COTTON IN BATTLE FOR MARKET SHARE IN Q1

BRAZILIAN DOMESTIC MILLS RESIST HIGHER PRICES

TURKISH LIRA WEAKNESS BOOST TEXTILE/APPAREL TRADE

US EXPORTS ON TRACK TO EXCEED USDA ESTIMATES

JERNIGAN GLOBAL
KNOWLEDGE IS THE NEW CAPITAL

CHINA CONTINUES TO BUY US COTTON; TRADE DELEGATION DUE IN USA TO REDUCE TRADE DEFICIT

The trade dispute between the USA and China has drawn worldwide press coverage and no shortage of opinions. One of the most interesting observations is the level of emotion it has created by those not directly involved in the process even though the US and China have generally handled the dispute as a business discussion. Regarding business publications, the well-respected Financial Times' China specialist, Martin Wolf, aggressively attacked the US for calling for China to reduce the trade deficit saying, "The US administration is so foolish that it doesn't understand this is a problem or is so arrogant it does not care". All the hysteria created by Mr Wolf and others appears to be summed up by Nassim N Taleb, author of the "Black Swan", in his new book, "Skin in the Game", which discusses the impact of taking advice from those without skin in the game. The focus of the discussion was that the US presented China with a list of grievances regarding trade. The US asks China to reduce the deficit by 100 billion USD in year 1 beginning June 1st and another 100 billion USD the next year. Other demands included eliminating market distorting subsides which created their excess capacities, eliminating technology transfer requirements for joint ventures, stop targeting

the US in Cyber Espionage, withdraw WTO complaints, reduce tariffs to same level as US for imports and open access to China's market for farm product imports. What appears to be surprising to the elite economist is the fact the US is attempting to actually address the issues. The US WTO negotiations with China were a farce which resulted in the complete transfer of America's manufacturing base to China. Of course US manufactures were behind the drive to allow China easy access as they rushed to reduce cost and increase profits. The transfer of almost the entire US mfg. base to China made this outsourcing model the norm so any challenge to address the problem draws forecast of trade wars and economic disasters.

The fear is easy to understand since global supply chains have become so complex; a product may make stops in several countries to add a component or process before it is completed and shipped to a customer. As the trade discussions continue Chinese importers of US products report increased delays in imports due to more stringent environmental checks and quarantine procedures. The reports which are emerging so far indicate that imports of Lincoln brand cars have been held up by port authorities in Shanghai and Tianjin for additional emissions checks. All US pork shipments were suddenly subject to inspections last month compared with about 30 per cent previously. China's cross-border E-commerce regulator also ordered online platforms to increase inspections of imports of foodstuffs, healthcare products and cosmetics imported from the US. US pet food appears to be one the largest imports affected. It is also reported that Chinese buyers have halted purchases of US soybeans.

At this stage it doesn't look as though cotton trade has been affected. Unlike soybeans, the duty free importation of cotton has been limited since 2015 to the WTO mandated annual volumes, except for the processing quotas. The WTO quota would appear to be immune from any special import duty due to the fact added duties to this quota volume would endanger the WTO agreed access of textile and apparel products to the US. China was an active buyer of US cotton during the week ending May 3rd taking 21,600 running bales of upland and 900 running bales of Pima for 2017/18 shipment and 88,800 bales for 2018/19 shipment. In 2017/18 China has purchased 211,900 bales of Pima with only 20,200 bales unshipped while upland purchases have reached 2,458,000 running bales with 671,200 unshipped. The increased purchases are linked to the fact that most of Chinese imports are now centered on cotton for the medium and higher count yarns, not open end. The US has had the cheapest high grade CFR basis for 2 years. Indian purchases are down sharply because of quality issues.

