December 2015 ICE cotton futures contract has been in a relatively tight band between 61.50 and 66.50 cents per pound since October 2014, for a spread of 5 cents per pound over the last 9 months.



What Does Not Cause Price Volatility?

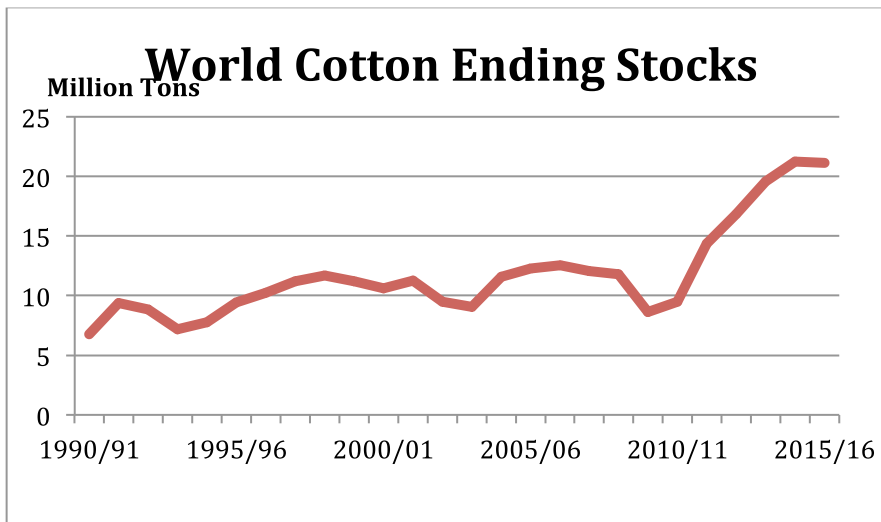
During 2010/11 when the Cotlook A Index rose to an average of $1.64 per pound and briefly exceeded $2, there was much gnashing of teeth over "volatility." Many government officials blamed speculators, futures markets, hedge funds or the "financialization" of commodity markets, meaning the inclusion of commodities in investment portfolios. Speculators, futures markets, hedge funds and commodity portfolios still exist, but prices are no longer volatile. The stability in prices during the current season should put to rest allegations that cotton market volatility during 2010/11 was ever a result of anything other than a wide imbalance between supply and demand.

Price Stability May Continue

In every other instance of particularly low within-season price volatility, including 1990/91 (a spread of 9%), 1996/97 (a spread of 10%), 1978/79 (a spread of 12%), and 2005/06 (a spread of 15%), volatility in prices reverted toward the average by displaying a within-season spread of at least 25% of the average in the ensuing season.

However, that may not be the case in 2015/16. As by now everyone is aware, the Government of China is managing a state reserve of more than 10 million tons, and Minimum Support Price operations by the Government of India account for another 1.5 million tons. Thus, out of world ending stocks of 22 million tons forecast on July 31, 2015, an estimated 12.6 million will be in China and another 1.7 million in India. Two-thirds of world ending stocks will be in two countries, and their respective governments will control 90% of the stocks in those two countries. Accordingly, both the direction of change in prices during 2015/16, and the magnitude of price movements, will be at the discretion of government officials. Both governments, China and India, have a philosophical predilection toward commodity market intervention so as to achieve price stability.

Cotton stocks are so large that even several consecutive seasons of reduced production will still leave government officials in charge of the direction of change in world cotton prices. The ICAC is forecasting 2015/16 world production at 24 million tons and consumption at 25 million tons, which would result in a reduction in world stocks of one million tons. Nevertheless, this would leave world ending stocks at a still more-than-ample level greater than 80% of use.



Record yields for corn in the United States are helping to reduce grain and oilseed prices around the world at this time. However, corn yields will not be record high every year. Over the long run, the biofuel mandates in the United States and Europe will cause upward pressure on the grain and oilseed complex, and cotton prices will look less attractive. Secondly, farmers react to prices with a lag of one year. By 2016, cotton farmers around the world will have experienced a full season of prices that are significantly lower than they were at the start of 2014/15. The result will be continued declines in cotton production in 2016/17 and probably in 2017/18 also.

