Cotton Outlook

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China Cotton Summit 2018
Improving Quality and Efficiency: Our Responsibility


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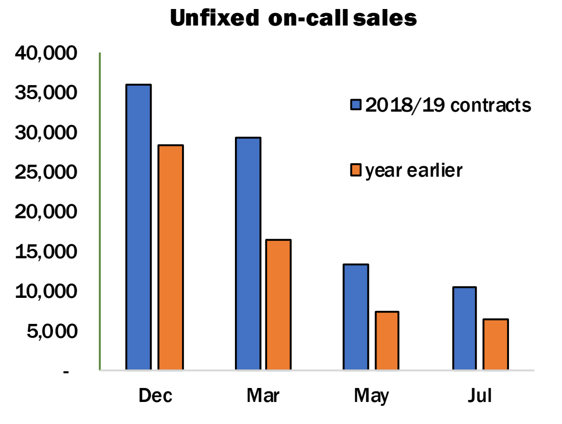
World cotton market: prices exceed expectations

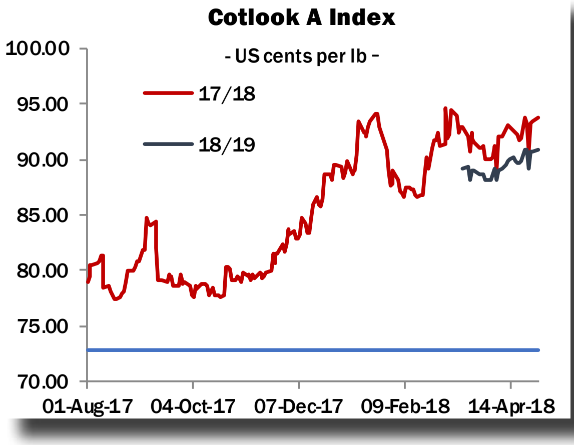
Mike Edwards, Cotton Outlook

World cotton prices have presented a strong appearance in recent months. In the autumn of 2017, as cotton from the Northern Hemisphere 2017/18 crops was poised to reach the market, trade sentiment was almost universally bearish. However, the market's performance since then has confounded those expectations.

The Cotlook A Index crossed the threshold of 90.00 cents per lb, first in early January then again in late February. At the time of writing, the Index remains comfortably above that level. Current world prices are well above their long-term average: over a thirty-year period, the average of the Cotlook A Index is below 73.00 cents per lb.

A range of factors has contributed to the international market's strong performance over the past few months.





Strong futures

New York futures have attracted a strong participation from the speculative community. Commodities in general are perceived to have been undervalued in relation to other asset classes. Fears that inflation is on the rise have also enhanced their appeal. An additional factor that has tended to support the futures market has been spinners' renewed preference for entering into 'on-call' purchase contracts. The volume of such contracts has reached unprecedented levels this season. Moreover, many of the mills in question have tended to wait until the approach of First Notice Day before fixing their purchases. This in turn has been a source of support for the contracts concerned as they approach maturity.

The tension between speculative long and trade short positions in New York has thus continued to preoccupy the market.

Mill demand

Mill demand in the physical market has also exceeded expectations over the past few months, and the underlying growth in world consumption, as discussed below, has been a positive factor. That trend has been accompanied by a significant change in the buying policy of some spinners. During the seasons that followed the extreme volatility experienced in 2010/11, buying was predominantly of a 'hand-to-mouth' nature, as mills were reluctant to cover more than their immediate needs. That risk-averse attitude has more recently given way to a more proactive stance. Evidence of the shift can be seen in the rise of unfixed on-call sales on the 2018/19 New York futures contracts. The chart shows the position by mid-April, when unfixed contracts were in excess of 89,500 contracts (equivalent to roughly two million tonnes), against almost 55,600 (1.26 million) a year earlier.

Additional evidence of stronger forward demand can be found in the United States export figures. By April 12, sales for shipment during the 2018/19 marketing year had risen to more than 3.1 million running bales (over 700,000 tonnes), the heaviest forward sales commitment since 2011.

The sustained strength of US export sales for shipment during the present season has also been impressive. USDA's April forecast for the season of 15 million statistical bales, or 3.27 million tonnes, would mark the second highest seasonal total on record. Were it not for the slow pace of shipments (the result of internal logistical difficulties), estimates of this season's US exports would be higher still.

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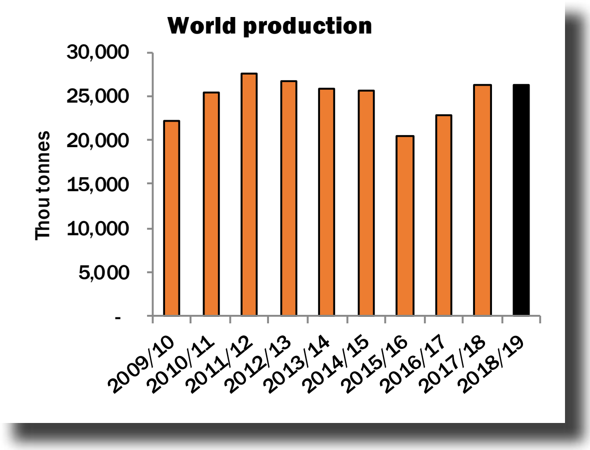
World supply and demand

Cotton Outlook's early forecasts of production and consumption during 2018/19 indicate a reduction in world stocks during the season ahead.

World production is estimated at about 26.2 million tonnes, virtually unchanged from the latest estimate for the current season. The firm prices that have prevailed in 2017/18 are likely to stimulate an increase in world cotton area, but that increase will be offset if yields (which in 2017/18 were exceptionally good in some major producing countries) return to average levels.

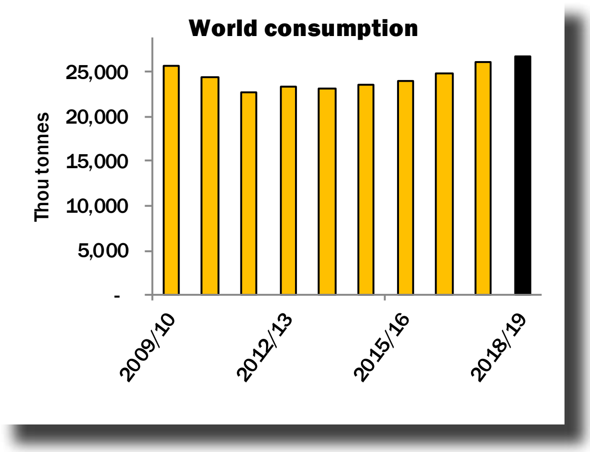


As always, forecasts must be treated with caution at this early stage. This is especially true of the United States at present, where the important West Texas producing region remains in the grip of a chronic drought. By the time delegates arrive in Harbin, the sowing period will be under way and the need for rainfall will have reached a critical point.

On the demand side of the equation, growth of 2.4 percent is anticipated, which would raise global consumption to nearly 26.8 million tonnes. That figure would represent a landmark, as world consumption would at last have exceeded the level prevailing prior to the financial crisis of 2008/09 and the subsequent shock to consumption as a result of the record world prices and extreme volatility that occurred in 2010/11.

China's import requirement

In addition to the anticipated shortfall of production next season, international trade sentiment is also influenced by the belief that, sooner or later, China must become an importer from the international market of quantities well in excess of those purchased in recent



seasons. Traders are of course not unaware that the decline of cotton production outside Xinjiang in recent seasons has created a substantial deficit – Cotton Outlook's estimates imply a volume of 3.0 to 3.5 million tonnes – part of which has been met in recent seasons from cotton held in the State Reserve. The progress of this year's State Reserve auctions has thus been closely followed. Extrapolating from the results so far, it would not seem unreasonable to anticipate that a further 2,000,000 tonnes or more may have been disposed of by the end of the process. If that proves close to the mark, the State Reserve would be reduced to perhaps 3.0 to 3.5 million tonnes. The expectation is that a review of import policy might then be undertaken by the authorities.

