Cotton breaks through recent resistance. Will it keep going?

- ICE raw cotton broke through recent resistance last night.
- Tight supplies continue to underpin prices. Chinese crop concerns and import buying is providing further support.
- Europe remains a significant risk to the demand and price outlook.
- However the slumping Australian Dollar can be viewed as a positive spin-off for the Aussie producer.

The current situation of tight global cotton supplies is expected to persist throughout 2010. This will help keep a firm footing underneath the market.

However we remain wary that developments in Europe have the potential to derail this situation quickly. When the GFC struck in 2008, prices (ICE 1st futures contract) slumped from around 70 cents to under than 40 cents in less than 5 months. This was due to a combination of general risk aversion, physical demand destruction and adverse valuation impacts caused by a sharp appreciation in the USD. We do not expect the current developments in Europe to result in a repeat of these circumstances, as least not to the same severity, but it must still be acknowledged as a risk.

The recent reliance in global prices during the European turmoil suggests, that the market is, for the time being anyway, more concerned about tight supplies than possible demand destruction. Recent developments in key cotton countries support these concerns.

India, a key producer and raw cotton exporter has recently limited raw cotton exports in response to tight domestic supplies and the desire to protect local Indian yarn manufacturers. This move created uproar from neighbouring buyers, namely Pakistan and Bangladesh, as they struggle to supply their yarn and apparel sectors. It now looks like Indian authorities may relax these restrictions. But Indian agriculture policy is always a moving target.

It has been China – the world's most populous nation, the world's biggest cotton producer, and the world's biggest consumer – that has helped push the market through recent resistance. Chinese production in recent years has been hurt by adverse weather conditions, resulting in an increasing reliance on imports to satisfy expanding demand. Weather events of recent days, including snow in some areas, is raising production concerns for this year. Chinese authorities have been busily allocating additional import quotas in a bid to increase local supplies and cool prices. Last week, an additional 1mt of quotas were announced, of which half has reportedly been allocated.

The USDA last week indicated that China's cotton use in 2010/11 would rise 3% to 49m bales, and they would be ever reliant on imports to meet this demand. The USDA have pencilled in Chinese imports of 11½m bales, up 10m bales in 2009/10 and 7m bales in 2008/09. Developments of the past week mean the required imports could grow even further.

Overall, the USDA acknowledged that that the firm prices of the past few months will induce a significant production response by farmers throughout the world. But they also factored in a significant expansion in consumption. Global consumption is forecast to rise 3% in 2010/11 to 119m bales. Production, whilst forecast to expand 11%, still falls short at 114m bales. The result is the global cotton stocks contracting to 50m bales. More importantly, the global cotton stocks-to-use ratio is tipped to decline to 42%. This is below the 45% mark that has historically been associated with firm prices.

To put this into context, the last time global stocks were this tight was in 2003/04, at which point prices peaked around 85 cents. Prior to that we look to 1994/95, when stocks fell to 38%. In that year prices averaged 88 cents and peaked near 120 cents.

We are leaving our price forecasts unchanged

Table 1: ICE cotton price forecasts, US cents per pound (CBA Research)

Current	Actual (Quarter Average)				Forecast (Quarter Average)							
at 20/05/2010	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12
83	55	59	71	77	81	80	80	85	88	81	76	72

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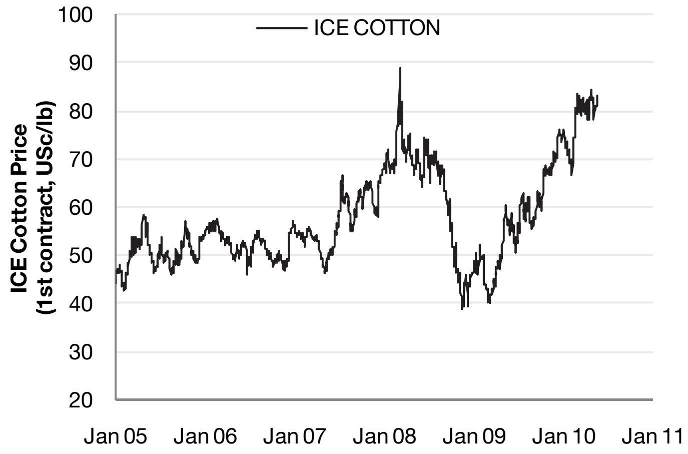
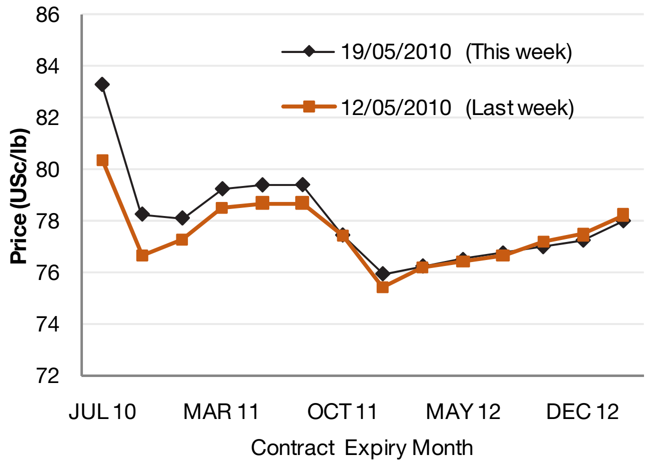
The Cotton Gallery

