The Xinjiang textile and apparel sector is estimated to be near the size of the entire textile and apparel industry of Turkey, with cotton use nearing eight million bales or more annually. The government’s program of massive subsidies has resulted in almost every major Chinese textile and apparel company locating a factory in the region. Subsidies include free land, lower electricity cost, low cost loans, transportation subsidies, and even subsidized labor. The subsidies have been successful in attracting a record amount of fixed asset investment in textiles and apparel plants to Xinjiang. The investment surge began in 2010, and from 2014 through 2016 the region realized investments of nearly 90 billion RMB, over 13 billion USD, of FAI in textiles and apparel. Moreover, it is estimated that Xinjiang experienced similar investment results in the two years following the subsidies.
that followed. All major Chinese textile and apparel groups are believed to have set up operations, with the heaviest investments occurring in cotton yarn spinning. Cotton consumption in 2018 is estimated to have been just below eight million bales, which represents 20% of China’s total cotton consumption. Texhong alone has set up a million-spindle cotton spinning operation.

At the same time, massive subsidies have been provided to create a modern mechanized cotton production operation that has also boosted production and quality. In 2010/2011, Xinjiang produced 2.79 million tons of cotton, and by 2018/2019 that had increased to a record 5.15 million tons (23.65 million bales), which equaled over 20% of the total global cotton production. Xinjiang has become the heart of both China’s cotton and textile production. Subsidies have played a significant role in the success of both sectors. In cotton production, growers are now offered a target price scheme that provides a major premium to international values. On the textile side, the combination of various subsidy schemes is quite extensive, ranging from free building and land rent, electricity prices at 50% of the rate of the East, labor subsidies, and freight subsidies. When all the subsidies are added up it comes to a sum equal to the approximate cost of the cotton; free cotton for the Xinjiang mills in other words. Without the subsidies neither cotton production nor the textile sector could be profitable.

Collectively, the schemes have been a critical success. In 2017, the administration of Xi Jinping took actions that have shocked the world. He is now endangering the entire Chinese textile and apparel industry. In a playbook not seen since the build up to WWII, China has established a system of prison camps that have now forced up to 1.5 million people from predominantly Muslim Turkic minorities – Uyghurs, Kazakhs and Kyrgyzs –into political re-education camps designed in part to make them renounce their religious beliefs, give up all local customs, and provide forced labor for the Xinjiang factories.

What makes the establishment of one of the world’s largest cotton-growing regions and corresponding textile/apparel base even more impressive is where it has occurred. Xinjiang is one of driest areas on earth. A large portion of the cotton belt and textile/apparel plants are in the area that surrounds the Taklamakan Desert, which is simply impassable with large areas of sand dunes and nothing else. The region, known as the Tarim basin, is surrounded by the Himalayas and Pamirs mountains. The snowmelts from these mountains have been captured and transported to the region under a massive irrigation scheme that reminds one of the California SJV regions. The region was first inhabited in 1800 BC as verified by the discovery of the Tarim Mummies. China conquered the region in the 1750’s at the time of the Qing Dynasty (this is the period when Chinese world power was at its peak) and ruled it until the dynasty ended in 1912. A large portion of what is now Xinjiang was known as ruled by the Dzungars. The Qing Dynasty conquered this group and massacred a large part of the population. This is known as the “Dzungars genocide.” The area became a focus on unrest as the Chinese civil war occurred. In 1933-1934, the first East Turkestan Republic was established in Southern Xinjiang. It was under Islamic influence and was short-lived, ending in 1934. A second East Turkestan Republic was established with Soviet backing in 1944 and ended in 1946. Since the region again came under firm Chinese control under Mao, an effort has been underway to increase the Han Chinese population.
The imprisonment of the local Turkic minorities has included men, women and children of all ages. Tactics have included brainwashing, torture, and separating children from their parents. Ever since the formation of communist China, an effort has been underway to integrate Xinjiang and solidify its role in China's plans for the future, which included efforts to increase the Han Chinese population. The current effort appears to be an accelerated attempt to erase the local culture and force assimilation. The tactics used are a modern version of those of the Cultural Revolution. The most extensive high-tech surveillance system ever developed is being used to collect data and to monitor all movements. The imprisonment has not received the expected condemnation from Muslim nations as China has used its economic power to silence this group through promised investment and the Belt and Road program. All 22 nations that condemned the imprisonment at the UN were Western nations lead by the US.

