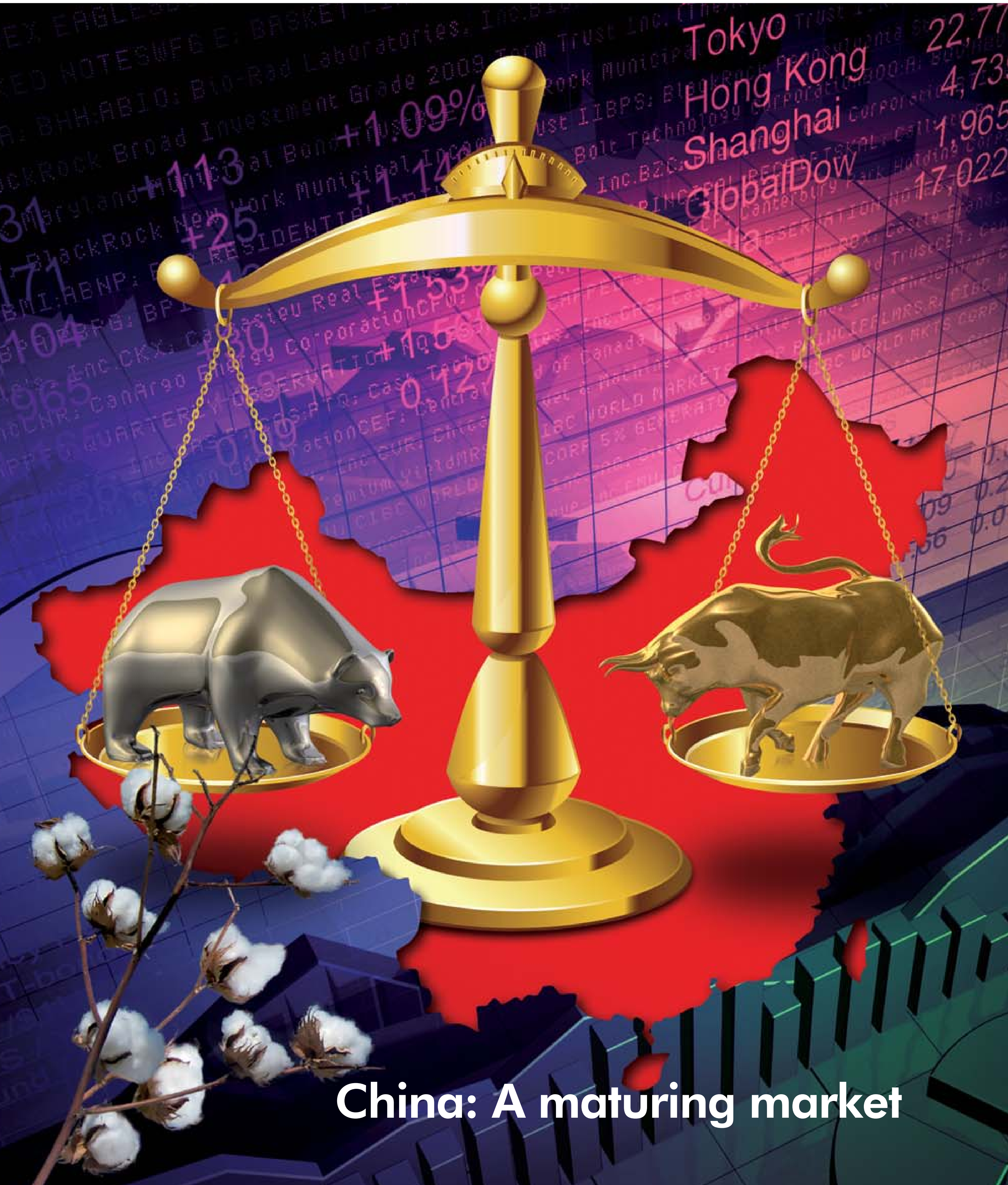
Cotton Outlook

Special Feature

June 2011

US$25



China: A maturing market

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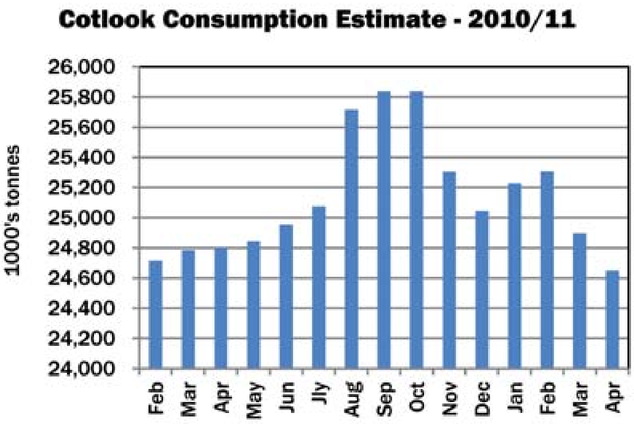
Price Rationing!

