# OUTLOOK OF U.S. COTTON PRICE

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## Abstract

US Cotton will remain well below average values for the next 1-3 years due to ongoing bearish fundamentals. This crop year's low prices via price discovery will help minimize the negatives facing the market but supply will have to be reduced as demand is increased to correct the current imbalance.

## Introduction

Last August, Matt Laughlin called and asked if I would provide an outlook on cotton prices at the 2002 National Cotton Council Beltwide. I was intrigued by the idea of a segment devoted to prices. Typically, price projections are made once fundamentals are reviewed, almost as an afterthought. Yet, price levels and more importantly, their direction, are the heart and soul of every analyst's job given their impact on the type and timing of any recommendations they may make with futures and options. Equally so, is their relevance to the activities of commercials like many of you. Lastly, prices and their volatility are the bread and butter for the media as the explanations they offer are what feed their readership. Consequently, prices and their direction drive each of us for our own reasons in our own unique way.

Predicting prices is challenging in the best of circumstances and conditions this past year have been anything but normal making price forecasting even more difficult than usual. The tragic events of Sept 11 took that difficulty to a whole new level. It could be years, not months, before we understand and appreciate the impact of that date not only on our country's history and that of the world but on individual economic details such as cotton prices. Before turning to the various factors that could influence prices, a historical view of where prices have traded in our lifetime may provide some perspective. Over the last 25 years, cotton prices and specifically, cotton futures have generally traded in a range of 50 to 70 cents with four exceptions. The first in 1986 when futures briefly traded as low as 29.50 due to a massive shift in a new farm bill. The next came in crop years 1990 and 1991 when high export demand pushed futures to just over ninety cents. The third in 1995 when cotton hit $1.17 due to record demand in the US and key crop failures in foreign countries. And lastly, 2001, when record crops in the US and the World resulted in huge surpluses and multi-year high ending stocks in the US along with the Sept 11 terrorist attack drove futures slightly below the 1986 low to 28.20 before rebounding to current levels.

## Discussion

As volatile as prices have been, the fundamentals behind those price swings have been equally explosive. Whenever supply and demand are out of balance, price movements are a reflection of the market's attempt to correct its surpluses or shortages. As we have seen this past year, those price changes can be dramatic given the acute surpluses facing the market. But, what about the second half of this crop year and into next, will prices remain grossly depressed or is some recovery on the horizon? The answer is hidden within this question: have prices been painfully low enough, long enough, to begin the process of reducing supply while stimulating demand and therefore, shrink ending stocks here and abroad to acceptable levels? Although seemingly simple, the answer is very complicated given how intertwined the US and World cotton markets are and the intricacies of the individual factors affecting cotton supply and demand. Before moving to our price outlook, a quick review of the major factors that we believe will influence prices may be of help.

Some of these factors are known whether they are positive or negative; others such as the ultimate size of the upcoming world crop can only be guessed at given the number of variables that will govern the final outcome. Most of the negative fundamentals have already been identified, given their impact on prices this past year. They include the record size of the US and World crops resulting in burdensome ending stocks especially in the US, an eroding economic environment here at home and overseas that has contributed to poor consumer demand for textile products, US mill consumption dropping to a 13 year low due to pressure from foreign imports and renewed strength in the US dollar and of course, the Sept 11 terrorist attack in the US that further exacerbated perceived weakness for any and all commodities and finished textile products that include raw cotton. As for future negatives, we also have to be cognizant of the potential for another similar type catastrophic event whether on the same scale as Sept 11 or much smaller but in greater frequency such as that experienced by Europe in recent years.

On the plus side is the increased market share gained by the US in world trade resulting in projected record exports this marketing year. If not for this past year's lowest prices in 3 decades in the US, export demand might be much worse than estimated. In the fall of 1998, prices dropped low enough to stimulate raw cotton demand to a point that global consumption hit a new record although that effect was not known until the following spring/summer. Second, into the next marketing year, the ongoing level of low prices could eventually produce a substantial recovery in global demand although quantifying that increase is difficult if not impossible at this time. After 3 years of stagnant world growth in raw cotton demand, this year's low prices should help boost raw cotton demand in 2002 and 2003 crop years. Finally, some reduction in US, and in particular, foreign plantings will be beneficial and in fact may be the most critical factor for the market during this current quarter. Whether those reductions are enough to substantially reduce the ongoing surplus leads us to our last area of factors, what I term "unknowns".

We are already aware of several countries or areas of the world such as China that intend to reduce northern hemisphere cotton plantings. The drop to multi-decade lows in the US cotton market and world prices as expressed through the Cotlook A index has proven painful enough to discourage cotton production while making other crops more attractive. However, the drop in area will have to be substantial especially if this spring's world weather is as favorable as it was last year for the world crop to fall low enough to reduce ending stocks to a meaningful degree. This is particularly true in the US where even a 10-15% drop in area from this year's 16.3 million acres with normal abandonment and yields could still produce a crop that exceeds demand and adds to stocks. Despite the inability of Congress to reach a definitive agreement on a new farm bill, the House version and that proposed by the Senate is unlikely to discourage cotton acres, putting even more pressure on the market to do so. Some help may be forthcoming from lenders who may be less willing to finance cotton plantings, as crop insurance and government programs are less lucrative than in the past. Besides the unknown size of the final world crop, the market will also be contending with the other half of the coin, demand.