Nevertheless, this does not mean that supplies available to the market will decline. The stock liquidation by China will continue for several more years until the state reserve has reached a desired level, probably about 5 or 6 million tons, or half the current level. Consequently, lower cotton production will not result in upward pressure on prices for several more seasons.

Therefore, it is likely that the stability in prices evident since October 2014 will continue for longer than anyone has experienced in the last four decades.

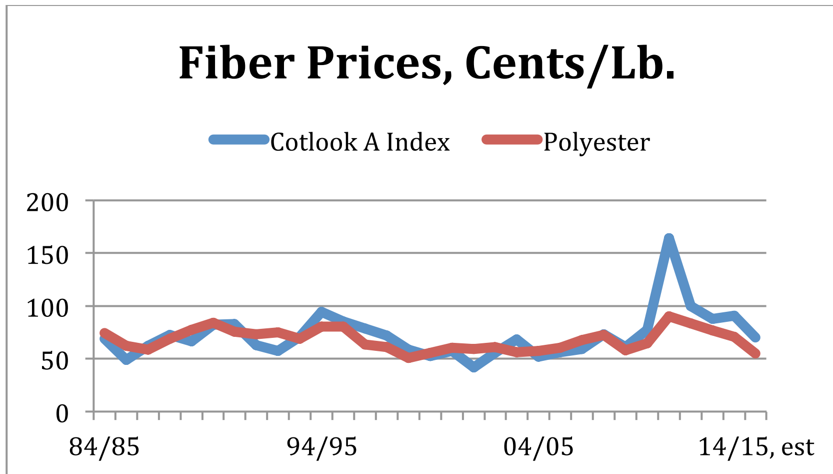
Consequences of Stability

World cotton consumption peaked at 26.7 million tons in 2007/08 and has been lower in the seven seasons since. In the current season, world mill use is estimated at 24.4 million tons, 9% below the 2007/08 level. Mill use is forecast to rise to 25 million tons during 2015/16, and hopefully, further increases will occur in succeeding years. Nevertheless, there is no guarantee that world mill use will ever exceed the 2007/08 level again.

Polyester now accounts for more than half of world fiber mill use while cotton's share has fallen under 30%, and even former bastions of cotton use such as denim are now experiencing inroads by polyester. With the new energy extraction techniques known as fracking, hydrocarbons are now in almost limitless supply, and there are no effective natural constraints to expanded polyester production. China's capacity for polyester

production continues to grow, and as of mid-June, polyester prices in China are more than ten cents per pound lower than the Cotlook A Index.

A very serious consequence of stable prices at the current level is that prices are not low enough to be competitive. If markets were allowed to reflect supply and demand, prices would be lower today, and world cotton consumption would grow to higher levels tomorrow. In the current situation, more price volatility is needed.



Another consequence of stable prices is that opportunities for profit by speculators will decrease. “Speculator” is a pejorative term in many countries. However, speculators are investors, and when opportunities for profit are reduced, investment will decline. Farmers are “speculating” when they plant a crop. Stable prices that are not attractive relative to other crops will result in reduced area devoted to cotton. Ginners are “speculating” when they buy seed cotton. Stable prices that reduce opportunities for gain in the sale of lint will result in less investment in ginning equipment. Textile mills are “speculating” when they buy cotton or sell yarn and fabric. Reduced opportunities to sell yarn profitably will result in less investment in textile activities.

“Be careful for what you wish; you may get it.”

Those who wished for stable prices have them now. For many, stable cotton prices will make management decisions much easier. There will be no need to hedge sales or purchases. Farmers will plant, ginners will buy, merchants will market, and spinners will sell, each knowing with greater certainty what their returns will be. However, a market situation that seems to be an advantage for individual participants will prove to be a disadvantage for the industry as a whole. Nevertheless, whether desirable or not, stable prices are likely to characterize the cotton market for several years to come.