If the foregoing analysis proves correct, 2018/19 may prove to be a watershed season in the recent evolution of the international cotton market. As the prospect of China's greater integration into the world market draws nearer, the relationship between domestic and world prices will come under renewed scrutiny. During the 2017/18 season so far, there has already been a significant convergence between the two. Rising world consumption, spinners' greater willingness to buy forward and the expectation that China will before long be a more active buyer from the international market have all influenced international market sentiment in recent months. As attention turns to the outlook for supply and demand in 2018/19, the mood could turn more bullish in the event of a setback to one or more of the major Northern Hemisphere crops.

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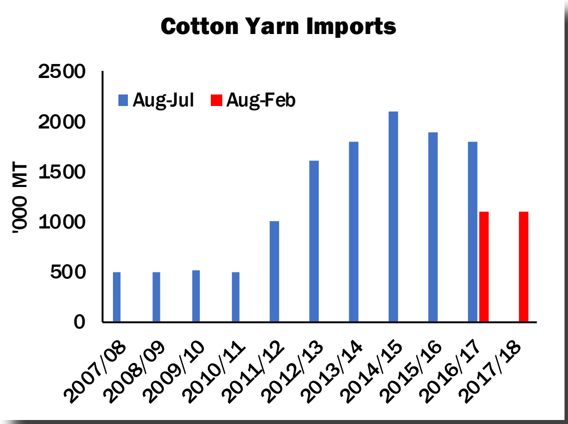
China's role in the world cotton market; where it is and where it might be going

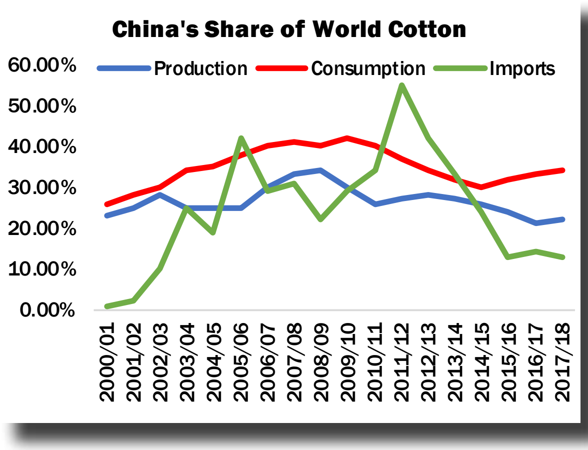
James W. Johnson
Agricultural Economist, Department of Foreign Affairs, USDA

China has been a major player in the world cotton market for many years. The last decade has seen many dramatic swings in China's cotton sector; production has ranged from 4.8 to over 8.0 million tons, while imports swung between 5.3 to less than one million tons. China will continue to be a major player for the foreseeable future, but what its exact role will be is uncertain.



Cotton Yarn Imports

China was the world's largest cotton producer from 1982/83 until 2015/16 when it fell behind India, as its share of world production fell to the lowest level since 1999/00. China still maintains its role as the largest spinner of cotton, a position it has held since 1965. China became the world's largest importer of cotton in 2002/03, shortly after its accession to the WTO, and maintained that position until 2015/16. During that time, China accounted for nearly one third of total world imports. Since 2015/16, when it was overtaken by both Bangladesh and Vietnam, China's share of world trade has fallen to just 13 percent.

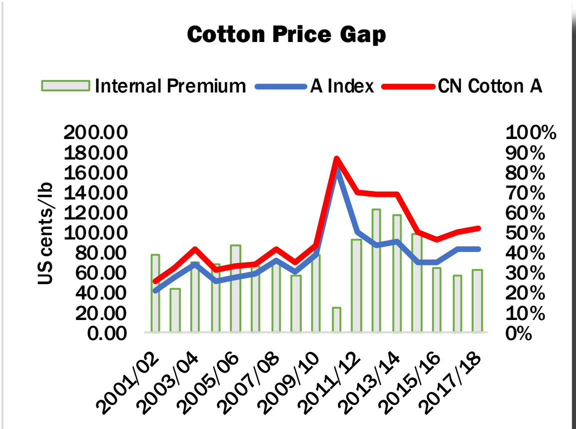


China's Share of World Cotton

It is unlikely in the short term that China's production will recover to the record level seen in 2007/08. However, given the level of support being provided to producers, especially in Xinjiang, production is likely to remain stable or even increase slightly over the next several years. The current level of support is scheduled to continue through the 2019 crop.

Where China's consumption will go over the next few years is more uncertain. Consumption has increased over the last three marketing years, lifted by the extensive support for increasing spinning capacity in Xinjiang, and the narrowing of the gap between internal prices and world prices. Growth in spinning capacity in Xinjiang continues to outstrip expectations, reaching 20 million spindles well ahead of the target date of 2023. As a result, the government has suspended support policies in the region. This could limit further expansion in Xinjiang, and may suggest that China's government is not interested in subsidizing unfettered expansion of the textile sector more broadly. In 2017, the rapid growth in spinning in Xinjiang more than offset stagnant or declining spinning in the inland areas, a trend that may not continue in a future with diminished subsidies.

The gap between internal cotton prices and world cotton prices has narrowed dramatically. In 2012/13, the CNCotton A price was nearly 70 percent higher than the A Index, the premium created by the high support price in China and large stocks outside of China pressuring the A Index. The gap has fallen to roughly 30 percent as the support price in China has been lowered and the A Index has remained relatively strong as global demand has recovered.



Cotton Price Gap

As spinning within China has recovered, China's fabric sector has not needed to import as much cotton yarn, and manmade fiber production stagnated in 2017 as government efforts to limit pollution and imports of recycling material increased cotton's share of China's fiber utilization.

These factors have helped China's consumption grow at a faster rate than the global average for the last three seasons. Whether growth in Chinese consumption will continue to exceed that in the rest of the world depends in part on how those underlying factors develop. If internal cotton prices decline, cotton support costs would increase, possibly restraining the government's willingness to see cotton prices fall. Stocks outside of China have been growing for three years and are now at record levels; if world cotton prices fall in response to these supply pressures, spinning in China would lose some of its competitive position. World cotton demand has seen very strong growth in recent years, and as a major textile exporter, China's cotton demand growth will also be affected by overall global demand.

Likewise, how China's import situation develops is of great interest to the global trade.

The gap between production and consumption in China has averaged about 2.7 million tons per year in the last three years. However, imports have been only 1.1 million tons, slightly above the WTO Tariff-Quota level. The rest of the gap has been filled by sales from the State Reserve.

By the end of this year's sales cycle, an estimated 7.25 million tons will have been sold from the State Reserve over the last three years, leaving an estimated State Reserve of about 4.0 million tons at the end of 2017/18.

The government of China has indicated that it wishes to reduce State Reserve stocks to an appropriate level. What that level is and how quickly the government plans to reach it will shape China's import situation over the next couple of years. Over the last three years, reduction of the State Reserve has been facilitated by limiting import access to the WTO TRQ, as imports at the 40 percent MFN over quota duty rate are uneconomical. With an estimated State Reserve stock of 4 million tons at the beginning of the 2018/19 season and the gap between production and consumption at 3 million tons, if imports in 2019 were again to be limited to roughly the WTO TRQ levels, the State Reserve would fall to about 2 million tons. Whether this would be below the appropriate level is not clear. Under this scenario, State Reserve stocks would be roughly 25 percent of domestic consumption.

Once State Reserve stocks are reduced to the as-yet-unknown appropriate level, the import situation becomes much more favorable. The main import policy driver would likely shift from State Reserve management back to price support, which could mean a return of sliding scale import duties, resulting in China once again dominating global import demand.