Attention is now turning to the arrival of Mr. Liu He, which the Financial Times calls, "the man in charge of China's economy", for negotiations aimed at reducing the trade deficit. The Wall Street Journal reported that China is creating a shopping list of purchases to address the imbalance and that they understand how serious the matter is for the US. US agriculture imports will be at the forefront of the negotiations. Cotton should play a role in any rebalancing; in the first quarter of 2018 the US imported 25.64 billion USD worth of textiles with 36.82% of the imports coming from China. China has been a

great customer for US cotton exports, however, the terms under which China joined the WTO have been a major driver in the destruction of the US textile supply chains. US cotton consumption peaked about 3 years before China joined the WTO. This destruction was driven by US retailers seeking to reduce their cost and increase margins. Since the peak the US has lost 8 million bales in consumption and the entire textile and apparel infrastructure while China has developed the most highly sophisticated textile and apparel supply chain in the world. This dynamic makes an agreement with the US to supply the raw material a natural in exchange for the quota free and lower duty access.

The next few weeks is expected to be extremely important in the negotiations. Thus far the agriculture sector has paid a price in the debate but the Trump administration has promised this issue will be addressed. A trade deficit of 375 billion is unsustainable and has to be addressed. It should be noted this is the first real attempt to uniformly address the balance of trade since China joined the WTO. At this stage Chinese industries have enjoyed record fixed asset investments and government subsidies and aid since joining WTO. As a result these companies are now the largest and most efficient operations in the world. This means any attempt to rebalance at this stage will have a significant impact on supply chains and cause extensive disruptions.

CHINA'S POLLUTION CLEAN UP CONTINUES TO EXPAND

China's pollution cleanup is continuing to expand across a host of Industries. The cleanup has now moved to the agriculture chemical sector where it has impacted approximately 700 Chinese chemical companies providing farm pesticides with closures due to environmental violations and irregularities. 30,000 agriculture chemical companies have been fined. China is a major exporter of generic pesticides but the volume of exports have dropped sharply and prices have risen. This has had a significant impact in Brazil where Chinese companies had come to dominate the market; a price rise in input cost of 15-30% is expected as a result. The fertilizer industry is also being affected as an estimated 50% of the nitrogen fertilizer production capacity has been closed down. New domestic production facilities in Brazil have been announced following the halt in the flood of underpriced Chinese chemicals, crop protection pesticides and fertilizer. This will increase agriculture production cost but have a very positive impact on the environment of China and also importing regions, such as Brazil.

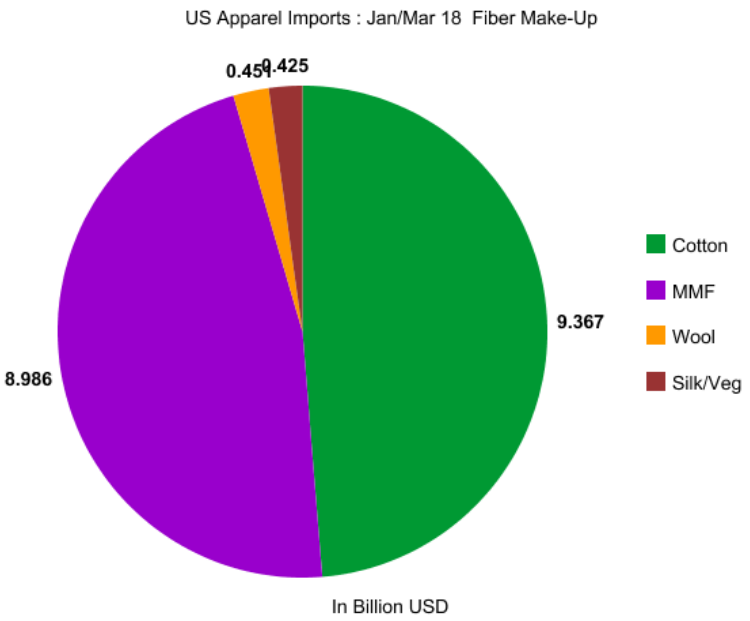
Regarding textiles and apparel, the cleanup continues as well with companies closed for violations and capacity being reduced. A group of 25 Chinese firms have announced the formation of a Chemical Stewardship Strategy. In the man-made fiber sector the greatest impact of the clean up so far has been on prices of polyester filament, which are made from PET. The price has risen by 30-38% year on year and compares to a 33% rise in polyester staple fiber prices. The recent rise in crude oil prices has not yet made its way into the raw materials market with a current decline in MEG limiting any further rise in polyester staple fiber prices above the 64 cent mark.