By Ray Butler,
Cotlook Limited

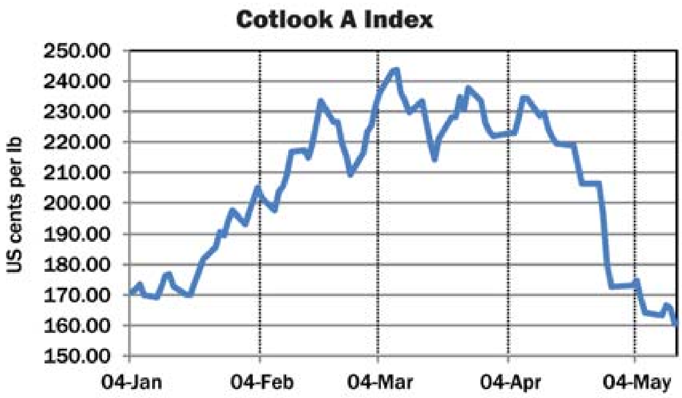
All through the early part of the year, as prices were breaking new record highs, references were frequently made to the prospect of price rationing, i.e. that prices would act in such a way that the remaining 'free' supply would be eked out by dint of spinners turning to other fibres, or simply curtailing operations. That prospect has indeed come to pass!



During the first four months of the calendar year, Cotlook's world 2010/11 raw cotton consumption forecast was reduced by almost 400,000 tonnes, and more such cuts cannot be ruled out in the coming months. Observers of the man-made fibres market had already identified substantial increases in the uptake of polyester (putting prices for these materials also on an upward curve), as downstream buyers, including retailers, sought cheaper alternatives. The fallibility of the meteoric price advance in cotton was exposed, especially when mills and traders (the latter, notably, in China) began selling back supplies to shippers and offering stocks to other markets.

The Cotlook A Index touched a high of 243.65 on March 8, against a background of declining world stocks, government interventions or price mechanisms inhibiting export activity in some producing countries, and political events elsewhere. By May 13, the Index had fallen back to 160.55 cents – a drop of 35 percent. In truth, the signs were that mill buyers would be unwilling to contemplate business within quite a distance from this value. More pressure on shippers' offers was thus predicted, especially for supplies from Australia and Brazil, both countries with massive, record crops in prospect. Moreover, despite the apparently well-sold state of many origins, notably US, buy backs by the trade and outright cancellations were beginning to free-up some quantities for resale, talk of the possibility of additional export supplies becoming available from India remained a potential market factor, and the apparent resolution of the political upheaval that has devastated Ivory Coast promised the release of committed quantities from that origin, and the easing of shipments from neighbouring countries.

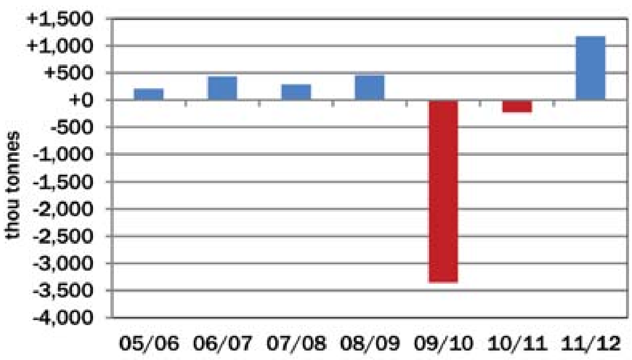
The paucity of import demand for raw cotton has been nowhere more evident than in China. That country's statistics remain a conundrum: disregarding (as one must) the wide variation