Mr. Johnson is the senior cotton analyst for the Office of Global Analysis for USDA's Foreign Agricultural Service (FAS). He is responsible for providing market and policy analysis regarding supply, demand and trade of cotton to USDA and other U.S. government agencies. He is the FAS representative to USDA's interagency commodity estimates committee, which formulates USDA's World Agricultural Supply and Demand Estimates (WASDE) for cotton.

Mr. Johnson serves as a representative of the United States to the International Cotton Advisory Committee (ICAC) and has served as Head of the United States Delegation at ICAC plenary meetings.

Prior to his work on cotton, Mr. Johnson served as an Agricultural Attaché at the U.S. mission to the European Union in Brussels, Belgium. He also worked on the Uruguay Round agriculture negotiations.

Mr. Johnson was raised on his family's farm in Iowa. He has a Bachelor of Science degree in Agriculture Business, a Master of Science degree in Agricultural Economics from Iowa State University and a Juris Doctorate from the University of Minnesota.

Promoting high-quality development in the domestic cotton industry

China Cotton Association

China commenced its historical process of opening-up and reform 40 years ago. During that period, economic and social development have made outstanding achievements, not only solving the problem of food and clothing, but also plotting a development path adapted to the Chinese context. Forty years later, China has entered a new era and people are yearning for a better life. However, unbalanced and inadequate development have lagged behind, as the domestic economy has shifted from a high-speed progressive phase to a high-quality development stage.

The cotton industry has trodden the same path followed by economic development. Ever since the opening-up era, and especially during the recent twenty years of market-oriented reform, China's cotton industry has made long-term progress, whether in the area of production, consumption, imports, or cotton textile and clothing output and exports. In all these sectors, China has a globally pre-eminent position and has become a true giant of the cotton industry. But at the same time, we must clearly realise that the unbalanced and inadequate development of the domestic cotton industry is still very prominent, as reflected in three aspects, outlined below.

Firstly: the unbalanced nature of profit distribution in cotton industrial chain. The cotton industry involves a long supply chain, in which the growers, who are at the front-end of production, lack pricing power and stable incomes due to scattered forces and low production efficiency. Although their basic incomes have been guaranteed by the target price policy, it is still very difficult for them to share in the bonus of industrial development.

Secondly: the imbalance of cotton supply and demand, production structure, as well as volume and quality. The scope for increasing production domestically is limited by resource constraints of land and water, plus the conflict between improvements in quality and growth in production. The problem of short supply will therefore persist over the longer term. Cotton production has been further concentrated in Xinjiang, whereas area has decreased in the 'mainland'. The former production pattern has therefore been totally changed, with associated risks that have always existed for market supply. With the transformation and upgrading of the domestic cotton textile industry, product quality has become superior, but this has brought ever-increasing raw material requirements. However, the quality of domestic cotton is still insufficient to meet production needs in full, and supply and demand remains unbalanced.

Thirdly: the imbalance between the traditional model and innovative development. As a traditional sector, the cotton

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industry has weaknesses in its concept of development, business mode, technical research and development. It still lags considerably behind the growth model for modernisation under innovative development.

Despite this, the opposition between unbalanced and adequate development does not inevitably result in conflict but is also where potential and opportunity exist. As the industry association representative, the China Cotton Association has long committed itself to the transformation of the cotton industry, quality improvement and brand awareness. In the aspect of policy, CCA strives to link the target price policy with quality principles and expects to implement a 'high quality and high price' standard. In this way, growers can be guided to increase their consciousness of quality improvement, as well as to solve the long-term quality problem that has been limiting the development of the domestic cotton industry from the supply side. As for quality standards, the CCA updates the China Cotton Quality Difference Table at regular intervals to popularise the 'high quality and high price' standard, which leads ginners to pay more attention to, and strengthen, cotton quality, improve ginning techniques and adapt them better to spinning requirements. In the aspect of brand, the CCA registered the quality certification mark 'Cotton China' in 2010 and strongly advocated concepts of 'environmentally-friendly, decent work and best quality' (for lint cotton), and 'high-quality, pure cotton and environmental protection' (for home textiles and clothing), so as to push forward domestic cotton production and consumption upgrades. After years of promotion, more and more enterprises and consumers have embraced the notion of 'Cotton China', as well as the high quality it stands for.

Today, China's economy has shifted from high-speed growth to high-quality development, and the cotton industry needs to follow suit, in order to achieve the target of 'Cotton Giant'. Therefore, in order to drive this transformation and upgrading of the domestic cotton industry and achieve the high-quality development target, CCA will conduct industrial research in advance to provide guidance for the industry, as well as to lay a solid foundation for government macro-regulation and market supervision.

At the 2018 CCA Council meeting, the task of 'high-quality development research of China's cotton industry' was agreed, which aims to achieve near-term and long-term targets for the high-quality development of domestic cotton. Progress will be based on the current developing situation and objective evaluation of China's cotton industry, as well as the introduction of a series of supporting policies and measures from government, industry and business.

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To set goals for the high-quality development of China's cotton industry, we need to make clear the meaning of 'high-quality development'. The first objective is high quality, which means the optimisation of cotton quality; second is high added value – cotton textiles are not just for meeting production needs, but must also contribute value in terms of research and development, and sales; the last aspect is to raise competitiveness via the improvement of efficiency in cotton and textiles.

The target of high-quality development is to increase the effective supply of cotton, pinpoint the degree of self-sufficiency of cotton and the high-end position of cotton textiles. We need to work together to push forward the reform process in quality and efficiency, in order to accelerate the construction of a modern cotton industrial system, so as to enhance creativeness, competitiveness and overall productivity and to quicken its transformation.

There are several tasks to accomplish before we can reach such a target: the first is concerned with effective supply, including quantity and quality. The degree of self-sufficiency in quantity must be sufficient to meet most of spinners' needs and render imports supplementary. Secondly, macro control, which intends to establish an appropriate macro-adjustment system based on the high-quality development concept. In order to perfect the integration of macro-control, policies of subsidy, the State Reserve, imports and exports are used to implement effective market control and provide a good policy environment for the development of the cotton industry; the last element is a system for evaluating high-quality development, by the creation of standards that are scientific and practical across the whole industrial chain.

The theme of the 2018 China Cotton Industry Development Summit is 'Improving the Quality and Efficiency: Our Responsibility'. In the process of high-quality development, we need to establish and perfect the system and mechanisms, under which every participant in the industrial chain assumes responsibility: the government is responsible for establishing a macro-adjustment policy with high efficiency, mechanism and normalisation, as well as perfecting the supervision policy, setting out a system of industry standards and credits, creating a better policy environment; the sector is responsible for developing the industry's role of self-discipline and coordination, setting out behavioural norms in the industrial chain, perfecting trade rules and so on, as well as guiding and restricting enterprises' management activities; while the enterprises are responsible for promoting the capacity for scientific and technological innovation, improving the quality of products and services, creating proprietary brands, nurturing talent and strengthening self-discipline.

As the spokesman of China's cotton industry, the CCA will continue to play a role as a bridge that links the government, enterprises and growers, coordinating the balanced interests of 'industrial, commercial and agricultural participants' in the industrial chain. It will offer effective suggestions to the government on behalf of the whole industry and promote the integrated development of the industry, so as to make new contributions to the high-quality development of the domestic cotton industry.

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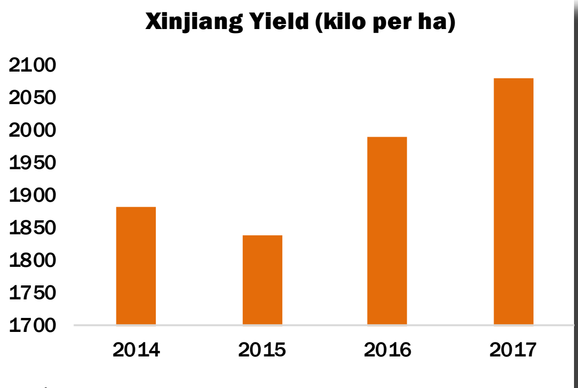
Xinjiang – the leading market in China

Chinatex Cotton International Trade Co., Ltd.

