MARKET INVERSION = HIGH RISK CONDITIONS **4/4/2022**

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The 2022 crop looks set to be one of the biggest crops we have produced in Australia - perhaps even the largest. In these high volume years, every element of the supply chain will be tested. The 2022 crop will be no different but it will be against the backdrop of Covid, domestic freight, ocean freight and regional labour challenges - and an aggressive demand environment. Essentially it will be a big crop with a lot of supply chain risks.

The ICE Futures market is inverted (technically referred to as a "backwardated" market structure) meaning the early part of the Australian calendar delivery spread that can be hedged off the May 22 and July 22 Futures contracts translates to much higher values compared to the latter part of the delivery period hedged off the Dec 22 ICE Futures contract at much lower values.

The reverse of the above situation is when ICE Futures market is in carry (technically referred to as "contango" market structure) where supply and demand is closer to equilibrium, or a more balanced supply and demand situation exists. Deferred ICE futures months trade at a higher values compared to the nearby futures contracts reflecting the increased risk associated with relatively unknown production/consumption, the cost of capital for financing a bale until it can be delivered in the future.

ICE Futures values will always trade the rigidity of the United States balance sheet and what exists now is a tight supply situation at the end of the 2020/2021 crop year versus new supply coming into 2021/2022 crop and this is a significant contributor to the hugely inverted market.

Australian cotton's historical delivery period trades across the USDA crop year and is exposed to intra crop year ICE Futures spreads should there be a big difference in supply/demand from one year to the other.

One of the impacts of the US-China trade deal which sought to rebalance their trade deficit has seen China buying more agricultural commodities from the US. US cotton is in the basket of commodities that has benefited from increased demand from China and this has contributed to generally tighter US crop balance sheets since 2019/2020. This has been and will continue to be a causative factor in the emergence of inverted intra crop year market structures.

What does this mean for Australian cotton? It means that the front end of the cotton shipment calendar spread for cotton that can be shipped from March to August will be priced against one US crop year balance sheet and the balance shipment period or the tail end of our crop will need to priced against the new crop year. Given earlier comments on the factors affecting the US cotton balance sheet, this has tended to contribute to greater supply and demand imbalances from one crop year to another. Hence, the probability of inverted market structures would appear to be increasing.

For the grower this is both positive and negative. Premiums could be evident in the front end of the shipment period priced off a US balance sheet that is tight toward the end of the crop year verses discounts priced on a new crop US balance sheet where US cotton supply is more liberal.

Historically the merchant has provided a single price for an Australian bale across these two crop years because historically old crop/new price volatility has been much less. In large crop years and in the context of the supply chain problems identified at the beginning of this article the real issue for the merchant is estimating when a bale can be shipped. If there is a misalignment between the month hedged (sold Futures) for the purchase and the month hedged (bought Futures) for the sale or shipment, the merchant has full exposure to an inverted market structure if they have to roll Futures. If we use July 22 and December 22 Futures contract as at 26/03/2022 as an example, the cost of rolling hedges through the crop year is approximately AUD 137 per bale so the risks are very high if the hedge month for the purchase is misaligned with the sale or shipment month.

If merchants have in the past accepted the risk of offering a single price across the traditional delivery period for Australian cotton why now is this an issue? Why are we seeing a different pricing structure for some merchant bids?

Firstly, it means competition is great and the 14 or so merchants competing for the Australian bale is very healthy. The risk appetite of those 14 merchants is individually different – this is good and is what you would normally expect to see in a highly competitive market. Does the marketing platform for Australian cotton need to change? No it does not - because it is underpinned by fundamental and extremely important trading guidelines of bale delivery. A merchant understands and accepts the risk for buying a known bale range and the grower delivers that bale range to the contract.

For the merchant, very real problems arise and risks emerge if those fundamental trading guidelines which underpin our industry break down or are not adhered to. The grower cannot control the strict timing of bale delivery that will be subject to picking and ginning times. All the grower can control is the contracted order of delivery and this year in particular that will be very important. If trading guidelines for bale delivery are not honoured, there are very real and heightened trading risk implications for the merchant. If that situation were to emerge the pricing mechanism for Australian may indeed need to change.

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