

## Global cotton market outlook

### Key points

- Global cotton prices rallied to record high levels in March 2011. Prices have since fallen sharply, but still remain high.
- High prices were needed to ration consumer demand and incentivise a higher planted area. Both objectives are being met, helping put downward pressure on prices, but the Texas drought will provide some offsetting support to world prices.
- The structure of the ICE cotton futures curve indicates that further declines in spot cotton prices can be expected. The curve structure also indicates that the required global cotton inventory rebuild program will take more than one season.
- ABARES expects the 2010/11 record-large Australian cotton crop to be followed up by an even bigger crop in 2011/12.
- CBA forecasts that international cotton prices (ICE, first futures contract) will average USc111/lb in H2-2011 before easing to USc100/lb in H1-2012 and USc88/lb in H2-2012.

### Cotton prices still exceptionally high.

Global cotton prices rallied to record high levels in first quarter of 2011, fuelled by extremely tight supplies and speculative exuberance.

The benchmark ICE cotton futures contract (first contract) rallied to an intraday-high of USc227/lb on the 7<sup>th</sup> June, 4.1 X higher than the decade average of USc55/lb. The previous modern-day price record, set back in 1995, was USc117.20/lb. Physical cotton prices rallied in line with the futures market. And AUD denominated cotton prices soared to unprecedented levels, exceeding A\$1,000 per bale in March, some 2.4X the 15 year average of ~A\$440/bale.

Since March, the global cotton prices have retreated sharply, but still remain at extremely high levels. ICE cotton futures (first contract) are currently quoted at ~USc155/lb, down 32% from their peaks. Australian dollar denominated prices are roughly A\$740/bale, down 30%. The Cotlook A cotton price index is quoted at USc149.25/lb, off 39% from its highs.

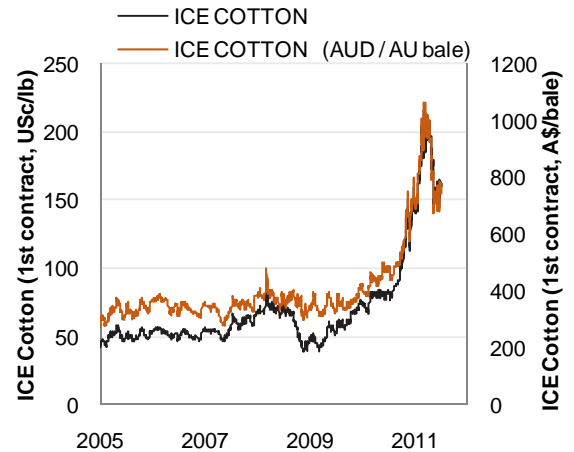
### Futures curve – in steep backwardation

The shape of the of the ICE cotton futures curve suggests further declines in spot cotton futures prices should be expected.

For example, the new-crop December-11 ICE futures contract is currently at USc113.42/lb, nearly 42 cents below the expiring old-crop July-11 contract. The July 12 contract is then quoted nearly 12 cents lower at USc101.56/lb and the December-12 contract is quoted a further ~5 cents lower at USc96.49/lb. From December 2012 onwards, the cotton futures curve moves into contango.

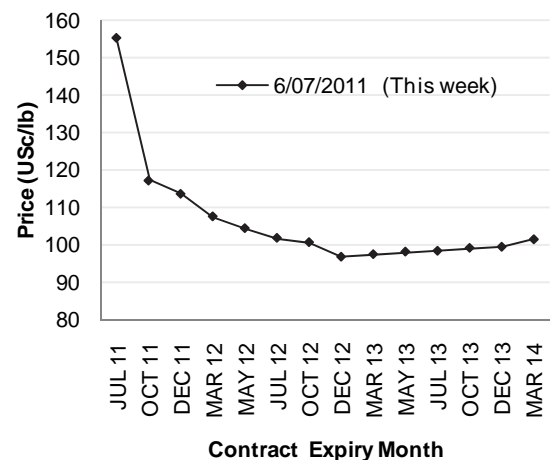
The curve structure illustrates both the short term supply squeeze currently impacting the market, and the expected new-crop production response. Given that the futures curve remains in backwardation through the 2011/12 season, and only moves into contango from December 2012, the market is pricing in a two-season inventory rebuild program.