During the past 67 years, Chinatex has been participating in the business of cotton trade, and Xinjiang cotton has long been a primary resource in the company's development. In recent years, against a background of dramatic changes in cotton markets at home and abroad, Xinjiang has increasingly become the key area in domestic cotton production, under the framework of the national support policy. Meanwhile, the region's cotton textile industry has also been developing rapidly to the extent that the region's supply and demand are equally important. It has become a leading market in China's cotton textile industry.

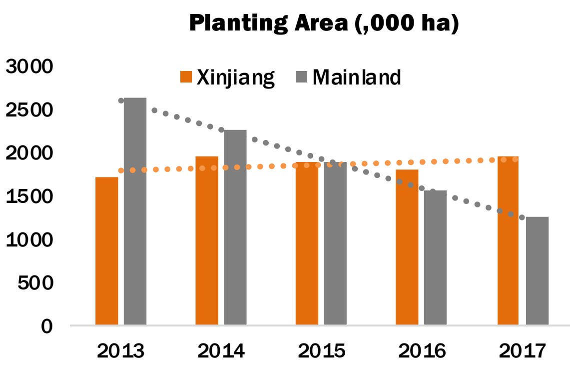
Xinjiang cotton output has exceeded market expectations in 2017/18. According to relevant data, by April 2018, lint ginning volume had reached over five million tonnes in Xinjiang, 24.7 percent more than during the same period in 2017. The figure has obviously come as a surprise to most of us, since it was absolutely unexpected at the beginning of the current season. So what Xinjiang's output in 2018/19 will be and whether it has much scope to grow further are important questions for those concerned with the market. We can carry out a simple analysis of this issue, based on area and yield.

National Bureau of Statistics (NBS) data show that the cultivated area in the 'mainland' has been decreasing significantly since 2013, but at the same time the area in Xinjiang has been expanding. Thus, Xinjiang's proportion has been increasing rapidly, from 40% in 2013 to 60% in 2017, at around 1,963,000 hectares. So, what about the figure for 2018/19? What we know of the situation is that the returns obtained from cotton planting in Xinjiang are better than those from other crops. Local growers thus remain enthusiastic. However, the expansion of cotton area has been constrained by, and subordinated to, a range of factors such as limited water resources. As a result, it is unlikely that we will see a major rise in area in Xinjiang in 2018. The current market feedback also supports such a prediction. Survey results from relevant cotton consulting agencies suggest a slight increase this year compared with previous years; data from the Xinjiang regional government also reveal a similar trend. For example, the local government in Aksu Prefecture, the main producing area in Xinjiang, has specifically determined that it will limit area in the region at below 7,200,000 mu (480,000 ha). The objective is to 'control area, optimise varieties, promote mechanization, and improve quality and efficiency'. The figure in question is 700,000 mu less than that cultivated in 2017. Therefore, we believe that area in Xinjiang will maintain a stable tendency in the future, and that area expansion will be replaced by quality enhancement.



(Data Source: National statistical Office)

So what about yields? Overall, the trend of yields in Xinjiang during recent years has been upward, from 1,850 kilos per ha in 2014 to 2,080 kilos per ha in 2017, a rise of 12.4 percent in four years. The increase can be attributed to technological advances, including scientific progress in cotton seed varieties, field management and a modernization of the scale of operations. Additionally, favourable weather conditions should not be ignored. The weather in Xinjiang in 2016 and 2017 can be regarded as having been ideal, and contributed to high yields. Therefore, in addition to technical factors, the final yields in Xinjiang will be largely affected by the weather, which needs to be closely watched by market participants.



(Data Source: National statistical Office)

As far as the textile industry is concerned, stimulated by government policy, more and more cotton textile enterprises have been transferring business or upgrading capacities from coastal regions to Xinjiang in recent years, with a particular focus on southern Xinjiang. By the end of 2017, the number of registered textile and clothing enterprises had increased to 2,703, up from 2,143 in 2014. According to survey results, by March 2018, the total capacity of Xinjiang had exceeded 14.46 million spindles. The general office of the State Council released the 'Guiding Opinion in Supporting the Industrial Development and Employment Promotion to the Xinjiang Cotton Textile Industry' in 2015, which envisaged that cotton textile capacity from 2018 to 2020 would reach 18 million spindles (including open-end rotors). However, in March 2018, the Xinjiang Uygur Autonomous Government issued an emergency notice to strictly control the disorderly development of Xinjiang's cotton textile industry, resulting in a slowdown of industrial expansion in the region. Presently, annual cotton consumption in Xinjiang has reached 1.0/1.2 million tonnes. Whether consumption is to be increased further will depend crucially on the orientation of policy.

In summary, Xinjiang is not only the most important source of raw cotton in China, it is also becoming an increasingly vital consuming market. Any one of us who is dedicated to the development of the domestic cotton industry, in production, circulation or consumption, should pay close attention to these issues in order to formulate a strategic vision.

Methods and measures of transformation: upgrading quality and efficiency in China's Cotton Industry

Mao Shuchun

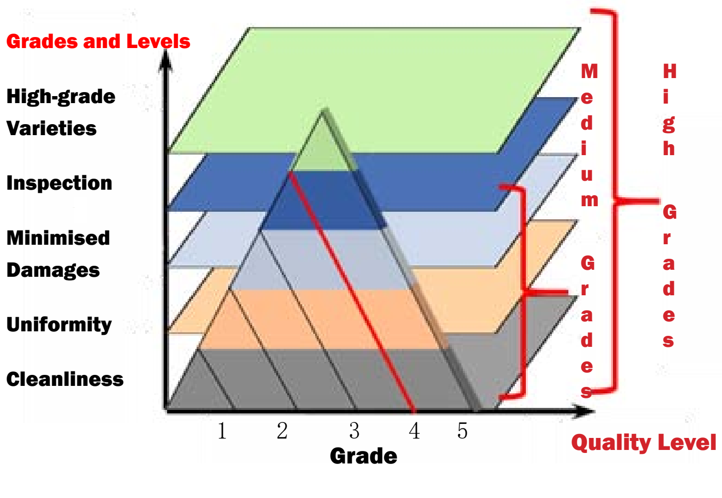
Institute of Cotton Research, Chinese Academy of Agricultural Sciences

To build and push forward the implementation of a 'Pyramid' model for medium to high-end cotton varieties

As a veteran of cotton cultivation from the Institute of Cotton Research of CAAS, Mao Shuchun first introduced the 'Pyramid Model' concept to express the medium and high grade quality of cotton in 2016 (as shown in the accompanying chart).

The quality parameters have been divided into five levels from bottom to top; the first level (bottom) is cleanliness, which requires producers to take comprehensive measures to control foreign fibres in seed cotton and lint, so as to ensure the cleanliness and purity of the fibres. The second level is fibre uniformity. This aspect of fibre quality can be improved markedly with a high concentration of a dominant variety cultivated for commercial use, and a single variety grown over a wide area. In addition, separate picking, sales, ginning and packing should be adopted, based on fibres with the same parameters. The third level is minimised ginning damage, at which the length indicator of machine-picked seed cotton should be limited within 0.5 mm after seed cotton cleaning, ginning and lint cleaning. In this case, the indicator of fibre uniformity will be limited at a minimised level with light damages, and the effect on quality of the primary ginning process will be improved as a result. The fourth level is the scientific nature of quality inspection. The quality indicators of the national inspection system are tied to cotton textile fibre indicators, so as to improve the practical functions of fibre inspection in spinning, and also lower the costs of inspection. The fifth level is high-grade variety cultivation, such as medium to long staple varieties, or ELS. As we can see from the model, the first four levels can achieve medium quality, while the fifth level – high-quality varieties – clearly have high-end features. Both need close integration of technology, systems, mechanisms and regulation measures, and represent not just individual adjustments but together a positive reform of the whole industrial chain.