With ending stocks higher in most countries this year, the increase in cotton demand is critical and although we assume some improvement, the key to price direction is not only whether it will it be enough but the timing of that improvement. Many economic pundits believe the US will sustain a turnaround this calendar year but the full effects on GDP growth, consumer confidence and textile demand may not be felt until the second half of the year and possibly into 2003. In predicting prices, we can make allowances for the delayed effect while keeping in mind that futures anticipate changes in advance. Recognizing a move as a real substantive change and not merely one driven by managed money funds or emotion makes for nightmares for all concerned. Besides the uncertainties of global supply and demand and the US role in both is the importance of one other country, China.

China has always had a major impact on cotton prices not only because they are the world's largest producer and consumer but also their unpredictable but almost always sizeable presence in international trade whether as an importer or exporter. Under the terms of China's recent admission to the World Trade Organization, significant imports could materialize but not in the near term due to the size of this year's crop. The earliest we may expect to see their presence in the world market is the second half of the 2002/03 marketing year and perhaps only then for specific qualities suggesting only limited help for improving prices.

Our next "unknown" for the market is the role the A index will play in helping futures or hurting them, as was the case this past year. The spectacular sell-off by the US futures was assisted in great part by an almost equal drop in the Cotlook A Index, which had not seen an uptick from Apr through October of 2001. Obviously, the A index will be driven by the available exportable supplies, the final size of the world crop, the breakdown of that crop, where the demand for raw cotton occurs, and exporters' attitudes toward perceived price direction. A large reduction in foreign area and presumably foreign production should help provide some support and stability for the A index but that steadiness may not extend to US futures or may prove insufficient if other factors override the A's beneficial effect.

Our last factor of "unknowns" is not a true fundamental but very important and that is the technical aspects of the cotton futures market. The market's sell-off that began in Nov 1999 and continued through most of 2000 was truly extraordinary and considered history making by many traders and analysts. Many of the studies used by technicians to illustrate the depth of a market's move saw those with cotton hit levels not seen in many, many years. Typically, when an event such as this occurs, it is singular in time and in price meaning it stands by itself such as the 1986 low and the 1995 high. If we accept this premise, then we must ask ourselves, will history quickly repeat itself with even weaker prices this fall or is the worst behind us. Those technicians I know and trust say it is the latter. Perhaps the best response for you and I as fundamentalists is to hope the technicians are right but be prepared if this crop year's lows fail to hold as the market attempts to make that final generational low. Each and all of these factors, known or unknown, positive or negative along with all of those not mentioned have a place in determining where prices may go this week, this month and this year. How each of these "unknown" factors play out will decide the extent of any additional recovery in price and whether that recovery is sustainable over time.

## Outlook

Now, moving to possible price ranges for futures over the next 6-18 months, we have to remember that the difference between the seasonal high and seasonal low from year to year typically averages 15-20 cents, with some exceptions. Normally, the more bullish the year, the wider the range and vice-versa but this past calendar year and the current crop year has run contrary to that rule. To date, the cotton futures market has been as high as 4260 basis the October contract in early Aug and as low as 28.20 in late October basis the December contract, a difference of 14 cents. On a larger scale, the nearby month has fallen by more than 30 cents in the last 14 months to a level tested only once since the early 1970's. A quick review of several technical indicators will illustrate how unusual that price movement was and help put in perspective the size of the drop as well as the absolute price low reached. The Relative Strength Index, Stochastics and other studies show not only how one-sided the market move was but also just how low futures traded down in terms other than cents using a percentage scale. When inflation is taken into account, you could even say that cotton prices have not been this low in several lifetimes. Some of you may already be aware of these extremes but I mention them now as they play a role in our price projections. As to what we can expect the rest of this crop year, an upside price of 43 cents is possible with the spring contracts. This price level equals a 38% retracement of the thirty plus cent drop and also represents a significant support/resistance level on the weekly chart. Some technicians are using 48 cents as their upside target, which is a 50% retracement of the entire sell-off but my suspicions are that we may not see prices that high until sometime into 2003. The July contract may have difficulty moving higher unless springtime plantings in the US are much lower than anticipated. In fact, July could bear the brunt of this year's US burdensome stocks and pressure from possible overseas panic selling as the season winds down. Of course, the US cotton futures market will continue to be influenced by any major change in the Cotlook A Index, which has been as low as 35 cents and is currently in the 43-cent area. Based on its economic model, the International Cotton Advisory Committee is projecting an annual A index average of 45 cents. To date, the A index has averaged just over 40 cents. If the ICAC is to be ultimately correct, the A index would have to advance several cents and remain higher in the second half of the season. There are two schools of thought by commercials regarding the A's direction: 1- with global export buying running ahead of normal, there will be fewer supplies in the third and fourth quarters of the season helping to support and advance the A, or 2- with the US garnishing an abnormally high market share of world trade, many foreign producing countries will be left holding more cotton than normal into the waning months of the season and will become more aggressive with their offers to avoid being left with excess supplies. Consequently, a lack of upside follow-thru or more upside than anticipated with US cotton prices may in due course be tied to movement in the A index.

