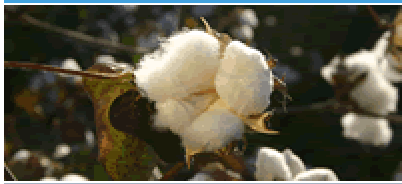

Plexus Cotton Limited
Market Report

January 20th 2011

NY futures continued to move higher this week, as March rallied 888 points to close at 152.94 cents, while December advanced 332 points to close at 105.70 cents.

Last week we were wondering where the selling would be coming from after Index Funds were done with their rebalancing. It seems that sellers have once again become very selective in a market that still has a disproportionately high open interest in comparison to the small amount of cash cotton that remains uncommitted.

Open interest actually increased this week, as Hedge Funds reportedly bought a sizeable number of new contracts. On Wednesday, open interest jumped by 2'436 lots in March alone, with the total increasing by nearly 4'000 lots. As of this morning there were a total of 202'326 contracts open, of which 149'764 contracts are in March, May and July. In contrast, the certified stock measures a paltry 1'510 contracts (=151'000 bales) at the moment, which includes bales 'under review'.

When we look at the market from the perspective of long and short futures, we believe that the longs have a much stronger hand at the moment. These longs, which belong mainly to Index and Hedge Funds, benefit from an inverted market that allows them to roll their position forward to a lower price all the way out to December 2012. Given the bullish fundamental and technical picture, they seem to be in no hurry to exit their position anytime soon. Also, with the futures market still not overvalued in relation to the physical market, some trade-related longs may be willing to take delivery of certified stock.

On the other hand the shorts seem to be in a predicament. The trade owns most of the short positions, which are primarily held against unfixed on-call sales by mills (still nearly 8.1 million bales on March, May and July) and against physical longs. Rolling a short position forward is a losing proposition in an inverted market and it is basically prohibitive with the March/December spread at over 47 cents. Since merchants won't allow their outstanding mill fixations to be extended past current crop, all of these current crop fixations will have to be dealt with by latest the middle of June. This adds up to a lot of potential buying pressure over the coming months.

Furthermore, every time a basis-long position gets sold, short futures are bought back, and since the bulk of the 2010/11-crop is already committed, there is very little hedge related selling left to counteract that. Brazil and Australia may still engage in some hedge selling against their crops, mainly in May and July futures, but these contracts will likely be covered as well because it does not make sense to roll them into December, at least not at today's massive inversion. Since rolling into an abyss is not really an option for trade shorts, the only way out is to either buy these shorts back or to deliver cotton to the board. There will probably be some deliveries by merchants if the price is right, but the amount of certified stock is currently too small to alleviate the shorts' woes.

While the longs are able to sit back and enjoy the 'roll gains' they collect on their journey into the future, the shorts have a gun to their head as they need to get out of a huge amount of shorts over the next five months, whether they like it or not. Unfortunately for the shorts, the current set-up may create a potential nightmare for them. As long as there is plenty of liquidity for shorts to get out, everything will remain orderly. It may take a higher price to entice sellers,

which is what we have been seeing this week, but whoever wants to get out still has a chance to do so at this point. However, we don't like that open interest has remained so stubbornly high and is actually increasing at the moment and that unfixed on-call sales are basically at the same level as two months ago.

The longer the shorts procrastinate in covering their position, the greater the potential for an explosive short-covering rally at some point down the road. There is a big difference between liquidating a long and liquidating a short position in a panic situation. A long cannot drop below zero and at some point opportunistic buyers will step in to stabilize the market. Not so in a short covering rally! Finding willing sellers to take over a big short position when the market is on fire is a lot more challenging, because the sky literally is the limit. History is replete with examples of such panic induced rallies, during which prices doubled or tripled in a matter of weeks.

Once markets go into melt-up mode they are no longer connected to any economic or common sense reality. At that point short-covering feeds on itself like a wildfire until the last short that needs to get out is finally out. The events of March 2008 and November 2010 gave us a preview of what can happen.

So where do we go from here? Based on the high open interest and the nearly unchanged on-call position, traders seem to have missed last week's opportunity to get out of harm's way. Cash prices have remained high, with the A-index at 177.70 cents this morning and the Chinese CC-index at over 191 cents. Meanwhile, the September futures contract at the ZCE closed today at over 204 cents, projecting high prices well into the 3rd quarter.

From a technical point of view, May, July and December futures all posted new closing highs today and are within striking distance of their intra-day contract highs. Only March remains a little over 6 cents below its record close. Nevertheless, the market has regained its upside momentum and seems poised to take out the remaining overhead resistance. If it does, the shorts will likely find themselves in troubled waters!

Best Regards