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MARKETPLACE INSIGHTS

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Once again, I am back at the National Cotton Council's Beltwide Cotton Conferences,and as I stated last year this is to me the most important presentation I make during the year.

I delivered some incorrect thoughts last year about prices, because I truly did not believe the U.S. textile industry would suffer as we have witnessed. I also believed that China, because of the World Trade Organization, would have been more active in procuring cotton than what has occurred during the last year.

I know the number one agenda item today is: what is the new Farm Bill going to look like, once it is passed in the next few weeks or months. I am in the minority, but I am personally happy that it has been delayed, so we have time to address what the U.S. cotton industry truly needs for the future.

Again, as we have found, over the last few years we are at the crossroads for the American cotton producers, but also for your traditional best customer, the U. S. textile industry.

I am concerned that the National Cotton Council is supporting a program and concept that encourages overproduction. One of the premier questions that I am asked time and time again by producers, is: "When are cotton prices going to rally back to the 70 cent level." The theme of the current Farm Bill being debated in the Senate and passed by the House is one of big payments, which I am not opposed to if administered correctly. It would seem to me that the payments should be substantial but more land should be dedicated to conservation, so as to attempt to balance supply. The world cotton-producing countries are not getting a clear signal from the U.S. concerning production.

The proposed bills encourage too much U.S. production, which has currently led to very low prices, and that will continue until there is a major production crisis in China, India, Pakistan, Central Asia, West Africa or the U.S. Even a robust world textile economy does not solve the problem if the world continues to overproduce. The answer to higher prices is simply to reduce the world carryover with less world production. I will address those numbers in a few minutes.

I have felt until the last four months that China near term would be the key to higher prices by making substantial imports, which I have been completely wrong about because they themselves are over producing. Just three weeks ago China released its National Bureau of Statistics number for cotton production, which says they will produce this season 24.4 million bales. China did not send a clear signal to the Chinese farmers, and they overproduced again this year thinking they would receive a higher domestic price. Last season, Chinese farmers received a much higher price than the world price. Those Chinese producers geared themselves to the same level this season, but the domestic price is considerably cheaper than last season's.

I know Dunavant Enterprises profits from overproduction in the U.S., and the world, because we are able to merchandize more cotton with big crops, and we are heavily involved in the warehousing business worldwide, and we make money by storing cotton for extended periods of time. I guess all of us have lost sight of the fundamental scenario of supply and demand. The original theme of the FAIR Act was to give flexibility to producers to plant whatever they so desired, but also we were to phase out government payments, which has never happened. In fact, payments have grown-not diminished-over the period of the bill.

Over the last few years, I have recognized how much the American cotton producer needs additional support, because I have seen many efficient farmers, many of them friends, leave the business of farming because even with this program they could not make it.

However, we should not go through the next ten years with farming being classified as an entitlement program. You would think that these very low prices would discourage production in the world, but we do not think that world production will be reduced enough to encourage prices back to the seventy-cent level.

I guess that is enough of my philosophy; and now to the task of talking about numbers for production and consumption for this season and projections for next year. First let me discuss the current situation as I view it today both in the U.S. and the world.

I think we are on target for final U.S. production to be approximately 20.05 million bales. Our company feels that U.S. cotton consumption will only be 7.6 million bales this season, versus the USDA number of 7.9 million bales, and our Dunavant number could be slightly on the high side. The first quarter of this year will tell the story. Remember, just four years ago we consumed 11.35 million bales, but the strength of the dollar and cheap imports are destroying a great industry. We know of approximately 74 U.S. cotton-consuming mills and plants that have closed in the last two years, and more will come.

The bright spot is U.S. cotton exports. We have already registered 9.5 million bales and this is only January 10th. We will probably register over 11 million bales and actually ship during this marketing year about 9.8 million bales. There will be a substantial number of bales that will be rolled into next season because there are still some very high priced sales and there will probably be cancellations from the existing registrations.

We started the season with a carryover of 6 million bales, which was too much, and when you do your adding and subtracting for this season we will end up with an 8.7 million bale carryover which again is way too much to stimulate prices.

Now let's look at our world numbers. They also are currently not very encouraging for this season but look improved for next season.

We started this season with a world carryover of 39.6 million bales, which is adequate, but certainly not a bullish carryover. For this season we project world production at 95.9 million bales, and world consumption at 90.55 million bales, which will add at least 5.4 million bales to the world carryover, and we wonder why March cotton is trading at 37.73 cents.

