

Just when you thought marketing was getting routine

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Following an article I wrote two years ago titled “Risky Business; but Long-Term Discipline Pays Off,” it is time to see what has happened in the world of cotton income management while Australian rivers and dams remain in need of water.

Extreme volatility

As Figure 1 indicates, all aspects of the Australian dollar cotton price have had some of their biggest moves over the past three years than any time since the mid-80s. New York futures have rallied from 20 year lows and have experienced the largest increase in volatility since the mid-90s.

With China the key demand player, Brazil the new supplier on the international scene and speculative fund participation at the highest level ever; global prices and futures are expected to remain exciting. Basis levels for producers at the gin have risen to levels never seen before in the industry.

The worst drought in 100 years is the primary catalyst, but low futures also mean higher relative prices for quality cotton (take a look at Pima). When the water comes, and production points over 3.5 million bales, get ready for the largest basis fall you have ever seen.

The Australian dollar has rallied from 30 year lows to seven year highs. The Australian economy remains strong but the US

economy and interest rates are the primary factors in this equation. The War on Terror and inexperienced economic management in China, coupled with growing debt in the US, will keep currency markets moving in all directions.

Missed opportunity

All of this action has meant huge opportunities for the patient and disciplined. Thank goodness irrigation allows longer term planning when compared to dryland farming — though it would be nice if that irrigation water availability was consistent.

But when it is not — as it has not been the past three years — marketing and financial tools are available to take advantage of favourable pricing situations even though water is not available. Those growers who have used the wide range of hedging products have likely performed better than those who have relied on simple forward or spot cash sales of cotton.

The use of options has protected and enhanced futures exposure as well as currency exposure. Basic Put and Call strategies have allowed growers to endure adverse price moves as well as enhance returns through minimum pricing. Picking the right times during the year (seasonal highs), has meant capturing exceptional basis — whether hedging with futures, puts, or swaps.

Contracting basis during the December to May period over the past three seasons has been the right move, versus locking-in basis from July to November. And at this stage, it appears this season will make it four in a row. If you have not used the various forward contracting tools and hedging products, you have been left behind.

US farm program

The US farm program for cotton is set to change. Make no mistake about it. It may take until 2007 for this to become evident, but for the first time since I have been in the business, it looks like the US is under severe pressure to change its ways.

What this means is that Step II (like export enhancement) will be phased out but some sort of price support (though it may eventually be de-coupled like the EU) will continue to exist. The US will fight for its indirect social welfare program and national security (feed and clothe the nation); but Step II has not saved the domestic textile industry.

FIGURE 1: Australian Price – Futures, Currency, and Basis



Showing some signs of survival, US textile production could make a comeback (as it has done before) with a weaker US dollar. If the US decides to re-introduce the Conservation Reserve Program, thus controlling production and offsetting price support, Aussie producers will benefit from the US Farm Bill as they did pre-1996.

The effect would likely be higher lows and higher highs for global price fluctuation. So be sure to stay tuned to changes in the US cotton program and how they will affect price, futures, and basis.

Conclusion

The industry is now mature in many respects, but the financial risks have not changed. Producer balance sheets look very good right now, and despite ever-increasing land values and water licences, it cannot last forever. Something has to give sometime.

The competition in the global cotton market is intense and will only get worse — everyone has the technology. Regardless of what the climatologists tell us, get optimistic — water will come. So despite the lack of income during dry times, there is a silver lining to the absent cloud.

Look for continued volatility in all three aspects of the Australian cotton price, and utilise the tools, especially options, available. You don't know where prices are heading any better than I do, so pay a bit of premium to have the flexibility to capture big swings in the market when they occur (and they will).

As I said in the previous article, “moderation and discipline are keys to survival and success when difficult marketing times are upon us. Winning the war is more important than losing a particular battle — performance over a few years is more important than one crop season.”



FIGURE 2: AMPL historical performance