Figure 1: ICE cotton prices (1<sup>st</sup> futures contract)



Source: Bloomberg and CBA

Figure 2: ICE cotton futures curve





Global supply extraordinarily tight, but recovering...

Global cotton supplies shrank to just 37% of total use (stocks-to-use ratio) in the 2009/10 and 2010/11 seasons, well behind the previous decade average of 58%, and the tightest level since the 1993/94 season.

Small global cotton crops through 2008/09 to 2010/11 – owing to a combination of reduced area planted and poor yields – caused the reduction in global cotton ending stocks.

Global cotton prices rallied during the 2009/10 and 2010/11 seasons because of the tight global supply situation. Higher prices were required to achieve two main objectives. Firstly higher prices were required to ration demand, particularly for US cotton. Secondly, higher prices were required to incentivise global farmers to lift planted area and production.

Over the past few months it has become apparent that both of these objectives appear to have been, at least partially, satisfied.

- Global cotton demand declined in H1-2011, evidenced by slowing Chinese cotton imports and consumption. United States weekly cotton export sales have returned one positive result in the past 14 weeks, meaning importers cancelled existing purchases in the remaining 13 weeks. Since March, international buyers have cancelled over 614,000 bales of previously-purchased US cotton supplies, equating to 6% of total US export sales for the entire 2009/10 season.
- Global cotton area is forecast to rise 6.6% to 35.74 million hectares in 2011/12 according to the USDA. This forecast represents the second largest global cotton planting undertaking in history. Clearly, cotton producers have responded to the extraordinary prices on offer.

Global production is subsequently forecast to increase 8% in 2011/12, and the global cotton stocks-to-use ratio is forecast to lift from 37% in 2010/11 to 41% in 2011/12.

It is clear, however, that the resulting increase in global cotton supplies in 2011/12 will prove insufficient to fully alleviate global stock tightness. This has two main implications. Firstly, the global cotton market is susceptible to production scares over the coming 3 months, especially in areas that are currently favourably rated. Secondly, the necessary global cotton inventory rebuild effort will continue into the 2012/13 season.

Drought in the United States will temper their production response...

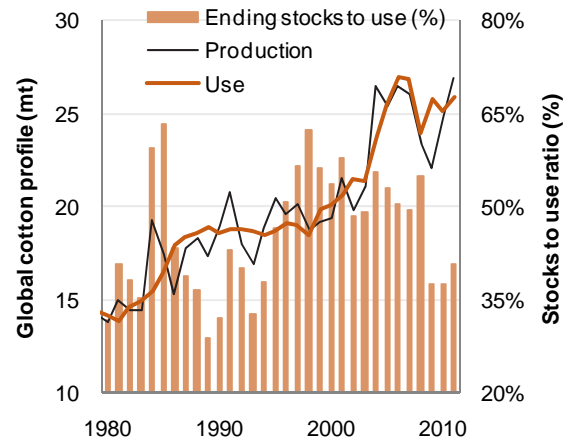
Although high cotton prices have induced a sharp increase in United States' cotton area planted, the final production response will be constrained by unfavourable growing conditions. Texas – the most important cotton producing state in the United States accounting for over half of the area planted – has experience severe drought this season.

The Texas cotton crop, as at the 3<sup>rd</sup> July, was rated only 14% good-to-excellent according to the USDA. Conversely 57% of the Texas crop was rated poor-to-very poor.

Overall, the US cotton crop was rated just 28% good-to-excellent, well below the past 6-year average of 51%, below last year's rating of 62%, and below the minimum result of the past 6 years of 41%.

