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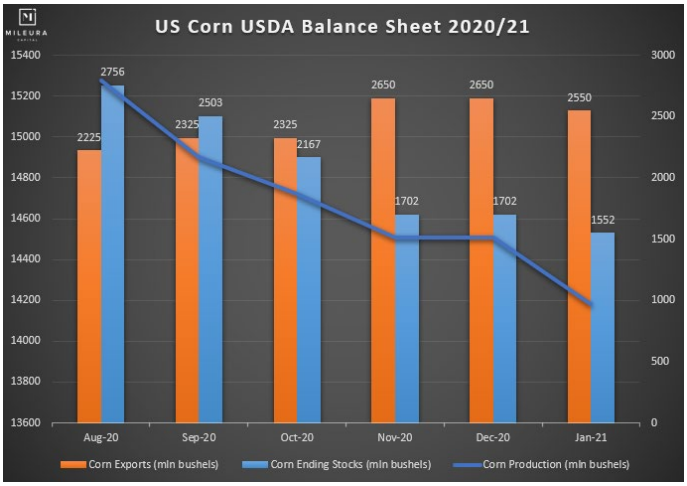
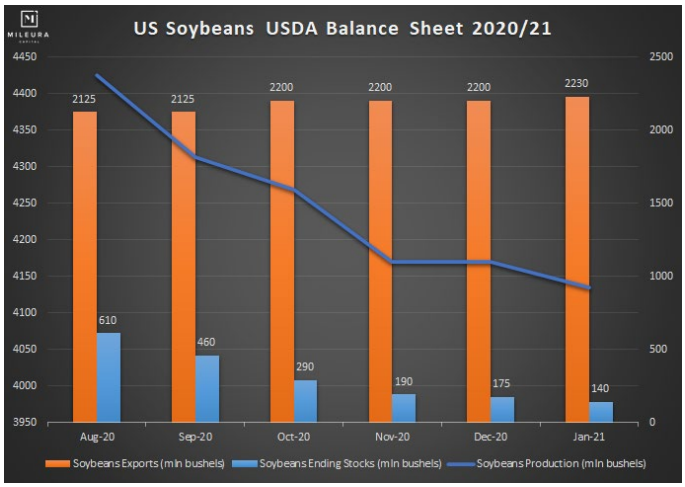
General

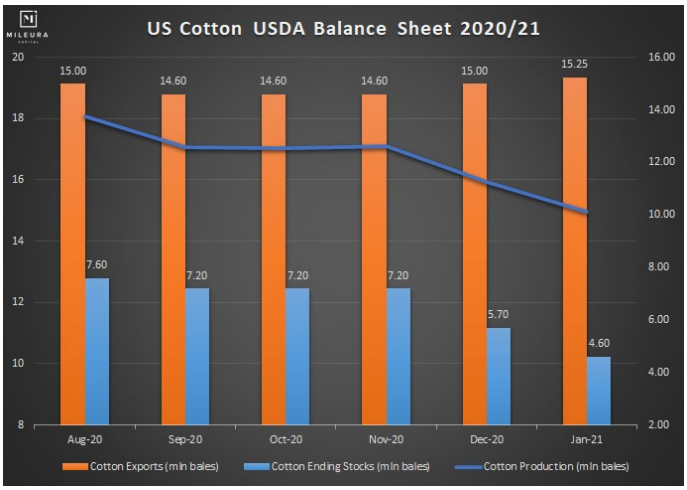
What a last few months we have had. A very minor sell off prior to the election and since then most assets, with the exception of Gold, have had a tremendous run. Bitcoin being the obvious outstanding performer.

In terms of commodity markets, even the agricultural sector has managed to rally. With the DBA Agri ETF up 12-13% since early October. Soybeans and Corn have been the standouts, rallying in line with Crude Oil between 35-40%.

Grains, Oilseeds and Cotton have benefitted from a larger import program from China than many had expected and decreasing supplies within the US. This has transformed the US agricultural commodity balance sheets from being burdensome to being tight. You can see this is in the decline in ending stocks numbers since summer 2020.







These fundamentals are now well known and have offered great returns for those that have been bullish since the early part of September. However, what are the opportunities as we heading to planting for the 2021/22 Crop Year?