Pyramid model



Several countermeasures to push forward the implementation of medium and high grade quality production

Key technology

The cultivation of primary genetic resources of high-quality cotton refers to high-grade resources with the associated fibre qualities in terms of length and strength, as well as those with early maturity; it also includes the adoption of high-grade, high-yield, early maturing and disease/insect-resistant machine-picked varieties. Specialised cotton cooperatives, extensive farmland and the PCC (army group) allow for the cultivation of high-grade varieties on a large scale, as well as the research and application of light, mechanised and eco-friendly techonologies, the control of plastic films, chemical fertiliser and pesticides, adopting a creative environmental cultivation model and key technology to improve yields and production efficiency.

Major measures

Firstly, we must stick to a scientific layout of area for cotton planting, and demarcate the protected cotton production areas, which is the main task in 2018. Currently, the national area designated for cotton planting is an estimated 2,333,000 hm^2, comprising 1,200,000 in Xinjiang Uygur Autonomous Region, 400,000 in the PCC, 267,000 in Shandong, 200,000 in Hebei, 133,000 in Hubei, 67,000 in Hunan, and 67,000 in Anhui. We need to implement the reasonable layout of domestic cotton planting.

The second task is to push forward measures to enhance the quality and efficiency of medium to high grade cotton cultivation within three years. We suggest raising such an idea to a significant action plan and a major project nationwide, so as to improve the quality of domestic cotton, and establish the model of fibre cleanliness and uniformity improvement, and to gather experiences which are workable and reproducible.

Last but not least, we must develop and support professional servicing agencies and cotton planting cooperatives as they enhance the organization of scientific cotton planting and promotion. We must stimulate the branding of areas that are the source of medium to high grade quality cotton to increase the 'brand effect'. Additionally, we also need to develop the creation of 'high-grade cotton production base brands' to support the establishment of the 'Better Cotton Initiative' brand, as well as a series of activities to popularise the slogan of 'quality, green and brand' in cotton production. With the aid of government initiatives, we can also lead agencies from scientific research, associations and alliances to participate in this process. We can thus establish an integrated chain, comprising large-scale, high-grade cotton planting bases, ginning units, spinning mills, futures and insurance companies, to create a collaborative and participatory 'build-to-order' production mode and a multi-market bargaining mechanism.

Cotton imports – spring is looming

Wang Jun, Hantrong Investment Co., Ltd.
Yan Jun, Lone Star Trans Global, Inc.

Ever since the 2017/18 season, the ICE futures market has been surging, underpinned by strong support at the level of 65.00/66.00 US cents per lb. Faced with the sharp increase of on-call contracts on ICE, domestic traders have had no choice but to buy at relatively high prices on the 1803/1805/1807 contracts.

Except for those Brazilian lots that were bought earlier by some traders at a lower fixed price, as well as US cotton that has been transferred to Southeast Asia, most of the imported cotton has been shipped to domestic ports and steadily entered warehouses to await sale. The situation of higher price overseas that happened during the same period last year occurred again, resulting in sluggish sales at home and smooth sales of imported cotton.

Affected by domestic policies and import quotas, stocks at Qingdao port have been maintained at over 100,000 tonnes after the Lunar New Year holiday (late February). In addition to some general trade sales that have cleared the customs formalities, most of the stocks are held in bonded areas for onward sale at the normal pace. Additionally, the domestic supply of spot cotton has been abundant this year, whereas mill demand has been rigid, and overall liquidity has been lacking. According to feedback from import cotton traders at Qingdao port, the sales status of imported cotton has not been as smooth as in previous years since the beginning of 2017/18, mainly because traders' market competitiveness has been weakened by the regulation and allocation of the quota policy. In addition, their management costs have increased due to price differences at home and abroad, as well as the increase of warehousing costs.

Most traders are in fact now more optimistic about cotton prices in the forward months. Although price increases may be limited, the market may at least break out of its current price range and continue to rise. As far as domestic policy and the trends forecast for 2019, most of them remain optimistic and bullish, especially in view of the strong probability that import quota restrictions will be eased, accompanied by the reintroduction of the sliding duty system. Based on that expectation, most traders have already started to procure imported cotton for shipment in 2018/19, and some of the more proactive have even been formulating their buying plans for the 2019/20 crops.

Cost-effectiveness is the primary factor for spinners in procuring imported cotton. However, as the risk of a trade war between China and the US has recently become evident, as well as the accompanying risks associated with tariffs and the exchange rate, domestic enterprises will be more cautious in buying US cotton and may turn to Brazilian and Australian until matters have been resolved.

Whenever we think back or look to the future, we can see opportunities always arise when the balance between supply and demand is broken, or the macro-environment has been improved. Spring is looming. Participants in the post-State Reserve auction era will always be eager to show their special prowess in this industry.

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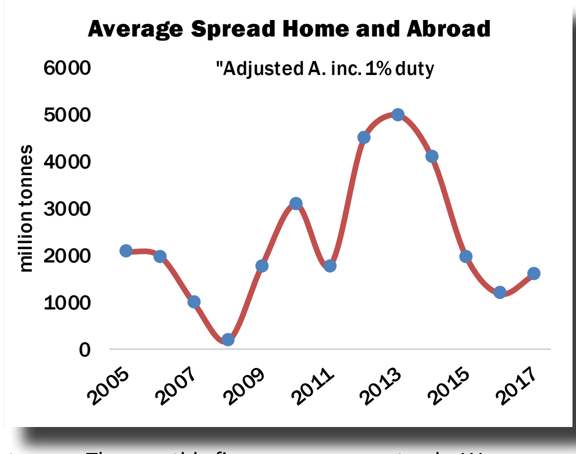
2017 Cotton import report

BCO

China imported 1,150,000 tonnes of raw cotton in 2017: 260,000 tonnes (28.9 percent) more than in the previous year, when the figure dropped to a ten-year low.

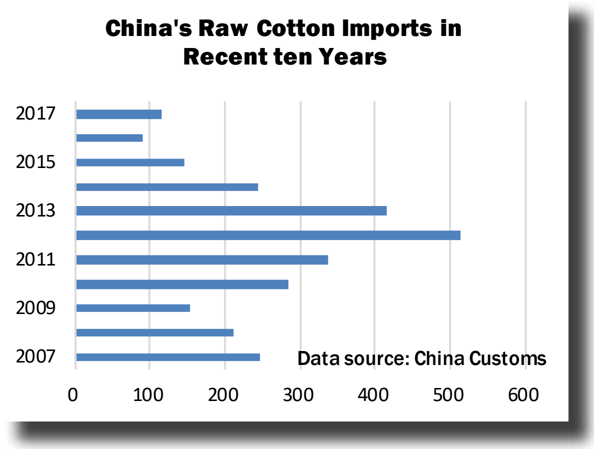


1 China's cotton import policy in 2017

According to the *Application Requirements and Allocation Principles for the 2017 Cotton Import Tariff Quotas*, a document released by the National Development and Reform Commission (NDRC), the cotton import quota was unchanged during 2017 at 894,000 tonnes, of which 33 percent was allocated to state-owned trading corporations. Also in that year, NDRC introduced for the first time an information system, via which it publishes the names of those corporations that have made applications for import quota.

2 China's raw cotton imports during the past ten years

China's raw cotton imports recovered to a level above one million tonnes in 2017, which nevertheless marks the second lowest volume of the past ten years.