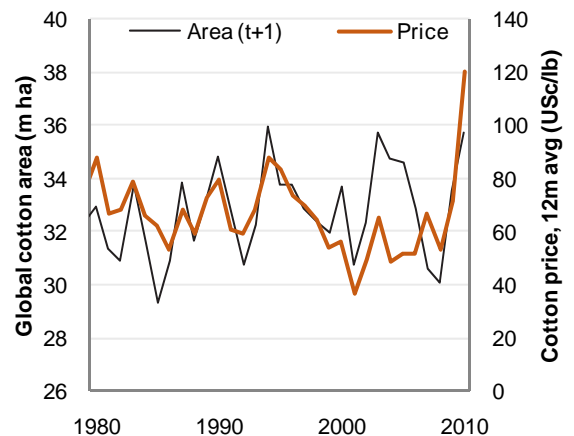
Therefore, despite a forecast 25% increase in the United States cotton area planted this year, poor crop conditions imply abandonment rates will be high and prevailing yields will be low. United States abandonment may exceed 20% this season, versus an average 10% since 2004/05, and just 2% last year. As a result, the actual United States area harvested in 2011/12 may be little changed from the previous season.

Figure 3: Global cotton supplies



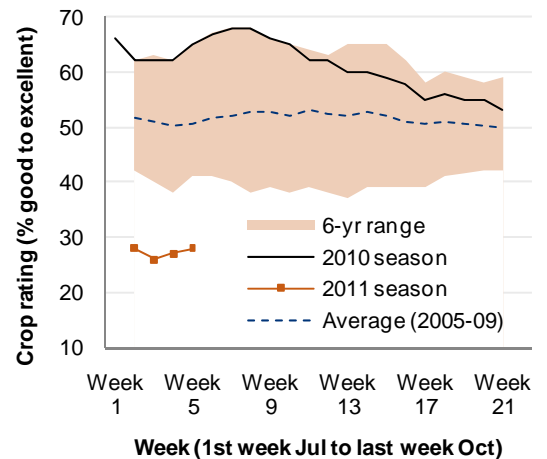
Source: USDA and CBA

Figure 4: Global cotton area and prices



Source: USDA and CBA

Figure 5: US cotton crop ratings



Source: USDA NASS and CBA



### Meaning that US stocks are only forecast to rise marginally in 2011/12.

The Texas drought means United States cotton stocks will not display the typical price-induced recovery in 2011/12.

On the 9<sup>th</sup> June, the USDA forecast United States cotton ending stocks for 2011/12 at 2 ½ million bales, up ¼ million from the record low 2010/11 ending stock estimate, but still sharply below the 2007/08 result of 10 million bales.

While there is the possibility of upward revisions to these stock estimates, largely owing to slow demand and increased area, the resulting 2011/12 cotton carry-out in the United States will remain tight. And at levels which justify well-above-average US cotton prices.

We expect prices to remain historically high until the 2012/13 season, at which time we expect a price-induced production response (assuming improved weather) to lift supplies to more comfortable levels.

### Australia's cotton outlook is bright.

Australia's cotton area nearly tripled in 2010/11 to 590 thousand hectares, supported by high prices and abundant moisture availability, according to ABARES. Lint production is forecast at a record 898 thousand tonnes, well above the previous record of 819 thousand tonnes set in 2000/01 season. Since 1990/91, Australia's lint production has averaged 497 thousand tonnes.

The 2011/12 season is set to be even more optimistic for the Australian cotton industry. ABARES, in their June Australian Commodities report, suggested that Australian cotton lint production would climb over 1.1 million bales, 23% above the 2010/11 record. The ABARES forecast reflects strong cotton prices, abundant irrigation water supplies and a return to normal yields following the 2010/11 floods.

Australian cotton lint exports are forecast to surge 76% to a record 965 thousand tonnes in 2011/12, with the value of those exports forecast to lift 55% to a record \$2.4 billion. Australia's annual cotton exports from 2000/01 to 2009/10 averaged 508 thousand tonnes, valued at just over \$1 billion per annum.