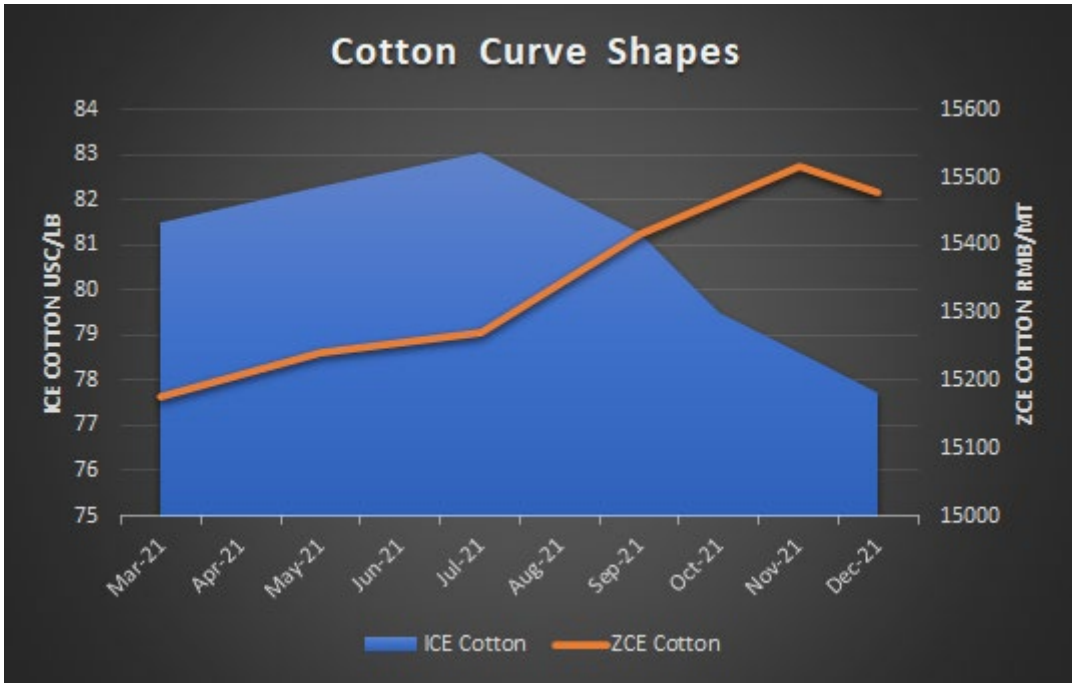
Assuming normal weather from now and given relative prices it would seem you are left with soybeans and corn competing for acres with cotton and wheat left in the background where they can be planted as an alternative crop. This provides a framework for plenty of opportunities on either side but not a market you would want be structurally short until production is well known in late summer.

The Cotton Market

Cotton growers in 2020/21 generally had a bad experience despite the higher futures prices. Not so long ago the US crop for 2020/21 was expected to be close to 18-19m bales, now we are looking at 15m bales or lower. So a lot of growers grew less cotton. On top of that the quality of the crop has been reduced resulting in large discounts for the lower grades. So their net returns were not what they had hoped just a few months earlier.

For merchants, typically US cotton is of middling quality. This means it needs to compete on price or typically the US is the residual supplier to the global cotton market. With smaller Australian crops in 2020, what high grades the US did grow have been in short supply resulting in a move higher in the high-grade premium. These qualities were often forward sold by merchants to end users resulting in a swift uptake of these qualities. On the other end of the spectrum the large amount of low quality cotton. Due to the large discounts applied to this cotton, it can be sold relatively cheaply on the export market and displace market share of cheaper origins of cotton that the US would usually not be able to compete against on price.

Finally, because of a ban being placed on cotton products made from Xinjiang Cotton, Chinese mills have had to import more cotton from the global markets (especially the USA) at the expense of domestic cotton in China. This is being reflected in a backwardated (inverted) ICE Cotton futures market between the old crop months (Mar/May/Jul) and Dec-21. In China the opposite is occurring with ZCE in contango. See NY Times article here regarding Xinjiang Cotton.



The Next 6-months

From here. What is the job of the cotton market? Now that carry out stocks are nearing 4m bales we are getting near a scenario that warrants persistent inversion between the July and December contracts unless US exports start getting displaced by exports from other countries. Potential export competitors are limited at this time of year to India and WAF and they are not machine picked origins so not a 1:1 competitor. Australian and Brazilian supplies won't be available until Jun/July and Sep/Oct respectively.

Do restrictions change with the Biden administration and China can use its domestic supplies for use in cotton products for export? I don't think that will be the case but it is a space to watch.

In terms of what does the new crop (December 2021 futures contract) price have to do? It needs to encourage production within the US, Brazil and 2022 in Australia and close the import arbitrage there is for new crop between ICE December 2021 and New Crop ZCE Cotton prices.

Outside of the US, production in Brazil is predicted to be lower thanks to fantastic soybean and corn prices in BRL. If Australia has rainfall production

The biggest risk to the bull case (aside from a macro event) is what happens to the Indian stocks. They carried a lot of cotton into a year with big production. This is being reflected in the relative cheapness of Indian cotton vs US. However, until we see Indian cotton displacing US exports and reflected in lower US export sales, it is hard to see this materially impacting prices in the short term.

H/T @CottonZapata for the chart.

Short term the Mar/May spread will remain under pressure as the speculators need to roll their longs, and the trade try to keep carry in the market for the moment. May/July could be another story and will depend on the availability of tenderable qualities within the US during the March to April period.

From here the best way to express a bullish view, in my opinion is in the December 2021 futures contract. Whilst not as fast of a horse as old crop, the story is more structural and likely to have lower draw downs. I would stay away from participating in the July/Dec spread as it could do anything at this point.