China's pollution battle has gone local, Chinese TV this week showed police in Changsha in Hunan moving block by block using water pistols to put out illegal smoky coal stoves used on the street. Last week China received some bad news indicating its efforts to clean up the environment would have to increase. A study by Peking University's Guanghua School of Management and the Center for Statistical Science showed the average daytime ozone levels jumped sharply according to a study of pollution data in 33 northern cities. Ozone is caused by the interaction of sunlight with nitrogen oxides and the vast amounts of uncontrolled volatile organic compounds produced by burning fossil fuels and traffic congestion. The ozone pollution has been linked to heart disease and strokes. In the Beijing, Tianjin and Hebei industrial heartland air pollution in March was up 27%.

We have been of the opinion that much of the planned new capacity in polyester and other man-made fibers will never become operational despite being approved and construction underway. This is being played out in reality as the pollution battles worsen. Mayors of several major northern Chinese cities were called to Beijing recently and told to halt new projects, reduce traffic and coal use because pollution in their cities had not declined. One of these was Handan, a major chemical producing center while another, Jincheng, has seen its fixed asset investments fall by 41% as projects have been closed.

To address these issues China is expected to soon announce dramatic new measures to further cut pollution in a 2018 - 2020 action plan.

COTTON'S BATTLE FOR MARKET SHARE AT US RETAIL BECOMES MORE INTENSE IN FIRST QUARTER



The US apparel market was weak in the first quarter of 2018 as consumers appeared to be turning from the wave of "Fast Fashion" and throw-away apparel. The focus in recent years on "Fast Fashion" and cheap apparel has left the US consumer generally unexcited about fashion and turned their retail spending to products other than apparel. Moreover, the switch from formal work wear, such as suits and ties to more leisure wear has also affected the interest in fashion. Total US apparel imports during the January - March period reached 19.287 billion USD which reflected a marginal gain of 1.63%. The volume of imports, a less accurate measurement, was flat at a .10% decline. Cotton apparel in value terms increased by 2.05% in the first quarter and accounted for 48.71% of the US apparel import market. This was near unchanged from a year ago while man-made fiber apparel imports reached 8.986 billion USD for 46.73% of the market. Wool increased its market share slightly to 2.35%.

One bright area for cotton was the growth in denim demand, total first quarter imports of all blue denim apparel increased 7.65% to 766.69 million USD. The strongest category for denim was women's jeans which increased by 9.68% while men's grew 4.40%. China remained the top supplier with just over a quarter of the market while Mexico continued to lose market share with a sharp increase in imports from Bangladesh, Pakistan and Vietnam.

First quarter imports of cotton fabric increased 9.2% to 355.6 million SME as a pickup in sewn in America programs were noted. The US has very limited cotton fabric capacity and much of what it does have is focused on commodity fabrics headed to Mexico or CAFTA to be cut and sewn. Imported fabric is required for the higher-end products which is causing significant problems for new designers seeking to use cotton. The limited US fabric production capacity is a major inhibitor to cotton consumption.