ABARES suggest that the Cotlook A index will average USc116/lb in 2011/12, down 28% or 46 cents below their estimated 2010/11 season average price. ABARES forecast fall in global cotton prices "reflects the effect of expected record production in 2011/12, which will outweigh expected growth in world cotton consumption". In March, ABARES forecast the Cotlook A index will fall to US91/lb by 2015/16.

Our initial impression is that ABARES 2011/12 domestic production estimate is optimistic. However, we do agree with ABARES underlying theme that the 2011/12 outlook for the Australian cotton industry, from both a volume and value perspective, is indeed bright.

### CBA cotton price forecasts

CBA forecasts that international cotton prices (ICE, first futures contract) will average USc111/lb in H2-2011 before easing to USc100/lb in H1-2012 and USc88/lb in H2-2012.

	Current at 7/07/2011	Actual (Quarter Average)					Forecast (Quarter Average)									
		Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	
Cotton (ICE)	USc/lb	147.5	91.9	132.1	191.3	165.7	115.4	106.7	100.0	100.0	90.0	86.7	80.3	80.8	81.3	79.5
	US\$/bale*	737	459	661	956	829	577	533	500	500	450	433	402	404	407	398
	A\$/bale*	686	499	668	939	769	536	506	487	507	470	456	423	425	428	418
<b>Currencies (period end)</b>																
AUD/USD		1.07	0.97	1.02	1.04	1.07	1.08	1.04	1.02	0.97	0.95	0.95	0.95	0.95	0.95	0.95

Note: Cotton bales refer to Australian bales (500lb or 227kg)

Source: CBA Research

Figure 6: US cotton stocks

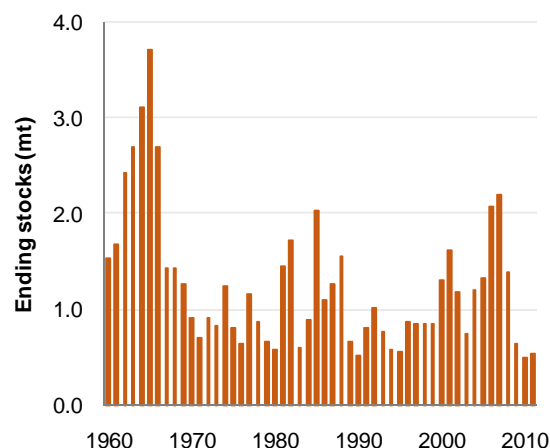
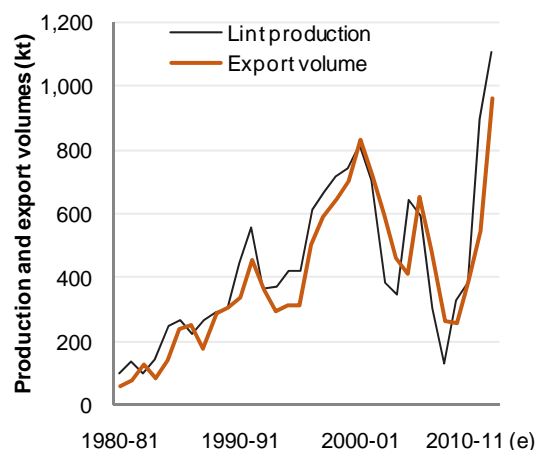


Figure 7: Australian cotton forecasts (ABARES)

		2009/10	2010/11	2011/12	% Change
Area harvested	'000 ha	208	590	550	-6.8
Lint production	kt	387	898	1 106	23.2
Exports	kt	395	549	965	75.8
- value	A\$m	755	1 540	2 384	54.8
Cotlook 'A' index	USc/lb	78	162	116	-28.2

Figure 8: Australian cotton forecasts (ABARES)



Source: ABARES and CBA



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