The entire scheme is now getting attention in the West, as the US/China trade dispute became extended. The Wall Street Journal sent reporters to the region and found that labor from the camps was being provided to Xinjiang's vast complex of textile and apparel factories. The reporters uncovered the fact that factories were manufacturing apparel under contracts with several major brands and retailers. This resulted in, first, cancellation of sourcing arrangements and, second, companies demanding greater transparency in their supply chains. Additional reporting has expanded on the Wall Street Journal's findings, reporting that approximately 124 labor camps have been established, with 193 prisons and 66 Bingtuan labor camps. Such a massive scheme has not been seen since the build-up of WW II.

The camps are now drawing worldwide attention in the West and are causing brands and retailers to launch investigations into their Chinese supply chain, introduce accountability, and pull out of China. During the Wall Street Journal's investigation, apparel for major international brands was found to be sewn by forced labor in cut and sew operations. Now, after additional reporting, European and Australian brands and retailers are being forced into reinvestigating their supply chains. The Australian Broadcasting Corporation's most popular news program, "Four Corners," ran a special last week on the plight of the Uyghurs and the massive prison camps. The investigative TV program began with the interview of a Uyghur woman who had migrated to Australia. She reported the plight of her sister's family who had disappeared. Her sister was a trained nurse, and it was later found that she and her husband were arrested and separated from their children. Her husband disappeared after the arrest and has not been heard from since. The sister was given a choice to work in a forced labor brigade or be sent to prison. She was sent along with a larger group that were handcuffed and shackled as they were transported to the textile plant where she was forced to work and live in the plant's dormitory.

Her sister's plight came to light after she managed to contact her sister in Australia through the Chinese social media platform, WeChat, which operates in Australia and is very popular with the Australian Chinese community. She told her sister to tell her story to the world. The video portion of the service was used to scribble notes on paper to be read instead of spoken, due to fears that the Chinese spy network was listening.
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She also showed her work ID, which allowed "Four Corners" to identify the textile plant at which she was forced to work. "Four Corners" traveled to Kazakhstan to interview another woman of Kazak decent that had been arrested while in Xinjiang and released with a group of Kazakhstan prisoners a year later. It was confirmed she was forced to work in a textile plant north of Urumqi that was sewing gloves for export to Europe. Her experience was nearly the same as that of the Australian woman’s sister.

“Four Corners” also interviewed German scholar Adrian Zenz, who has done extensive research in Xinjiang and was responsible for exposing the camps. Dr Zenz reported he had in his office thousands of documents from Chinese companies operating in Xinjiang, along with public Xinjiang government documents. After reviewing the documents he confirmed that a massive slave or forced labor scheme was underway. He stated factories were paid 5,000 RMB, about 724 USD, for each prisoner it trained and hired for three years. In addition, the companies received a host of other subsidies, such as free land and rent. He further revealed additional research indicated that children were being separated from their parents and then forced into brainwashing programs.

“Four Corners” investigated the major Australian brands and retailers and found most were sourcing apparel from China, the top supplier of apparel to Australia. Several of the brands researched their supply chain and found some cotton yarn and other products had come from plants using the forced labor. They announced they would be pulling out of those contracts, and all indicated they were reviewing their supply chains and demanding more transparency. This means you have three of China’s main apparel export markets are now reviewing supply chains, and they will likely pull additional sourcing. Another significant export market, Japan, was one of the nations denouncing China’s prison camps at the UN. In America, the US customs and border control already have the authority to ban imports suspected of being made with child or slave labor. This has already been used to ban all textile and apparel imports from Turkmenistan because of forced
labor. It may be only a matter of time before the US government moves to do something similar to China, or a Congressman brings it to the border control’s attention. There are several bills moving through the US Congress to penalize China over the camps. Furthermore, President Trump held a meeting at the White House last week on religious freedom, and the attendees included several members of the US Uyghur community and the daughter of a famous jailed Uyghur scholar. Vice President Pence is expected to deliver a major blistering speech on the Chinese attack on religious freedom soon, and the administration is thought to already have a set of penalties ready against Chinese companies supplying the surveillance equipment being deployed in Xinjiang.