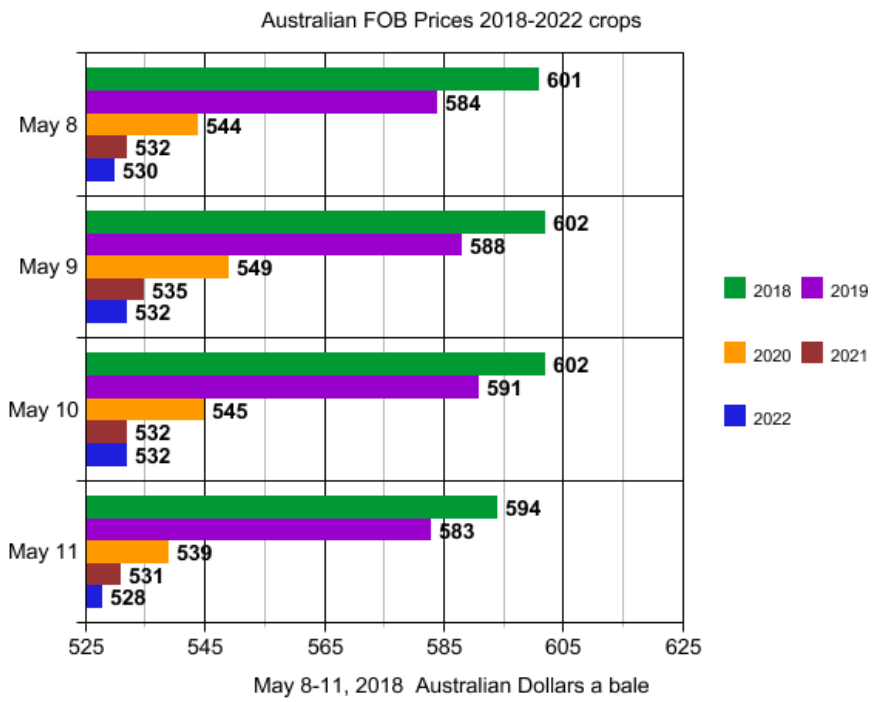
INDIAN PRICE PRESSURE CONTINUES AS PRIVATE ESTIMATES SUGGEST A SLIGHLY HIGHER CROP

The CAI has left its production estimate unchanged at 36 million bales after adjusting the individual production of several states. Private estimates by some groups suggest that total arrivals may exceed the current CAI estimate by a million 170 kg bales or more. The ginners and internal market appears in no mood to hold stocks and continue to aggressively offer for export. This willingness to sell has caused a reduction in the correlation with the ICE market. The average export CFR basis for Indian cotton collapsed when ICE prices rallied above 85 cents. The poorer quality of the 2017/18 crop has added to the difficulty in moving the crop to export. Much of the cotton is suitable only for lower count open end yarns which has decreased demand from China and other markets. Quality requirements has kept Pakistan a buyer of US and allowed outstanding sales to be completed despite the price gap with Indian styles. Any increase in the crop size will have only a nominal impact on the ending stocks level due to the tightness projected by the CAI of 2.1 million 170 kg bales which is basically the volume required for their pipeline.

AUSTRALIA HARVEST ADVANCES AS MAJOR STORMS HIT JUST SOUTH OF SOUTHERN VALLEYS

A polar vortex caused a major winter storm in Australia's southern island state of Tanzania, Victoria and the central Tablelands of New South Wales on Friday and over the weekend. This follows almost no transition from summer as the storm produced 130 mm of rain in the capital of Tanzania, Hobart, causing major flash flooding. The rains extended into Victoria but were much lighter; a few 1-6 mm rains have been recorded in the southern cotton Valleys. A very unusual freak snowstorm produced a light dusting of snow across the central Tablelands which are mainly grain areas. The southern cotton Valleys will continue to have chance of rain through the weekend with high winds and cool temps, lows of 4 - 7C or 39 - 45 F, which of course will halt any defoliation on late fields.

Harvest is rapidly advancing as weather is quite good so far across most areas. The southern Valleys are very important and any outbreak of winter will not be welcome. The crop is mature and much more advanced than last year with harvest very active and advancing with yields greatly improved at



11.5 - 12 bales per hectare. In the northern areas most cotton in now at the gin and attention is turning to the need for water supplies for the 2019 crop. The extended forecast indicates a major rain event is possible in Queensland the last half of May. Such an event would be welcome with the cotton acreage harvested.

It was a very active week in Australian trade as more than 200,000 bales may have traded as cash prices for the current and the next 4 seasons all reached attractive levels. The large volume was the execution of resting orders to sell the 2018 crop at 600 Australian Dollars a bales; the 2018 crop reached a high for the season of 602 Aussie Dollars last week. By Friday the price had weakened to 592-594 a bale as futures weaken and merchant demand waned. The 2019 crop was also active as prices reached a seasonal high of 591 AD per bale before retreating to 581-583 on Friday. Many growers are fully sold and could be over sold if water supplies do not improve. Interest in the 2020, 2021 and 2022 crops is active due to attractive prices. The 2020 crop reached a high of 549 AD a bale, 2021 crop reached 535 a bale and 2022 reached 532 AD a bale. The uncertainly over water availability remains the largest factor in additional selling.