The U.S. and China have produced huge crops this season. Fortunately, for world prices, China has not been an aggressive exporter, and I do not think they will be aggressive during this year or the next marketing year. Their entry into the World Trade Organization will be the factor.

India and Pakistan have had considerably smaller crops this season, not because of less acreage, but because of poor yields in certain areas.

In conclusion, for this crop year we see a substantial increase in our world carryover to a level of 45.0 million bales.

Fortunately, the Southern Hemisphere countries for this crop year are sharply curtailing production primarily because of low prices at planting time. Australia produced 3.7 million bales last season, and we project that it will produce only 3 million bales this season. Brazil produced 4.1 million bales last season and we project only 3.2 million bales for Brazil this season. Paraguay will reduce production from 450,000 to 350,000 bales while Argentina will go from 750,000 to 450,000 bales.

The Southern Hemisphere countries will produce 2.0 million bales less cotton, and the reason is price. These countries are very price responsive because of the lack of substantial government subsidies.

Now let's look at 2002-2003 crop year to see what we project the numbers to be.

The U.S. we project will plant under the current farm program about 14.6 million acres and that should produce approximately 18.0 million bales-considerably less than the 20 million plus bales this season.

Remember this current season we planted about 16 million acres and produced a record crop. I think the price of competing crops, and the reduction in the price of the insurance program for cotton, are the major factors for the acreage decline. This season the insurance price in the Mid-South was 63 cents, and next year it is projected to be about 50 cents.

We anticipate domestic consumption to rise as the economy improves to a level of 7.8 million bales, and U.S. Exports should rise to 10 million bales. So our off take will be 17.8 million bales, and with a crop of 18.0 million bales, our carryover rises again from 8.7 million bales to approximately 8.9 million bales. This is certainly a modest increase from this season, but nevertheless an increase.

Remember, this is January and a lot can happen both with production and consumption over the next 12 months.

Certainly the numbers in the U.S. are not bullish as we look to the future.

Now let's address the world. We think world production will decline sharply from this season's 95.9 million bales to our next season's projection of 89.5 million bales, which is 6.4 million less bales of production. World consumption will change from this season's 90.55 million bales to our projected number for next season of 91.8 million bales-an increase in consumption of 1.25 million bales.

This creates a drop in the world carryover from 45.0 million bales to 42.7 million bales, but still too much cotton. At least world production is showing some response to lower prices, and as our numbers show, we think the world textile economies will improve next season.

We think China's production will be sharply curtailed, but still a big crop of 21.0 million bales. Chinese yields have really improved over the last 2 years because of Bt seed and other better varieties. Chinese consumption will be 23.75 million bales and their carryover will decline from 13 million bales to 12 million bales. We project their imports will be 2.0 million bales next season, which is a real step in the right direction. Remember, I thought China would have been more active in importing during the last two seasons, but it has never occurred.

We think Pakistan, India, Central Asia and West Africa will plant slightly less acreage with the world price over 40 cents. As I stated earlier, India and Pakistan had smaller crops this season, not because of reduced acreage but because of poor yields. With normal conditions, their crops will be larger next season, even with reductions in acreage.

I also believe that in September and October 2002, as the Southern Hemisphere countries begin to plant, that just like this year they will respond to price, with lower prices/less acreage, and higher prices/more acreage.

We identified last year a new and expanding area for cotton and that is the Mato Grosso area of Brazil, which has unlimited production potential with higher prices. It is a high yielding area with unbelievable production capacity with yields on non-irrigated cotton being 2.5 bales per acre, and their quality is very similar to the Mid-South and Southeastern styles of cotton.

As we look to next season let's identify the major customers for U.S. exports.

As I said, China will import 2.0 million bales, but it certainly will not all be U.S. cotton. Price and quality will dictate area of growth to be purchased.

Mexico will continue to be a big customer for U.S. cotton. Hopefully, their industry will come out of their current textile recession. They presently have a lot of high priced contracts with U.S. cotton merchants, and a substantial volume of these contracts have not been performed on. Some of these sales, as I stated earlier, will be rolled into next year. Mexico will buy from the U.S. 1.8 million bales next season.

Turkey this season will buy from the U.S. 1 million bales and next season we project they will purchase approximately 1 to 1.1 million bales.

India and Pakistan have been a pleasant surprise this season because of very poor crops and high local prices. Recently their local prices have dropped considerably and with normal crops, they will not be major buyers next season.

Korea, Japan, Taiwan, Hong Kong, and Indonesia will continue to be large buyers of U.S. cotton next season.