The Xinjiang prison/labor camps are very important to the global cotton community. First, China has been the largest cotton consumer in the world, and consumption in Xinjiang has represented at least 20% or more of that consumption. It was also the consumption that was least likely to be replaced by polyester. Xinjiang’s consumption has been reduced by brands and retailers cancelling and pulling orders and by the weaker Chinese domestic market. The threat of future escalation of the movement of sourcing from China will cause Chinese cotton consumption to decline even more and cause additional disruptions to the global supply chain, which is already in a fragile state. Secondly, it will cause additional damage to the image of cotton with global brands and retailers. The use of forced and child labor for picking in Central Asia has drawn lots of press and has been cited for some switching from cotton. This will receive similar press, since cotton is mentioned in all press coverage of the camps because of Xinjiang’s cotton production and the textile complex’s role. Xinjiang is the second or third largest cotton producer in the world, and the move to suppress the Uyghurs has been associated with Communist China since it was created. Unfortunately, man-made fiber production in China has created an environmental disaster. It is the largest contributor to the microfiber crisis worldwide. But it is not in the headlines or the press at the moment. The fact that several of the cotton producers, such as India and Pakistan, have been quiet in the crisis is not helping.
Despite the record crop now moving to gins, the CFR basis for Brazilian styles has firmed as futures have declined below 63 cents in Dec futures. Middling 1 1/8 offers have firmed to 900-1025 points on Dec for August through March shipment. This reflects a 50-point general improvement from June and about 150 points off the season low for 2019/2020 offers. However, merchants appear to be willing to discount basis levels in order to obtain solid offtake. Middling 1 1/8 traded into Indonesia at 800-850 points on Dec recently. The basis has been supported by firm prices in Brazil, with the ESALQ Index of a 41-4-35 landed Sao Paulo falling to 69.21 US cents a lb., still a large premium to ICE futures. Strict Middling 1 1/8 offers are generally at a 75-100-point premium to Middling at 1000-1100 on Dec. A few of the larger merchants also are offering SM 1 5/32 at 1200-1300 points on and Middling 1 5/32 at 1125-1200 on Dec. 2020 crop offers have remained steady at 875-1000 points on Dec 2020 ICE futures. The basis has not yet shown much reaction to the reduced 2020 crop prospects. We now expect acreage to decline, with Mato Grosso growers switching back to corn following the dramatic changes in price relationships.
India is facing a crisis in agriculture production as the monsoon falls below normal. The problem is most advanced in the key cotton growing regions of Gujarat, Saurashtra, and Kutch, where rainfall has been extremely limited. Both regions are experiencing greater drought conditions due to a record dry period prior to the monsoon that depleted water supplies. A cyclone brought earlier rains to Gujarat, which brought about the start of planting. As of July 18th, 2,143,793 hectares had been planted in the state, which is above normal. Since most of the acreage has been planted, rainfall has been very light. Gujarat is the first or second largest cotton producing state in India, with the highest yields and the most advance farming. Last season a drought impacted yields and production, and the drought has continued. July was the hottest in four years. The Dharoi Dam is dry. In the reservoir catchment area of the dam the water level has dropped to the point that a temple covered by the water is now visible for the first time in 41 years. Monsoon rains in the Saurashtra and Kutch areas are 64% below normal, which is the greatest deficit in all of India. These conditions are making it likely that Gujarat yields will again fall short in 2019/2020.