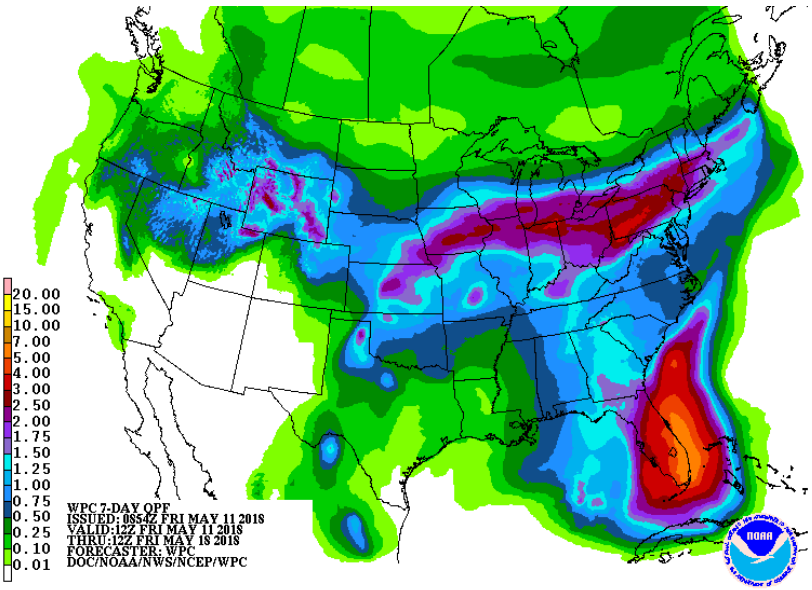
BRAZILIAN DOMESTIC PRICES CONTINUE TO ADVANCE AS DOMESTIC BUYERS BALK

The ESALQ Index of a 41-4-35 landed Sao Paulo continued to advance last week reaching a new seasonal high of 96.60 cents a lb. on May 10th. Not much business is occurring at these levels as domestic mills balk at paying such prices. Some discussion has actually surfaced that mills may announce extended vacation periods before the arrival of new crop in order to stretch supplies. The import duty and tax structure has limited the interest in imports. The new crop CFR export offers remain very firm from a basis standpoint with merchants appearing to feel comfortable with their basis positions, despite the size of the crop. The basis for a Middling 1 1/8 for October – December is at 1200 on Dec which compares to an E/MOT Middling 1 1/8 at 1150 points on. This marks a major change in basis relationships between US and Brazilian styles and also illustrates how the US CFR basis is under pressure. The Brazilian market faces a difficult period from July - December as both the domestic industry and exporters fight for shipments. The market would face great difficulty with any crop delays.

Dry weather has continued over many crop areas, in central east Mato Grosso the second crop acreage has not received any rain in 30 days and is under some stress. The middle north crop districts and the northwest crop areas of Mato Grosso both reported beneficial rains on May 4th. Last week rain appeared confined to the western area of the state. Rain is forecast this week for much of central Brazil, which will be welcome.

USA WEST TEXAS REGION BAKES AHEAD OF INCREASED RAIN CHANCES

On Friday the West Texas region reached 100 degrees F in some areas as a major heat wave gripped much of the US cotton belt, record highs were expected in several areas of the belt . Irrigated acreage was planted last week with dryland growers awaiting rain. The region will experience a chance of rain from Monday, May 14th through Thursday, May 17th. The clock is ticking daily for the dryland acreage with the main areas of concern being the 1-S and 1-N crop districts. The Rolling Plains have received rainfall and have a much better moisture profile, which is also true for the extreme southern areas of the 1/S crop district. Planting of the irrigated and best moisture profile dryland areas rapidly progressed in all areas of the belt during the week.