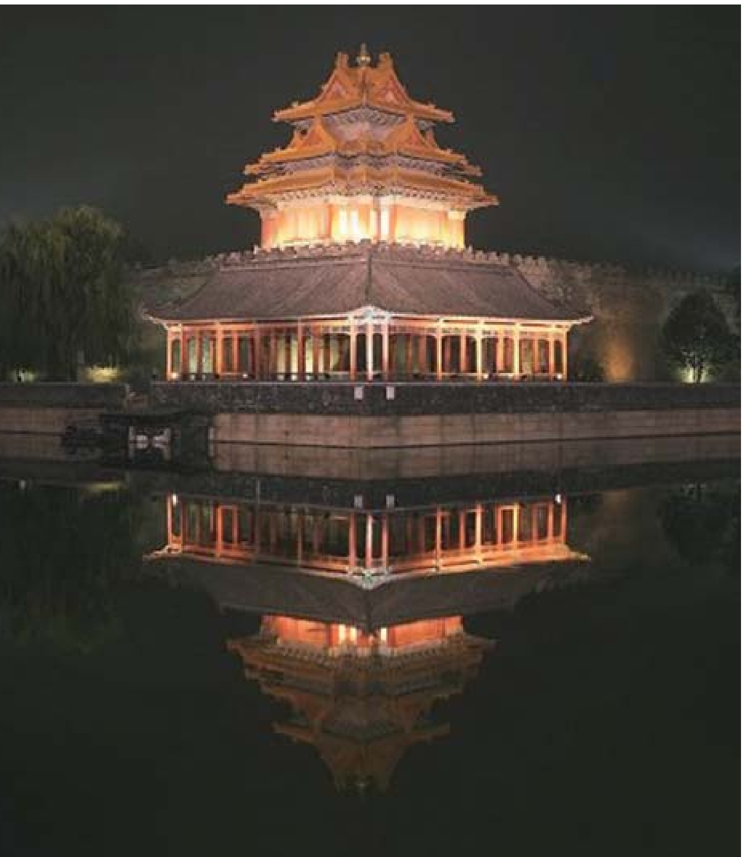


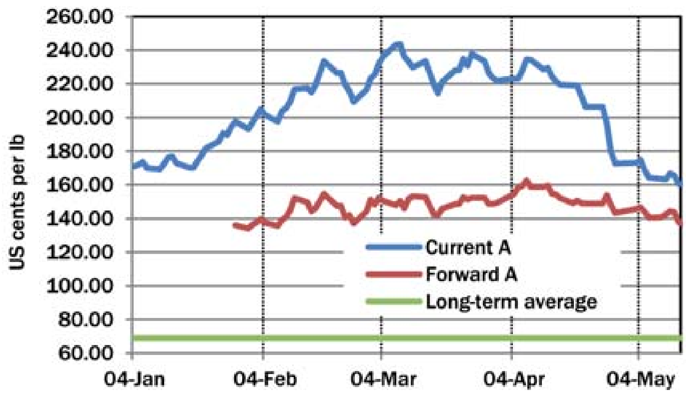
Memphis
Liverpool

between the figures promulgated by various Chinese bodies and international agencies, they all point to a contraction of stocks in China this season. This is logical, given that government reserves to the tune of one million tonnes were released to the market in late 2010. What has been less comprehensible, however, is the persistence of domestic cotton prices some 10 percent or so below international parities, the resultant lack of urgency in mill requirements for imports and the resale of previously contracted lots. Some arguments have been advanced that the inclination of Chinese traders to deplete their positions in imported growths has been financially driven, either for liquidity reasons or as a means of taking profit from the higher international prices, and that China's import requirement will burgeon once again during the third quarter. In terms of the 2010/11 season's data (the international cotton season, from August 1 to July 31), however, Cotlook's import forecast has been lowered to 2,800,000 tonnes, which is a reduction of no less than 700,000 tonnes from its peak level.

Apparent Changes in World Stocks







So where does that leave cotton? The short-term scenario is that price rationing has changed the statistics – the market can be said, in that sense, to have acted rationally. Spinners have been unable to sustain the high prices that had ruled previously, as yarn demand dried up. At some point, nevertheless, prices will reach a level that spinners deem is workable. Moreover, at the time of writing, some markets, on paper at least, still needed cover for a considerable proportion of their third quarter shipment requirements – a period for which a substantial premium is still demanded, compared with 2011/12 crop supplies. Conjecture has also persisted as to the demand outlook in China; after re-selling existing supplies, will a supply gap emerge prior to the availability of the domestic new crop?

The third quarter of course brings with it the roll forward from current into new crop price influences. Dealing with the switch from current to forward values will prove a test for sellers and buyers alike. The former will naturally wish to bring existing contracts to fruition and take advantage of any obtainable nearby premium, while the latter will doubtless hope that the new crop discount will be readily attainable.

Even should the latter prove to be the case, prices seem likely to remain high by historical comparison. For instance, the Forward A index is currently more than twice its long-term average, as it has been almost since the date it was launched, in late January. Although world stocks are predicted to show some recovery in 2011/12, the estimated amount so far is barely more than one third of the reduction we believe has taken place during this season and last. Our forecasts presume for the time being that consumption will recover from the current, price-rationing setback and, since Northern Hemisphere new crops are barely in the ground, that mostly average yields will be attainable from a generally expanded cotton area. The many attendant provisos in regard to production include the course of weather developments in a number of important growing areas, not least the timeliness of rains in Texas and the normalcy of the Monsoon in India.