Australia has taken away a lot of markets for U.S. cotton because the quality is very much desired by foreign spinners. It competes very well with the California styles of cotton.

Now that we have looked at this year's carryover numbers and next season's projected carryover numbers, what does all this tell me about price for the balance of this season and 2002-2003 crop year.

This season we saw December futures drop to a level of 28.20 on October 26th, and then December futures rallied to a level of 37.90 on November 30th, and March cotton rallied to a level of 39.80 on November 30, 2001. During this time frame commodity funds went from a short position of 26.6% to a long position currently of 28.5% a swing of 55 percent.

We have had nearly a ten-cent move from low to high. Commodity funds and speculators will always move the market as they enter or exit.

The A Index World Price has been very critical during this time frame, as it has risen from a low of 34.95 to the current level of 43.40, which is an eight-cent rally.

Many foreign producing countries would not sell as the price dropped below their cost of production and the U.S. has been very competitive and taken a volume of business away from West Africa, Central Asia, Greece, and Australia.

Until recently the Step 2 Marketing Certificate has been very beneficial to U.S. exporters in taking markets from other countries.

Now, because of rising world prices the Step 2 Certificate has gone to zero and is not a factor in U.S. pricing. A great percentage of U.S. exports, in my opinion, were made based on the exporter expecting to receive a certificate of 2 cents.

We must also remember that the certificated stock that is on the contract is still 218,000 bales and is still a burden on the market even though we have full carry from month to month.

I think we will continue to be in a trading range for current crop and I strongly believe we have seen the lows for this marketing year.

I believe the market will be in a trading range of 34 cents to 40 cents on the March contract, and today we are at the upper end of the range.

I strongly believe, with a U.S. carryover of 8.7 million bales, that U.S. cotton producers should sell when they can receive an equity of any amount.

There is still a volume of cotton in the market place that has been popped and is not eligible for the loan, and will have to be sold in the next few months.

As we enter the spring, if there is a major problem with planting the new crop then prices may rally in late spring, and pull old crop prices higher, but we still have an excessive U.S. carryover for this season.

On the flip side for prices, if some competing countries wake up in May, and find out there is no demand for their cotton, because the U.S. has taken their markets, then world prices could nose dive as they struggle to sell their cotton rather than carry to new crop.

There is certainly nothing bullish for prices in the U.S. and the world, but I would certainly caution all of us because cotton prices are at historically low levels.

There are 3.9 million bales in the loan today and I believe that a substantial amount of this cotton will die in the loan this season, and the government will catalog this cotton, and sell during the next crop year, which could put pressure on new crop prices if we produce a projected 18.0 million bales next season.

New December is currently trading at 43.75, and when looking at only the supply and demand numbers it would seem too high, but I would not recommend to a grower to sell his new crop cotton at least until we have a new Farm Bill and get through planting time.

I think the Farm Program itself gives you enough protection that you don't have to risk selling at cheap prices. We have no idea of what the loan deficiency payment will be for next season.

Remember at one point this season the POP was 31.02 cents and today it is 22.80 cents because of the strength in world prices.

Presently, I would like to be long current crop between 33 and 35 cents and short above 40 cents because at this level you run into a volume of cotton that is available for sale. At that level, the producer can receive a small equity.

For 2002-2003 crop year I do not want a position at this time. Fundamentally, for new crop 43.75 cents is too high when looking at supply and demand, but I do not want a position because too much can happen, and it is too early to make that determination, especially since we do not have a Farm Bill.

If a grower must make a move now, selling equities for new crop is the right move because we are again looking at a potential oversupply next season. Also, we don't even know the loan level for next season, because we do not have a Farm Bill in place. We do not know, at this stage, conclusively if the new Farm Bill will affect next year's loan level, or the five years succeeding.

Options, even though they seem expensive, are a mechanism to protect the upside and downside for new crop, and they will have value for six to eight months.

In closing, let me share that these are very difficult times for all of us in the cotton industry. I recognize that prices are very low, but the U.S. textile industry is experiencing something I have not seen in my lifetime. Their current difficulty is certainly going to affect all of us in every segment in the future. However, the world textile business is better than the U.S. textile business, but currently it is not a home run either. I would sincerely hope that we address the new farm bill carefully as new deliberations start in late January.

Even though I am not on the same page with the National Cotton Council's support of the bills before Congress, I have to applaud them for stepping forward in creating what they deem necessary for the future of the U.S. cotton industry. History has recorded that all seven segments have not always been in agreement; but the National Cotton Council's history has been one of doing the right thing at the right time, even though we may not all agree.