Overall, the crop is late, which means movement, at best, will occur 60-90 days later than normal, thus requiring more imported cotton. There is potential that the 2019/2020 crop will repeat the production levels of 2018/2019, and fall to 30-31 million bales. Even that level will depend on improved rainfall before the monsoon departs. The Cotton Association of India has lowered its estimated of the 2018/2019 crop to 31.2 million 170-kg bales, which is a 300,000 bale reduction. It has also raised imports to a record 3.1 million bales and lowered ending stocks to a record low of 1.5 million bales.
Indian mills have continued to purchase additional US and African Franc Zone styles. We expect this import demand to continue into the fourth quarter of 2019, which is offering one of the few bright spots to world trade. For Indian mills, the imports are a lifeline at a time when domestic cotton prices even today are at 81-82 cents ex gin, which has reduced their competitive position. It has also provided an opening for increased man-made fiber use at a time when cotton use should be expanding. US brands and retailers are increasingly switching orders to India.

US PRICE DEFLATION CONTINUES AT RETAIL; JUNE SALES FALL

The US retail sector is in major disarray. As we discussed last week, four major retailers are in a battle to take market share from each other and are forcing other retailers to match the price. June US retail sales at apparel stores fell .90% to 22.486 billion USD. April to June 2019 retail sales of apparel at apparel stores is down 1.1%, and the reason is not weak consumer demand but lower prices. The lower prices are killing the margins of the traditional stores. Coresight Research forecast that a new record 12,000 retail stores will close in 2019, which follows 5,864 in 2018 and 8,139 in 2017. Dress Barn, a large apparel retail chain, alone will close 649 stores. It is happening at both ends of the market. Barney’s, a leading luxury retailer in NYC, is considering bankruptcy, while Bed, Bath and Beyond, a well-known home furnishing retailer, has seen its shares fall 70%.

The price deflation, led by Amazon, Walmart, Costco, and Target, is being felt throughout the supply chain. They have increased the pressure on all segments of their supply chains to further reduce cost, and it is being felt at the spinner level. In those markets where spinners face cotton prices at large premiums to either international values or man-made fibers, increased polyester fiber use is occurring. The cotton industry has failed in its ability to create pull through demand from the consumer. In China, cotton is at 65 cents a lb. premium to Polyester Fiber, while it is 10-22 cents premium in other markets.

AFRICAN FRANC ZONE BASIS AT RECORD PREMIUM TO US TYPE OFFERS DESPITE RECORD CROP

The African Franc Zone is expecting a record six million-bales crop, but despite this the CFR basis is holding at very firm levels and record premiums to US and Brazilian type offers. The US in 2018/2019 has damaged its reputation by the quality of cotton being shipped against type offers. Cotton shipped on a type is not as strict as under the Green Card system that includes the classing results. This has allowed cotton of lower quality to be shipped, and quality issues to be settled in claims. Because the 2018/2019 US crop was one of the lowest quality crops on record, mainly in color grades, the type offers have moved to a sharp discount. The spread between a 2018/2019 crop MOT Middling 1 1/8 offer for prompt shipment and a Middling 1 1/8 African Franc Zone now stands at 250 to 400 points. This sort of discount would have been unheard of several years ago, given the contamination issues with the hand-picked Franc Zone styles. The quality of the Franc Zone crop has been improving, and a large percentage of the crop reaches 1 5/32. At the same time, the general quality of US cotton has improved, but such issues as the failure to switch from a plastic bale covering to a cotton covering has contributed to the decline in the US premium.