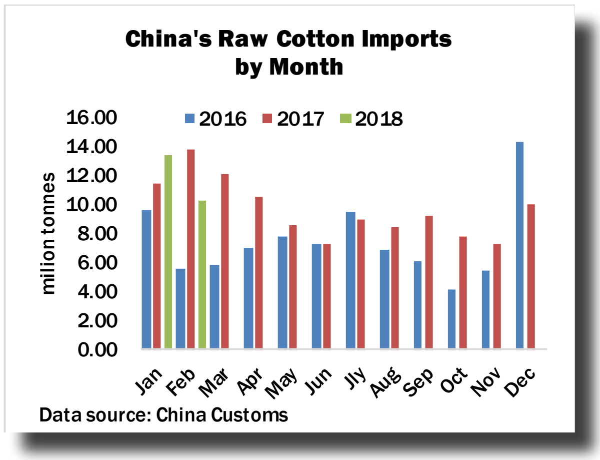
3 Reasons for the increase of imports in 2017

The increase of imports on a year-on-year basis can be attributed to two factors: the improvement of domestic cotton consumption, and the price advantage enjoyed by imported cotton. The price gap between domestic and foreign cotton expanded at one stage to over 2,000 yuan per tonne. Although the overall import quota remained at 894,000 tonnes in 2017, the extensive price spread, the carry-over of quotas from 2016, and the relatively stable consumption of spinners in bonded areas together helped the recovery of China's cotton imports in 2017.

The average spread between the China Cotton Index (CCI) and the Cotlook A Index (converted to yuan and including the 1% tariff) in 2017 was 1,595 yuan per tonne, up 34.8 percent, year-on-year. The figure was also 52.7 percent lower than the average for the past five years.

4 China's monthly cotton imports in 2017

Average monthly imports during 2017 amounted to 96,000 tonnes. The monthly figures were very steady. We can see in the chart that the peak occurred in February, at 138,000 tonnes, and the lowest point in November, at 72,000 tonnes.

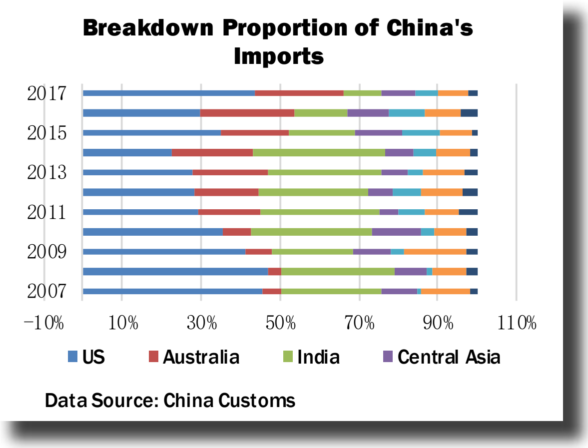


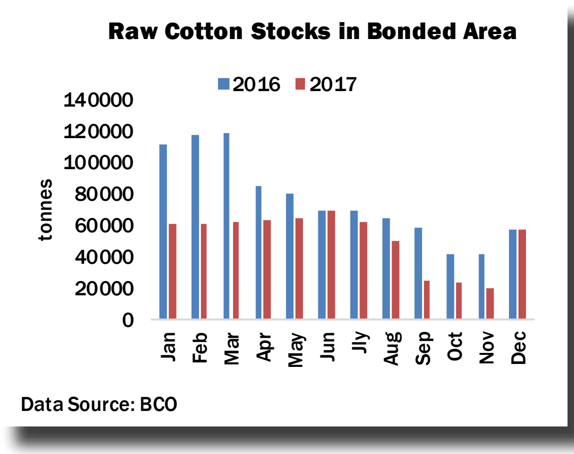
5 Breakdown of China's cotton imports over the past ten years

According to Customs data, the origin of China's cotton imports was relatively concentrated last year. The United States remained the primary source of supply and accounted for 44 percent of the total, a contribution that was also relatively high during the past ten years. The share of Australian cotton was stable at over 20 percent, while that of Indian has shown a decline over the past three years, to reach the lowest point of the past ten years. The shares claimed by Central Asian and Brazilian cotton also declined slightly, while that of African origins was relatively stable.

6 Imported cotton inventories at bonded areas during 2017

Cotton inventories in bonded areas at ports were maintained at a relatively low level in 2017, but in late December increased to the same level a year earlier. Although imports increased markedly in 2017, most traders and spinners with quotas had no hesitation in taking delivery of lots as they arrived, thus stocks at ports have hardly increased over the past year.





7 Outlook for cotton imports in 2018

1. The situation of China's imports may become more complicated than in 2017

Although imports increased in 2017, China's consumption requirements have been fully satisfied by abundant domestic inventories held in State Reserves, a rise in output and imports. However, in 2018, ending stocks in Xinjiang, sales from State Reserve auctions, as well as global cotton area and consumption are all unknown quantities. As a result, imports in 2018 will be more complicated than in the previous year.

2. Market attention is focused on whether import quotas are to be eased

The 2017 State Reserve auction programme stabilised market needs, and growers' returns have been guaranteed with the support of the target price reform. The import quota policy was maintained during 2015 to 2017. However, given the widening price spread between domestically produced and foreign cotton in the last quarter of 2017, at 2,000 or even 3,000 yuan per tonne and above, the market has been paying close attention to whether more import quotas are to be released in 2018. As a result, whether it is necessary to ease the policy will be an issue of wide concern.

3. US and Australian origins remain the main sources of imports

Given their cost-effectiveness and rigid demands, the US and Australia will remain China's main sources of imports. Although Indian cotton has been sought after in the international market in recent years, its cost performance is still considered slightly inferior to US cotton. Therefore, the presence of Indian is expected to remain light in China this year.

At the time of writing this article, the trade war has not begun, so its implications have not been included.

Achieving innovative development by futures and spot trading

Du Ying, CEFC Futures

The 2017/18 season has really been a year of 'revolutions' for the domestic cotton market. Firstly, Xinjiang, where over 80 percent of China's cotton is planted, has been chosen as the cotton futures standard price region by the Zhengzhou Commodity Exchange. In addition, the three transit delivery warehouses have been upgraded into ZCE standard cotton futures delivery warehouses after one year of trials. Secondly, after over a decade of market fostering and development, the functions of cotton futures have been fully brought into play. Given that most major international cotton traders insist on an active basis trading option, many risk management subsidiaries of futures companies have devoted themselves to cotton basis trading. This has finally helped the registered warehouse receipts on the futures market during the current season to break through the barrier of 250,000 tonnes. The volume even surpassed 400,000 tonnes, if unregistered warehouse receipts are also calculated. The total accounts for around eight percent of Xinjiang's output. If we estimate it in scale, it means around 30 percent of Xinjiang cotton has entered the ZCE to participate in hedging trading. Trading in cotton futures provides ginners, as well as spinning mills and traders, with another option for the implementation of risk management.

1 Basis trading

The combined operation of futures and spot trading has already become widespread in the market. Given the scarcity of funds and qualified staff at the disposal of Xinjiang ginners, they have faced many constraints preventing them from direct participation in cotton futures hedging operations. Thus ginners have tended to shy away from futures trading during the decade that has followed the arrival of the cotton futures business. As a result, during 2017/18 it has become popular for them to approach the futures market via third-party trading enterprises, such as major international cotton traders, risk management subsidiaries of domestic futures companies as well as some domestic traders who have at their disposal abundant funds, professional staff and trading experience. They will follow a mode of 'lead cotton contract on the ZCE+basis+premium/discount' in spot products and standard warehouse receipt procurement, and at the same time conduct hedging in the futures market to implement risk management by transferring risk from ginners to the futures market.