The USDA's first official forecast placed the 2018/19 US crop at 19.50 bales based on a planted acreage of 13.47 million acres and harvested acreage of 11.13 with an average yield of 841 lbs per acre. The production outlook remains quite fluid with several million acres of dryland cotton immediately in play over the next 30 days.

USDA ADJUST STOCK LEVELS IN 17 COUNTRIES, BUT NOT INDIA

We are simply amazed at how determined some of the staff at the USDA are as they try to convince the world that India is holding record stocks today and will hold 26% of all stocks outside of China at the end of the 2018/19 season. The USDA used the May WASDE report to adjust ending stocks for more than 2 years in 17 different countries, which had only a minor impact on stock levels. The shocking aspect was that India was not adjusted. The entire Indian cotton industry has been rebuffed by the USDA and remains surprised at the level at which it is supposedly carrying stocks. When the CAI estimates are adjusted the USDA stock levels remain over estimated by 7 - 8 million bales. Currently the Indian industry is showing that it cannot handle large inventories of cotton following the changes to credit which have occurred. The Indian textile and apparel sector is also battling to boost exports and also shows no desire to hold large inventories except on credit. The USDA has presented its logic to the Indian industry regarding its stocks estimates but their explanation has been rejected. The USDA forecast that India at the end of 2017/18 will hold 12.630 million bales which equal 16.175 million 170 kilogram bales. Simply impossible and we continue to challenge the USDA to show us exactly where the bales are being held.

The USDA made a host of changes to the 2017/18 balance sheet. The net of the changes was a small increase in the import level, export level and domestic consumption. The USDA also provided the first look at 2018/19 via its estimates but the estimates provide no real insight due to the fluid nature of production and the overestimation of stocks in India.

US EXPORT SALES AND SHIPMENTS REMAIN ON TRACT TO EXCEED USDA

The US sold an impressive volume of cotton for both 2017/18 and 2018/19 shipments, which is not at all surprising as the CFR basis continues to weaken ahead of the end of the season. The behavior of the basis is simply shocking given the stock levels. The merchant community appears to be willing to completely empty warehouses and be short the basis going into the movement of new crop. The US will have no cushion if the US new crop harvest is delayed or the early crop is smaller than expected. The US has now sold 17.125 million bales which mean that 20.525 million of the 20.925 million 2017 crop has been committed. New crop sales now total 4.03 million 480 lb. bales; much of this volume is sold for first half shipment which illustrates that the US trade short basis position for August - October is again expanding.

Despite these conditions the CFR basis out of some merchants is the cheapest in years. The E/MOT Green Card 31-3-38 is offered at 1100 on July compared to a slightly higher grade SM 1 3/16 Australian at 1600 points on July. An E/MOT Strict Middling 1 1/8 is offered at 950 Points on July. A 400 point invert means this cotton carried past July expiration has to sell at over 1350 on Dec for August - October. Then you have storage cost. It is surprising that the Trade has not demanded an ICE committee to review why the ICE contract has continued to face intercrop year inverts and a general difficulty in ever reflecting carry for any period of time. The behavior of the spreads has made merchandising much more difficult.

At such basis levels it is not at all surprising that the US is selling cotton at a record pace. For spinners, the ability to acquire a SM 1 1/8 at 950 on is a bargain. The same basis for a West African T-Juli/s 1 1/8 going into the invert is 1300 points on which triggers the question, WHY?

UNFIXED ON-CALL SALES; THE SUPPORT THAT KEEPS ON GIVING

The use of On-Call sales is expanding and has reached record levels as spinners and others view it as a free option which gives them extra time to take advantage of a special pricing opportunity. The practice has appeared to work well during the past few years. The increased liquidity of the ICE contract and the increasing level of the Managed Fund's position have provided the volumes needed to offset record unfixed positions. The On-Call sales report for the week ending May 4th added 3,682 contracts to the total unfixed On-Call position pushing it to a new record of 163,680 contracts.