CFR basis levels for both 2018/2019 and 2019/2020 African Franc Zone crops have firmed during the past 30 days, as ICE futures have declined. The 2018 crop basis has firmed 100-250 points, while 2019 crop offers have firmed by about 50 points. Despite the firmness, export
China has a debt problem. The Institute of International Finance estimated that in the first quarter of 2019 total Chinese Debt has reached 40 Trillion USD, which is 303% of Chinese GDP and 15% of global GDP. It also equals twice the annual GDP of the US. This means China faces major hurdles in servicing this debt, even with a booming economy. What happens when the economy slows? The impact is already occurring as Chinese companies that have been on global buying sprees cannot repay the bonds and loans issued. This was highlighted by the default by China Minsheng Investment Group, an insurance, Property, Aircraft leasing group with international investment in the Bermuda re-Insurance market. Its defaulted-on interest and principal payments due on a 2.35 billion RMB bond (341 million USD) issued in Hong Kong. The bonds are now trading at 50% of face value. It is estimated that total bond defaults have reached 33 billion RMB (4.78 billion USD) so far in 2019. China’s large textile and apparel groups also have been on a global investment spree that included acquisitions and record investment in Belt and Road projects, as well as Domestic Fixed asset investment. The largest of these is the Shandong Ruyi Group. This company began as a state-owned company. It eventually listed its shares and then issued additional shares in companies it purchased, creating a global network. At the root its largest shareholder is the Chinese state, which meant it had almost unlimited access to loans and capital. This allowed it, up through the first half of 2018, to acquire a global portfolio of brands. These include Gieves & Hawkes, Bally, The French SMCP group, Lycra, and British Aquascutum. It also has made massive investments in the Belt & Road countries, including Ethiopia, the new textile/apparel sourcing hotspot. In Australia, it has acquired Cubbie Station, the largest cotton farm in Australia and owner of the largest water irrigation allocations. Its chairman, Yafu Qiu, made headlines in 2013 when he purchased a 33 million Australian dollar home in Sydney. He is listed in *Forbes*’ top Chinese billionaires.
The buying spree ended suddenly in early 2018, when it appeared Beijing halted its ability to expand its loans or to get USD out of China. An earlier acquisition of a British small brand was made with additional payments due in 2019. These payments have been delayed, with the company citing that it was unable to get USD out of China. The global buying and investment spree appeared to have been halted by Beijing without much prior notice. In the US, the company signed a much-hyped MOU in Arkansas, which was touted by the Arkansas Governor to establish a million-bales cotton spinning plant in Forrest City, Arkansas. This would have been the largest investment in cotton spinning in new capacity since the industry’s contraction began. It would also have reflected a 25% increase in US cotton consumption. In addition, it suggested the company had much bigger plans in mind. First, it focused on the full supply chain, not just cotton spinning, and there was no ready market for new US yarn production. The announcement drew lots of attention, and the hope was that it was the start of major Chinese investment in the US textile sector. Two years later nothing has happened, and the MOU appears dead. During this same period, the company announced other MOU’s in Africa as part of the Belt and Road. These included an MOU worth billions of USD in Nigeria to build a complete supply chain, from cotton production through cut and sew. Nigeria lacks infrastructure and a strong textile industry and has major corruption issues, and such a project was very early in any development scheme. So far, this MOU has not been transferred into an active project.

The ability of the large Chinese groups to manage the debt and its service will be crucial to the global textile/apparel sector. These companies have been the largest investors in textile/apparel operations around the world. Their slowdown in expansion or even contraction will create a major void, just as their halt to expansion in the US did. This opens the question of who will fill their space, as the global supply chains move out of China. Indian investment may be a real possibility, as several large Indian groups receive increased orders form the main brands and retailers.
A US/CHINA TRADE AGREEMENT REMAINS IN LIMBO

Last week was not a period for the global cotton community to take much comfort that a US/China trade deal was advancing. A headline in the *South China Morning Post* has cast doubts that China had made a commitment to start buying US Ag products, or that it was laying the groundwork for no such purchases to occur. The article cited sources that said, while US President Trump had pushed China to buy US Ag products, Xi Jinping had made no such commitment. This theme was repeated in other press outlets last week, saying China would make no such purchases until the US agreed to remove all restrictions on Huawei. On the US side, US President Trump tweeted his disappointment that China had not started to buy US Ag products as agreed, and that, as a result, he was considering the placement of tariffs on the remaining Chinese imports that had been delayed. Then, on Friday, rumors in the grain markets were that China was inquiring for US soybeans. Soybeans are clearly the way both sides judge the progress of talks.