Figure 1: ICE cotton futures, first contract (USc/lb)



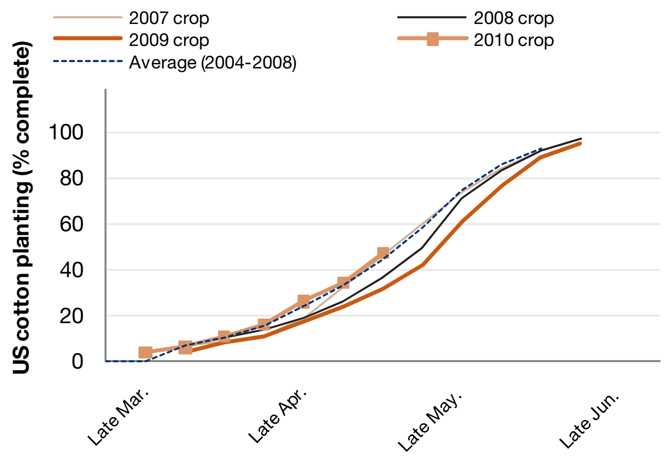
Source: Bloomberg

Figure 2: ICE cotton futures strip (USc/lb)



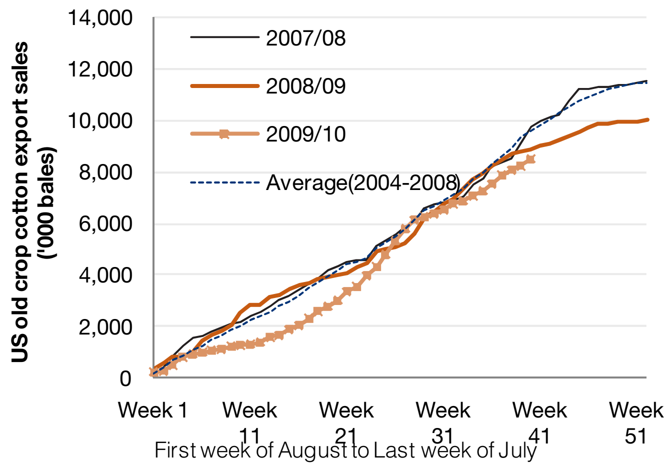
Source: Bloomberg

Figure 3: US cotton planting progress



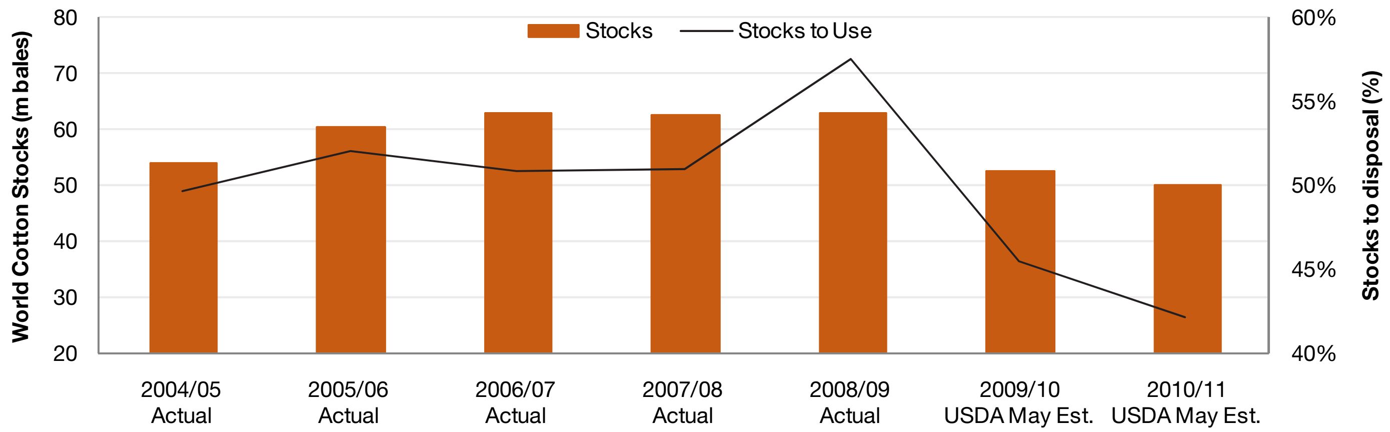
Source: Bloomberg

Figure 4: US old crop cotton sales (cumulative, k bales)



Source: USDA, Bloomberg, CBA

Figure 5: World cotton stocks



Source: USDA and CBA

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