The nearby drama remains focused on the July where 55,085 contracts remained open. The unfixed level in the 2018/19 contracts is rapidly increasing with a 3,584 contract increase in the last week alone, which suggests a large sales of Australian, Brazilian and other growths. Unfixed On-Call sales for the 2018/19 season have reached 96,499 contracts, 9.649 million bales, which is a record for the forward season. Unfixed On-Call sales now extend into the 2020 season.

TURKISH LIRA WEAKNESS BEGINS TO SLOW COTTON DEMAND

Turkey is a very important global player in textiles and apparel . The erratic movement of the Lira/ USD and Lira/EUR is continuing to impact its ability to import cotton. The Lira last week weakened to 4.3119 per USD representing a 13.40% decline for the year. The pressure on the Lira is being driven by the overall pressure on the developing market's currencies and the political drama which continues to mark Turkey. The textile and apparel sector appears to be performing well, even in the face of the Lira's weakness and political issues. Exports in the first quarter of 2018 have expanded by 11.5%. The US is a small market but exports to the US were up 26.58 % reaching 412.13 million USD, however, cotton products were less than 25% of the volume. The EU is the largest market for Turkish textile and apparel exports with Germany and the UK the largest markets. The UK though

has turned into a weak market with retail sales in April suffering the largest monthly drop in sales since 1995.

ICE JULY PERFORMANCE DISAPPOINTS

The July ICE contract had a disappointing week. The contract problems which appear to be tied to the weakness in the CFR export basis and the weakness in the export basis confirms the Trade is less concerned about a shortage in cotton than it is in liquidating every bale ahead of the invert.

Spinners with the outstanding unfixed On-Call sales position used weakness to fix positions but did not follow the early strength which provided support to each period of weakness. The frustration for the bulls remained due to the market failure to find support from continued brisk export offtake and strong shipments. The COT data for the week ending May 8th revealed the Trade continued to add shorts to July, as well as, the entire market selling 14,544 contracts during the week with 6,416 contracts of new shorts in July. Active trade has been noted in Australia but it is a bit surprising the Trade is still establishing new shorts with only 29 trading days left before first notice day in July. Maybe the experience of last season is playing a role, last year the Trade triggered a Managed Funds long exodus in mid May which resulted in the July/Dec spread collapsing and prices correcting sharply. Despite the proximity to first notice day July attracted widespread interest in July options, by Friday Open Interest in July stood at 138,728 contracts. This is very close to the level of OI a year ago on the same date.

The July drama remains more of a futures affair than any cash cotton crisis due to the weak CFR basis levels. There is no panic in the physical market and traders appear to still hold sizeable long Australian and Indian positions and offers of other growths continue. This, plus the level of new crop US CFR offers, suggests the Trade may be right in continuing to fight the premium in July. The July/Dec spread traded heavy volume this week and narrowed in to 375 points on Friday before closing at 438 points, well off the highs for the week in the spread. With each passing day this drama will become more intense until Open Interest drops sharply.

The December contract also drew heavy Trade selling all week, however, much of the new export offtake is unfixed On-Call which reduces the immediate support. In addition, a heavy volume of Australian and Brazilian was sold this week which was likely hedged in Dec. The Dec contract is showing technical signs of weakness which may or may not happen. The major event for this market over the next 30 days is the rain or lack of rain across the 1-S/!-N crop districts of Texas. A sizeable improvement in moisture should allow a retreat in prices, without that any weakness will be short lived. Several months ago we were aggressively bullish Dec and expected prices to reach the 80 are which they have. We also suspected that the 75 area would evolve into the new major support area for any ICE contract. We continue of that opinion. Spinners should add to coverage on any major

correction. While forward FOB basis levels have been strong for growers in Brazil and Australia they are weak for US growers. US Growers should be careful with forward basis selling due to first the weak general basis in many locations, second the lack of proper compensation for quality. Any forward selling should be focused on ICE futures and options.

JERNIGAN GLOBAL

KNOWLEDGE IS THE NEW CAPITAL

@Globalej

@JerniganGlobal

Eddie Jernigan

Register for Research
info@JerniganGlobal.com

ed.j@jernigancg.com

JerniganGlobal.com