The technical chart we viewed earlier demonstrates how very oversold cotton futures were this past fall. It took an amazing number of negative fundamentals culminating in the Sept 11 attack to ultimately force cotton futures along with the A index to their record setting low levels. A repeat test of the sub-30 cent level, quickly or in the long term, would appear doubtful unless fundamentals worsen substantially or some other horrific event occurs. Cotton futures, having run up 10 cents from the late October low, have held extremely well in the mid-30's. With the funds in a moderately long position, it is possible this area of support could be breached. The key to any re-test of the low 30's is tied to whether or not there is sufficient mill buying waiting in the wings.

Before addressing potential new crop prices, I want to discuss a possible change in the relationship between US cotton futures and the A index as it may have a bearing on producers' pricing actions this fall. Over the last 12 months, cotton futures have remained on average 300-700 points below the A index with both dropping to near record levels by almost the same amount. As a result, the Adjusted World Price had dropped to record levels that in turn pushed the Loan Deficiency Payment to just over 31 cents, its highest level ever. Producers were given the opportunity to either utilize the loan program at price levels well above market values or collect a record payment in exchange for giving up use of the loan program on some portion of their cotton. The same may not be said for new crop year due to the very thing that could support prices. A larger reduction in foreign area compared to that in the US should improve the A index's overall price level versus that of US cotton futures. Whether the widening difference occurs due to a stronger A or weaker US cotton futures is not known at this time but it is unlikely the AWP will be as low at harvest this fall as in 2001 and therefore the LDP will not be as large either.

As for new crop year prices, barring a significant increase in US stocks and assuming a slightly higher A index, US futures should continue to find support in the low/mid-30's when harvest pressure is at its greatest this fall. However, potential actions by the CCC in auctioning off substantial portions of loan cotton forfeited by producers could weigh on cash and futures enough to threaten this crop year's seasonal low. If the 28.20 low fails to hold, the next line of support is approximately 26 cents, the 1972 low.

By the spring of 2003, prices should be slightly higher than this spring with an upside target of high 40's/low 50's. China's prospective import role could easily make a difference of several cents, as could the outcome of the 2003 farm bill in regard to any changes in cotton plantings, up or down, relative to current expectations.

Looking beyond this year and next, the large supply in the US should fall but ever so slowly as the market attempts to discourage production at home and abroad while finding new avenues for demand via prices below those in recent years. Ironically, recent farm bills, including the 1986 version, were designed in an attempt to reverse the US role of being a residual supplier of cotton to the world. It now appears as though domestic policy has achieved that goal as US cotton is very competitively priced enhancing its ability to provide exportable cotton. The trade-off of course has been much lower prices that could easily be with us for at least another year or two and possibly longer.

## Conclusions

In conclusion, after the astonishing run to over a dollar in the mid 1990's, and subsequent above average prices with cotton futures and other cash related instruments, talk of a new paradigm for prices was on almost everyone's wish list. The break-up of the former Soviet Union and an anticipated leap in world consumption had many believing that cotton prices would remain above their long-term average as supply struggled to keep up with demand. World consumption did hit a new record in 1998 and has remained close to that level, but unlike the wished-for model, those same major consuming countries found the resources to expand their own production levels in ways not imagined or anticipated until the new century was well underway. Will this past year, next year and those that take us into the middle of the decade, mark a new paradigm of excess supply resulting in much lower prices over time or will it prove to be only one thread of many changes in the fabric of time for cotton prices. It is my belief that for the next 1-3 years**,** US cotton futures are likely to trade well below the 50-70 cent range to which we have become accustomed the last two decades. Our projected prices are for seasonal lows in the 25-30 cent area and seasonal highs in the 45-50 cent area.

If we can correctly understand and anticipate the impact of all of the positive, negative and unknown fundamentals, you and I can better predict price changes. But, predicting prices is like predicting the weather, we get better at it as technology improves but Mother Nature is still volatile, spontaneous, and highly variable, a description that can also be applied to US cotton futures. The same can be said for the fundamentals that impact and drive prices in their relentless pursuit to obtain that ideal balance between supply and demand. The US and World cotton markets were hit by a "perfect storm" this past year pushing prices to unbelievably low levels with few reasons to expect a reversal in the near term. As important as using hedging tools have been in the past for you as producers, this year and those that follow are even more important to your survival as we face some very uncertain times into the new millennium. At first blush, the safety net provided by the loan program would appear sufficient in maintaining your livelihood but in reality the guarantees offered by the loan program are only part of the answer. You want to develop and then implement an overall business plan that includes pricing your crop at the highest level possible, benefiting from any price movement in US cotton futures with futures and/or options while managing the various government programs to maximize your return. When your need is greatest, changes in fundamentals and therefore changes in prices are not always apparent, but proper hedging techniques will protect and benefit you as prices fluctuate.