ICE FUTURES FIND SUPPORT BELOW 63 CENTS AS THE US & BRAZIL FACE LARGE CARRYOVERS

The CFTC commitment of traders report for the week ending July 16 confirmed the market has reached some extremes. First, the managed fund net short position reached a new record at 44,270 contracts, which by Friday could be very near the 50,000 contract level, a point that may mean at least a temporary limit on that position. The market is in uncharted waters, but the 50,000- and 100,000-contract levels have reflected benchmarks in the past. The position that continues to draw our attention is the massive unhedged position by the trade. The collective size of the US, Australian, and Brazilian crops is near the same as last year, but the trade position is dramatically different. The gross trade short in futures is 63,056 contracts (6.305 million bales). Last year the size of the gross short was 217,699 contracts (21.770 million bales). The net short today is a record 5,703 contracts, or just 570,300 bales out of at least 30-plus million bales that needs to be hedged. Last year the net short at the same time was 158,890 contracts (15.890 million bales). The swap position revealed the hedging is not occurring in swaps. The net swap long position is 38,284 contracts, which is down sharply from 61,272 contracts last year at this time. We also know the volume of forward sales to mills is far below a year ago, especially in US positions. This means that, as the Futures hover near 63 cents, the large 2019/2020 crops are not hedged, and merchants, coops and growers are carrying the risk. This means that the market appears to have been waiting for a US/China trade deal to happen at any moment over the past year and simply has left the position open. The question is will the trade panic at some point, or attempt to await a speculative short covering rally or some trade arrangement.

Such conditions reflect a very uncertain period ahead. It’s clear that the trade had expected a quick return to the status quo in US-China relations, and that they had maintained that hope for over a year. The market’s willingness to react to any encouraging news was exhibited Friday when futures rallied sharply following rumors of Chinese soybean inquiries. We continue to have our doubts that a Chinese/US trade deal is forthcoming. Even if it does, the supply chain movement and softness in the Chinese economy will not restore Chinese demand. Reserve purchases are always a possibility if any real US/China deal occurs or if China really makes major US ag purchases beyond a few token soybeans purchases. The big question is will the trade lose hope and begin to sell if no purchases occur or the trade talks go nowhere, and the Brazilian crop movement advances, and the US crop movement begins. For now, the Trade appears to be holding firm, the CFR basis overall strengthened over the past week as ICE futures declined, indicating an unwillingness to follow the weakness for now. However, there still appeared to be a willingness to accept any solid bids at lower basis levels. US styles are the cheapest
in the world in the lower grades and Type offers, which has stimulated increased US sales over the past two weeks. As we discussed before, the US does face a 5.4 million-bales carryover and a much larger 9+ million carryover at the end of 2019/2020, unless the demand outlook improves. It would appear this means some encouraging news from the China/US talks is crucial, or the trade’s ability to continue to hold firm could be in doubt.

On the other side, the Managed Funds net short may be peaking. The question is will it be extended to a 100,000-contract net short. This is a possibility because of the lack of inflation and extreme negative rates. The market is also receiving less support from long Index funds positions. The net Index Fund position is 55,122 contracts, which is 33% smaller than the position at this time last year of 82,770 contracts. This has removed major support.

China’s markets appear uncertain. Polyester staple fiber prices have retreated to near 52 cents a lb., following a 58-cent high immediately following the G-20 meeting. ZCE cotton futures have held their contract lows, but they have also retreated from the G-20 highs and displayed a reluctance to follow ICE on rallies. Cotlook’s Cotton Textile PMI for China has moved to another record low in June, reflecting very weak conditions. The Index has fallen 50% from its 2019 high.

Supply side issues are not drawing dramatic attention. The heavy rains that hit the US Mid-South early last week did some damage but did not alter the supply outlook. As we discussed in the July monthly, economist and hedge fund manager Roubini has warned about two major Black Swan events that could tilt the world into a global recession. These were the "end of globalization" and "oil shock." The end of globalization is clearly underway, and we remain skeptical that a lasting China/US trade deal will occur or hold if it is agreed to. China does not seem to understand or care that the hardline approach will likely even harden further under an opposition administration, which means there is no waiting Trump out. Regarding the second Black Swan event, Iran seized two British oil tankers late Friday, which has raised the prospect of armed conflict. Against this backdrop we fear confidence in the global supply chain will not be restored easily, which means forward demand will remain limited. For now, some consolidation is possible in prices, but we fear weaker prices still lie ahead.