PRICE AND MARKETING STRATEGIES FOR THE YEAR 2000

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Abstract

The world cotton situation includes stable consumption and excessive supplies. As a result, prices are expected to remain weak for another year. December '00 futures may range between 58 and 45 cents per pound.

Production in the U.S. will likely exceed total use and increase carryover beyond 5 million bales by the end of next season. However, projections indicate fewer acres in foreign cotton for the new crop. With more cotton in the U.S. and less in foreign countries, the CotLook "A" Index may increase relative to the U.S. futures price. The result of fewer foreign stocks and higher price could be a lowering of the loan deficiency payments (LDP). If the "A" Index increases to the mid-fifty cent range and December '00 futures decreases to the 50-cent level, the total producer price for cotton (market price plus LDP) would be near the 52-cent loan rate and much less than in the 1999 harvest season.

Producer marketing plans for the new crop need to include pricing strategies, like buying puts, forward contracting, or other alternatives, that place a floor under the cash price. Seasonal forces and adverse weather conditions could support modest price rallies this spring.

Introduction

The cotton situation includes plentiful world supplies, sluggish foreign use, competitive synthetic fiber prices and increasing imports of textiles into the U.S. However, funding of the Step 2 program will allow a competitive price for U.S. cotton and encourage exports in the world market. Also, an improving foreign economy and prices some 20 cents per pound less than a year ago will support U.S. cotton exports. The low price should increase world consumption and decrease foreign production.

In all, the market price outlook for the New Year is bleak for growers. With large stocks in exporting countries, world prices are expected to remain weak. Loan deficiency payments (LDP) will likely decrease but remain sizable for another year. Until foreign and U.S. carryover stocks decline by a total of 3 to 5 million bales, the market is expected to continue sluggish. December '99 futures closed out at 48.42 cents per pound, the lowest price since 1988.

In the U.S., another year of excess production over consumption is expected to increase carryover stocks above 5 million bales. That is up from 4.5 million the year before and 3.9 million two years ago. The expected carryover would be the largest amount since 7.1 million bales from the 1988 crop. These excessive stocks could put pressure on December '00 prices to fall below 50 cents per pound at peak harvest -- perhaps in the vicinity of 45 cents. The top side for December appears to be around 58 cents. The worst case scenario is that the world price goes up to 66 cents per pound and December '00 goes down to near or below loan level. The result would be little or no LDP and only loan value for cotton. Even if the "A" Index goes up to 55 cents and December futures drops below loan to a range of 45 to 48 cents, the resulting total market price plus LDP payment stays close to loan. Thus, with another large increase in carryover stocks, the total price for cotton (market price plus LDP) would be much less than in the 1999 season.

A market price that is near or less than the Commodity Credit Corporation (CCC) loan rate is a clear signal that U.S. producers should plant fewer acres to cotton this year. But, indications from growers suggest acreage will stay around the 14.6 million acres of all cotton planted last year because alternative crop prices are also low. Too, the large LDP for 1999 cotton is encouraging producers to lean toward planting cotton versus alternative crops. In my projections, I am assuming 14.3 million acres of all cotton planted with an average loss of 7 percent before harvest and a yield of 645 pounds per acre.

However, a repeat of the large LDP of around 20 cents per pound received in December 1999 is not likely for the new 2000 crop. The world price depends mainly on the foreign supply/demand relationship. If foreign acreage is reduced as expected because of the low 40- to 50-cent price range in 1999, and cotton farmers in China cut their production, then the "A" Index may increase to at least the mid fifty-cent range. The resulting LDP would be near 10 cents per pound with the "A" Index around 56 cents.

Preliminary projections point to fewer acres in foreign cotton for the next season. Typically, foreign acreage declines substantially in the second year of low prices. In recent years, large foreign crops have decreased the deficit gap in foreign production versus consumption, causing excess supplies and world prices to be lower than U.S. cotton prices. However, the foreign production deficit may increase to the 7- to 10-million bale range for the new crop. The reduction in foreign supplies would likely support a world price ("A" Index) well above 52 cents. But, increased stocks because of sizable

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acreage would likely drive prices next harvest season even lower in the U.S. than in 1999.