In the traditional basis trading process, the basis and premium/discount are basically fixed, and the level of the lead contract on ZCE can be regarded as the key factor capable of affecting the final sales price from the ginner. In other words, ginners can enjoy improved earnings from a price rally on the ZCE. On the other side, many enterprises that adopt basis trading will be active in hedging and expanding the scale of market operations, which will lead to investors' active participation in the futures market. At the same time, the pricing and risk avoidance potential of the cotton futures market can be developed so as to create a healthy and benign development strategy for the whole cotton industry.

2 Definition of basis

In basis trading, the third party will calculate a relatively fixed price in a certain time, on the basis of the warehouse inbound fee (transport and re-inspection fee), costs of capital (spot product/deposit interests), running costs, taxes and other dues (value-added tax and stamp tax), handling charges (for futures trading and delivery), as well as profits. Given the fierce market competition during 2017/18, the basis has declined sharply to around 300/450 yuan per tonne (warehouse inbound fee included), and the net profit of the third-party enterprises is ranging from 50 to 100 yuan per tonne. However, because some international cotton traders have cost advantages in comparison to their domestic counterparts, they are obviously more competitive in the basis buying market.

3 Adjustment of basis – how to find the best one

The third party's purchasing basis is not a fixed one. Normally at the beginning of the season, when the enterprises' inventories are low and capital is abundant, their offered basis buying level is relatively low with the purpose of accomplishing their annual business plan, or even at the cost of incurring small losses. However, with the inventories expanding, optional resources increasing and funds decreasing, their basis level might gradually be increased. Therefore, ginners should test basis levels before the arrival of new crops, with the aim of locking in part of the basis once the level is satisfactory. However, the pricing period, renewal agreement and liability for breach must be clarified beforehand. For example, when the basis is fixed, if there is no good pricing opportunity for the January contract, both parties involved can make an agreement to extend renewal to the May contract in order to perform the contract, or to terminate the contract under exceptional circumstances, so as to avoid losses caused by mandatory pricing in particular market cases.

4 Premium/discount in quality

Another index in basis trading is the premium and discount based on the quality of cotton, which is a key index for ginners to achieve the target of 'high quality and high price'. Presently, there are two basis trading modes

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in that market that indicate two different quality standards. The first is to procure a cotton futures standard warehouse receipt via basis pricing, which has been widely accepted by those demanding risk management subsidiaries. The premium and discount standard will be strictly adhered to in accordance with the relevant regulations of the ZCE. Because the premium/discount standard of the futures product is higher than the standard of the spot product, this is good for the seller (ginning mill); conversely, when ownership of the standard warehouse receipt has been transferred to the third party and the futures alternative delivery product is less competitive, by this time those standard warehouse receipts will flow out from ZCE delivery warehouses once the cotton futures price declines substantially and to a level much lower than that of the spot product. This is also the main reason that those warehouse receipts will run out after May every year.

Secondly, procurement of cotton in the spot market by a basis pricing strategy can be done according to the first mode, a practice that has been adopted by traders and risk management subsidiaries. The premium/discount level based on quality is not always the same, but follows the relevant regulations issued by ZCE and the China Cotton Association. The levels of different enterprises' cotton grades are also different and with their own pros and cons. Therefore, we suggest that an enterprise should comprehensively evaluate the basis, premium/discount standard and cotton quality of various prices quoted, so as to choose the optimal seller with whom to conduct business.

5 Risks in basis trading

1 Risk of contract performing

In order to prevent contract violation from sellers on account of price rallies after a transaction on the futures market, buyers would charge an advance deposit of 5/10 percent from sellers, in an effort to control risks. A trade will only occur after the contract has been signed and such funds have been paid.

However, some traders have already established an assessment mechanism for large-scale enterprises, and will magnify the single trade volume for those enterprises with a sound reputation. Those customers will be granted a certain level of credit which enables them to place an order without paying the deposit before concluding a contract via phone confirmation, so as to make operations more flexible.

2 Risk of value-added tax

Value-added tax is one of the main risks in basis trading, if the invoice price of the final sales (delivery) is well above procurement price, the buyer will pay more VAT and the cost rises accordingly, which may lead to a decline in profits or even losses.

In order to avoid such a risk, it is suggested to buy ten percent of the long position in forward contracts on the ZCE under the premise that the price on the futures market is obviously low and there is a high possibility of a price rally in the future. If the price rises, the profit of the long position is enough to offset the extra VAT. On the contrary, if the price continues to fall, the losses will be hedged by the lower VAT and will thus break even.

Strategic analysis

In addition to basis trading, how to choose a suitable hedging opportunity is also a key problem in futures/spot trading. As well as fundamental supply and demand analysis, we suggest that investors pay close attention to the spread between ZCE and the CCI 3128B Index. When that spread reaches the null axis, it is an ideal time for ginners to participate in hedging, or for traders to begin spot basis procurement.

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Worked example

In late January 2018, the spread between the main contract of ZCE 1805 and CCI3218B broadened to -200 yuan per tonne and above, or the highest point of 123 yuan. The price of the former was running between 15,400 and 15,600 yuan per tonne, equivalent to a high-grade Xinjiang cotton price in spot market at around 15,700 yuan per tonne. We can see from the historical trend chart and market analysis that the opportunity was there for basis trading and for ginners to hedge.

At the same period of time, we can buy 1,000 tonnes of high-quality machine-picked cotton produced from northern Xinjiang at a price of 15,700 yuan and sell the 1805 contract for hedging at around 15,500 yuan per tonne.

In early 2018, when the 1805 contract has declined below 14,700 yuan per tonne, we can get a profit of 800 yuan per tonne by selling it on the futures market, and the spot price at that time was still stable at 15,700 yuan per tonne with poor sales. If we lower the price by 200 yuan to 15,500 yuan per tonne for sale, such a price will be more competitive in the market and we can earn 800 yuan per tonne profit. Despite a 200 yuan per tonne loss, we can still get a profit of 600 yuan per tonne.

If we buy spot products at 15,700 yuan per tonne, during the two and half month from late January through early April, the two-month interest will be 200 yuan per tonne and the final net profit will be 400 yuan per tonne.

We can see from the above example that basis trading can both lower enterprises' management risks and increase their extra profits by a strategy of hedging, which are necessary measures for the steady development of business.

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Basis trading - the prelude to a great revolution in the cotton industry

China National Cotton Exchange

Basis trading, also known as 'basis quotation' or 'pricing trading', is very popular in the domestic cotton market nowadays and has been widely accepted by traders. Once a buyer has access to relevant information such as the quality and storage site of cotton, he can then keep a close watch on futures and basis prices. By comparing these with the general spot market price, he can use such a trading strategy when opportunities occur, along with the declines in the futures market. Such a trading mode in spot transactions has changed the traditional way of earning profits ('buy low and sell high'), and provides buyers with more products with 'high cost performances'. Generally, it can save buyers' procurement costs and accelerate sellers' sales progress.

Ever since 2014, the traditional 'buy low and sell high' spot trading mode has been disrupted by the 'buy high and sell low' basis trading mode. Many domestic traders have been affected and found themselves paralysed in business immediately after implementation of the provisional State Reserve procurement policy. However, most have maintained strong viability and have quickly adapted to the change in the market. Overnight, they have learned basis trading which has become prevalent among traders.

Basis trading is actually not new in international trade circles, but why has it become more familiar to domestic traders since 2014? The reason is that the domestic industry has changed since 2014 and the new model has come into vogue.

Firstly, the abolishment of the provisional State Reserve procurement policy, the commencement of the target price subsidy trial, and the marketisation of cotton prices in circulation, have all created a market premise for basis trading.

If the development of basis trading was affected by the provisional State Reserve procurement policy during 2011 and 2014, why had it been unpopular before 2011 in China?

Before 2014, the market information for pricing of lint was disseminated to growers and spinners via intermediaries under macroscopic regulation and control. In this process, the development of a 'pure market economy' in the cotton industry was intermittent. Domestic traders had little knowledge of hedging in futures and were only familiar with arbitrage and high-risk speculative transactions. Generally speaking, basis trading had an inconsistent and unfavourable market environment and was very hard to develop. However, with the formation of a free market pricing mechanism in 2014, a solid foundation has been created for the development of basis trading.

Secondly, the professional warehousing policy that supported the target price subsidy policy provided fundamental guarantees to the cotton spot market, as well as a development opportunity for basis trading.

A functioning cotton spot business is a fundamental guarantee of the smooth development of basis trading, and a healthy futures market must be supported by the normal running of the spot market. A professional warehousing policy has a great impact on the normalisation of the cotton spot market. Ever since 2014, the China National Cotton Exchange's professional warehousing system has implemented electronic warehouse receipts. Ownership of goods is transparent and contract performance is guaranteed. This has played a crucial role in the development of basis trading.

Before the arrival of professional warehousing, once traders had procured spot goods as buyers and hedged in futures market, a default or partial default by sellers would mean the huge risk of loss equivalent to the short position that has been established in the futures market. However, the introduction of the professional warehousing system has eliminated the risk of default. When traders use futures to offset the fluctuation of spot prices, they will realise hedging with the support of a professional warehousing supervision system, which provides basis trading with fundamental guarantees.

Thirdly, the adoption of internet technology in futures/spot trading provided basis trading with technical support and trading efficiency has also been improved.

The 'Internet+Cotton' business also boomed immediately after 2014. The combination of internet concepts and technology in the cotton industry has provided buyers with technical support allowing connectivity between futures and spot prices. This has not only created a new flow of trade information, but also, with the implementation of electronic warehouse receipt management, buyers can easily participate in trading via laptop, which has improved efficiency and popularised basis trading.

Fourthly, with the incorporation of hedging theory into practical business, conceptualisation been replaced by functionalisation, which has helped enterprises to consolidate their position in futures trading.

Previously, hedging stayed only on a theoretical level and the vast majority of domestic enterprises took futures delivery as a hedging measure. After 2014, many have gradually come to understand the trading mode of futures transactions, or in simple terms, they use the spread between futures and spot prices to offset the risks of spot price fluctuation and then attribute risks to a speculative transaction. From the point view of circulation of funds, to offset losses in the spot market by earning profits from the futures market means to use basis trading to transfer risk.

By virtue of the above four aspects, basis trading became prevalent. In this process, CNCE takes on its responsibility as the provider of professional warehousing services, offering customers involved in basis trading the support of abundant spot warehouse receipts, safe performance guarantees, as well as reliable funds and comprehensive transport services.

The report of the 19th National Congress of the Communist Party of China made clear that the domestic economy has shifted from a rapid growth phase into a high-quality development stage. Basis trading is capable of helping Xinjiang ginners to sell lint at a higher price, lowering spinners' procurement costs, and offering subsidies to spot enterprises by profits from the futures market, it can also facilitate price discovery in the futures market and enhance the the functioning of hedging, which indicates that in the face of the current high-quality development stage, basis trading can both improve ginners' and spinners' quality and efficiency, and optimise the structure of enterprises. At present, domestic basis trading enterprises consist of foreign companies, traditional traders who have finished company transformation, and capital enterprises from other industries. The clash and fusion between cotton industry capitals and financial capitals has just begun, with the continuous opening of the domestic financial environment, the country's cotton industry will also enter an era of great revolution.


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2017/18 China long staple market analysis report

Fu Changjian, Changzhou World Cotton Co., Ltd.

De-stocking and spread narrowing will be the keynote for China's long staple market during the 2017/18 season.

Long Staple Balance Sheet

ten thousand tonnes

	2014/15	2015/16	2016/17	2017/18
Beginning stocks	8	6	7	9
Output	8	13	20	8
Imports	6	5	4	6
Consumption	16	17	22	18
Ending Stocks	6	7	9	5

Note: 1) Domestic cotton season starts from September through August

2) Inventories include industrial/commercial stocks, and imported long staples at ports

2 Characteristics of the domestic long staple cotton market

1) Sharp declines in area, yield and output

Long staple growers' planting enthusiasm was severely dampened by the sharp fall of seed cotton prices during the previous season, and the planting area in 2017/18 was halved compared with a year earlier. In addition, adverse weather has meant that yields have decreased by 20 percent and total output this season has declined from 200,000 tonnes to 80,000 tonnes.

2) De-stocking, imports and prices increase, consumption drops

The big drop in output soon led to a rapid increase of long staple seed cotton prices, and a rush to buy. Seed cotton prices increased from 7.8 yuan per kilo to 9.4 yuan in just half a month, as a result of panic buying, especially in the seed cotton market. Prices of the 2015 and 2016 old crops soared and imports also increased blindly, which stimulated the rebound of the Pima price, which had earlier dropped to 150 US cents per lb, before recovering to 170 cents per lb. The excessively rapid growth of long staple prices has limited China's consumption this season, by around 20 percent, year-on-year. As a result, we saw a phenomenon whereby three resources – old crop, new crop and imports – have been competing fiercely in a single market with irrationally divergent asking prices. Several months later, old crop supplies won the game by virtue of their good cost effectiveness and such styles of cotton have largely been digested. Meanwhile, consumption of imports and new crop cotton has declined. Starting from March 2018, the price of Pima fell from 31,500 yuan, the highest level, to 28,500 yuan per tonne lately, with poor sales. New crop prices have also lost over 1,000 yuan per tonne, whereas old crop prices have stabilized, having gained 2,000 yuan per tonne since last year.

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3) Market becomes rational and spread becomes reasonable

The domestic long staple market has tended toward a more rational situation during the course of this season, after an irrational surge in its early stages. The price spread between different resources has been narrowing. Below is the spread change from new crop arrivals to May 6, 2018:

- Spread between upland cotton and old crop long staples: from 5,500 yuan to 7,500 yuan per tonne;
- Spread between upland cotton and new crop long staples: from 9,500 yuan to 8,500 yuan per tonne;
- Spread between upland cotton and Pima: from 15,500 yuan to 12,500 yuan per tonne;
- Spread between Xinjiang long staples and Pima: from 10,000 yuan to 5,000 yuan per tonne;

Compared to the relatively stable domestic upland cotton market, the sharp fluctuation of long staple prices has brought big risks to market participants, who are now extremely cautious buyers and firmly adopt a hand-to-mouth buying policy. Thus, the volume of transactions has been continuously decreasing.

3 Market outlook for the later stages of 2017/18 and for 2018/19

In the later stages of this season, the market has been affected by uncertainty with regard to international trade policy, the decline of long staple consumption, as well as price spread factors. Imported long staple prices still have room to decline, new crop will become weaker in price, but the price of old crop should be relatively stable.

The domestic long staple market will become more rational in 2018/19, and de-stocking and a decline in imports are predicted. After three years of divergence from upland cotton, the price of domestic long staple has finally been reduced. It is predicted that both will rise and fall in a more synchronized manner during 2018/19.

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Group Established in the Business since 1927

Physical Trading Division:

- Cotton/ Cotton Waste/ Cotton linters
- All Yarns and textile Goods

All Fibres - Commercial Services:

- Natural :
  Bamboo, Kenaf, Hemp,
  Jute, Wool etc.
- Man Made:
  Cellulosic – Viscose,
  Polyester Staple Fibre,
  Acrylic, Aramids,
  Polyurethane, Polystyrene,
  Polyethylene, Carbon fibre,
  Glass fibre, Ceramic Fibre etc.
- New and Speciality Fibres.

Services & Intermediation:

- Consultancy & Advisory
- Research & Guidance
- Procurement & Supply
- Broking Services
- Commission House & Ancillaries
- Other Agricultural & Textile Items

Kotak Commodity Services Pvt. Ltd.

1st Floor, Nirlon House, Dr.A.B.Road, Worli, Mumbai - 400 030

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