The current and potential for excess cotton supplies, particularly in the U.S., leave producers with limited marketing alternatives. The objectives in your marketing plan for next year's crop should include strategies that place a floor under the cash cotton price. With prices already depressed, the CCC loan is a floor. Yet, there may be an opportunity to enhance the total price received by implementing strategies during price rallies that protect against market prices going well below the loan rate. There is a good chance for seasonal forces and bad weather to support modest price rallies during planting season this spring.

The 1999 crop is a good example that shows the financial rewards of establishing a floor price in a declining market. December '99 futures dropped from 72 cents per pound in mid-August 1998 to 50 cents per pound by mid-July 1999. A put with a 66-cent out-of-the-money strike when December '99 settled at 68.25 on November 13, 1998 cost 2.08 cents per pound. On July 15, 1999, December settled at 49.93 cents and the put had a gross value of 16.08 cents. The net to producer was 14 cents after put premium. Even as late as November 12, 1999, the 66-cent put was worth 15.33 cents (15.33 - 2.08 = 13.25). That week the LDP was 19.37 cents and the market price was around 42 cents per pound. Thus, the total price to a producer with a 66-cent December put could have been 13.25 + 19.37 + 42.00 cents = 74.62 cents per pound. The agricultural marketing transition (AMTA) payments would be additional income.

Marketing Strategies

Successful operators are sharpening their skills in marketing. Although producers do not individually control price, they do control when and how to price. Price movements in cotton carry a great deal of uncertainty because of changes in weather and resulting yields, in foreign and domestic policies, in government and trade policies, and in supply/demand forces.

It is clear that the financial stakes are high in developing a sound plan to deal with fluctuating prices. A marketing plan requires a logical approach in deciding at what price to sell or buy and by what method to establish that price. The decision requires an informed understanding of how and why prices move up and down. Knowing the basics of supply and demand are necessary. But, also understanding the chart patterns helps in timing pricing decisions.

Marketing Plan Essential

A marketing plan is an essential step in effectively managing price risk. A plan includes evaluation of the financial position of your business, risk-taking philosophy, timing of cash flow, estimated breakeven cost, and a realistic profit margin based on selected pricing strategies. A computer is helpful in calculating expected income for each crop. Then use tables and charts to set total levels of income needed to cover cash and total expenses and an acceptable income for the operation.

Another consideration is the timing of sales to meet cash flow needs. Payment of expenses influences the pricing method chosen. Income from pricing strategies that pay at harvest is usually preferable to storage.

The estimation of costs and returns is critical to the economic health of the business. If you have trouble showing profit on paper, it is important to consider relevant alternatives before financial obstacles become too big to overcome.

Develop Market Expectations

Develop market expectations from reliable outlook information. It is desirable to gather outlook perspectives from several sources to compare market views. Develop your own skills as to evaluating and interpreting price expectations -- that is even if you use a market advisor or marketing group. Learn to watch for signals that indicate price changes.

You can gain a better understanding of markets by reviewing historical charts on futures and cash price movements relative to supply and demand relationships. Knowing the expected difference between local cash and futures prices (basis) helps to estimate your price. Organizing a marketing club or joining an existing club is a good way to learn more about markets and to keep informed. The Texas A&M Department of Agricultural Economics web site at http://agecoext.tamu.edu/ has considerable information on how to organize and conduct marketing club educational meetings on price risk management.

Market Guildelines

Seasonal price variations exist and vary according to the overall supply/demand balance. In short crop years, prices tend to peak early -- both for crop just harvested as well as forward prices for next crop. In years when crop supply is abundant, prices tend to be weak early and strengthen toward mid-year. Also, in short crop years, prices are more erratic.

Stay abreast of market forces and be ready to adjust price objectives. Avoid "round number" price objectives, such as 65 or 70 cents per pound.. Be careful in pricing near USDA report release dates. Markets are jumpy near these times. Overall, consider downside price risk versus topside price potential.

Implement Your Plan

Markets are not going to give you anything if you do not take action to implement your marketing plan. You have to take pricing opportunities from the market. Price a part of the crop if a realistic price level exists. Don't wait too long to start. Don't try to pick the market peak. The peak is only known after it happens.

Space pricing over time and at levels hopefully above costs. Try to use scale up pricing during market rallies. Be prepared to take advantage of short-term price rallies. Learn the key technical signals and use moving averages to help identify price trends. Discipline to follow a year-round marketing plan helps to overcome the emotions of fear, greed and panic.

Cotton pricing problems stem largely from fluctuating prices. Cash farm prices are linked to the futures market. As prices move up and down, the futures and options markets offer a wide selection of pricing opportunities. There are several pricing alternatives available to use in setting a price when the market is "right" for your business. Forward cash contracts, options, futures, or a combination of these alternatives are all viable pricing considerations.

Cotton futures and options markets offer the flexibility to custom build a selling or buying program. Producers, merchants, and mill operators can design a program, spread over time, to manage ownership transfers and forward deliveries at favorable price levels.

Options may be used alone, with forward contracts, and with futures. Options, depending on pricing goals, are extremely flexible. They can be purchased, granted, or used in combination with contracts and futures to develop pricing strategies that fit the needs of users.

The purchase of options protects against adverse price moves and allows participating in favorable price rallies without margin deposits. Looked upon as "price insurance", options premiums can be added to other production and marketing expenses in setting a price objective. A big plus for hedging with put options for a producer is that if price increases, additional profits can be enjoyed.

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Table 1. Possible All U.S. Cotton Production

	--Pounds Per Harvested Acre--			
Million Acs. Planted	550.0	600.0	650.0	700.0
	--Million 480 Lb. Bales--			
15.0	16.2	17.6	19.1	20.6
14.5	15.6	17.0	18.5	19.9
14.0	15.6	16.5	17.8	19.2
13.5	14.5	15.9	17.2	18.5
13.0	14.0	15.3	16.5	17.8

Table 2. Example for 1999 Cotton - a 66-Cent Put.

In November, 1998 put cost 2.08 cents.
In November, 1999 put value 15.33 cents.

Net	13.25 cents
LDP	19.37 cents
Price	42.00 cents
Total	74.62 cents

Table 3. Selected Pricing Strategies

- Buy Put
- Contract and Buy Call
- Buy Put At Money, Sell Call 4 to 6 cents Out-of-the-Money
- Join Cotton Marketing Association

Table 4. Risk Management

- Attend Marketing Club Meetings
- Marketing Plan Essential
  - Yourself
  - Advisor
  - Pool

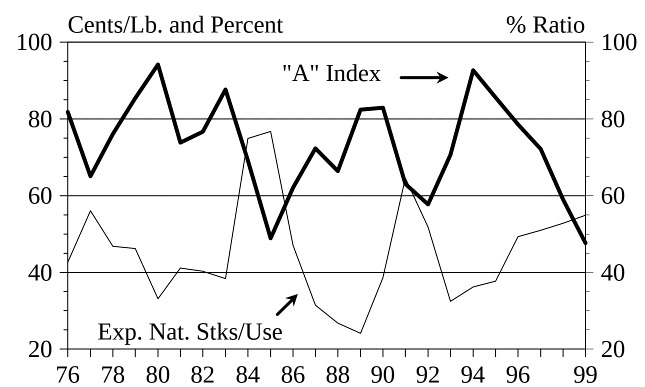

Figure 1. "A" Index Versus Exporting Nations Stocks to Domestic Use Percent.

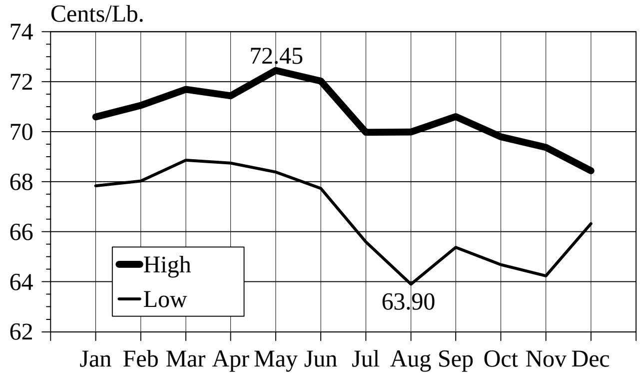

Figure 2. December Cotton Futures Settlement Price High and Low Monthly Average, 1992 - 1999.