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E-mail : cotton@bhadreshindia.com
www.bhadreshindia.com / www.bhadresh.com

New Challenges to Conventional Wisdoms

By Eric Yeh, Managing Director, Ericot/Amfine Co., Ltd.

In 2010, a significantly increased number of cotton buyers in China have joined their counterparts around the world in buying imported cotton on forward contracts. The timing couldn't be better in the cotton history! For fixed-price contracts, market prices have become much higher when the shipments were received. For first-time, on-call buyers, although some may have missed a few good chances for their fixation, the cheaper basis contracts signed earlier are still beneficial in cost and have secured the quality and quantity for their production in a year of severe cotton shortage.

As a close observer of China's cotton market, I've been stressing publicly the importance of forward commitments to Chinese buyers for years. It is an honour to be invited to share views from a cotton agent's perspective on a few subjects of common interest:

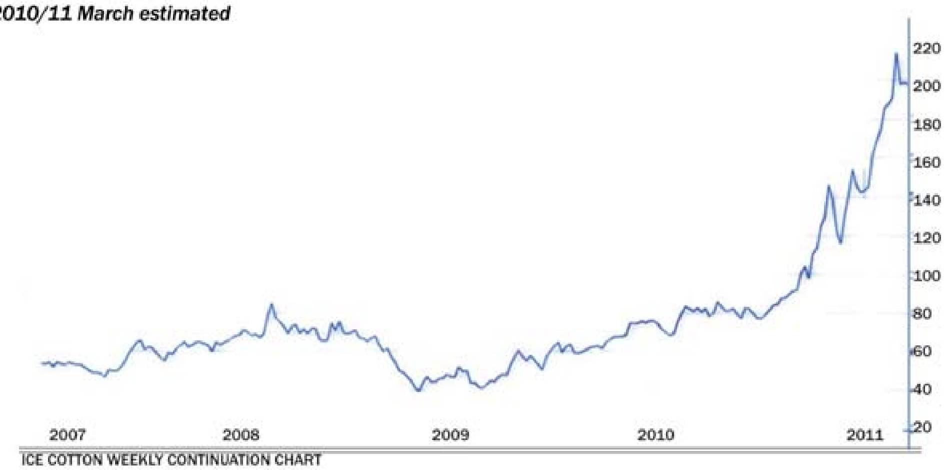
A textbook hedging procedure tells us that when a merchant owns physical cotton, he will sell an equivalent quantity of contracts in the Futures market and buy back the Futures contract upon selling the physical cotton to his buyer. On the other hand, when a merchant sells physical cotton to a buyer in a short position, he will hedge by buying equivalent contracts in the Futures market and liquidating the long position when he buys the cash cotton from farmers or their cooperatives. Unfortunately, this standard hedging operation was almost shattered by The Black Swan in 2008! What had been a protective measure turned into the probable cause of the fall of several reputable international cotton shippers.

In retrospect, the tragic events in 2008 occurred in a year in which both China and the USA had small cotton crops, but, most other cotton producing countries produced ample supplies. In the meantime, textile mills in other countries generally had sufficient cotton stocks both in warehouse and in their forward purchasing commitments. Therefore, when the Chinese buying spree was driving up NY Futures from the 60s to the 90s cents/lb range in a two-month period, shippers' physical cotton, mostly US growths, which had risen in price, was not saleable in the cash markets. Most buyers were either standing on the sidelines or buying much cheaper foreign growths. Margin calls become unbearable and shippers were eventually forced to liquidate their Futures short positions. The nightmare ensued after the exhaustion of China's import quotas; NY Futures retreated, initially into to the 60s, before falling to the upper 30s. Un-hedged physical cotton was then sold to the cash market at below the cost price to traders. The following year, 2009, was a consecutive year of short crops, but the real run on cotton prices was delayed by The Economic Crisis. NY Futures traded between the 40s and the 60s until the last quarter of 2009, when the world economy began to show signs of recovery, at a time when the world textile pipeline was virtually empty. Although a 'Perfect Storm' was then foreseeable, no one could have predicted the result would be NY Futures over 2 dollars!

I am blessed to be an agent representing Amcot, an American cotton farmer's cooperative organization. All our sales contracts have been performed every year without delay. However, oftentimes I've asked myself the questions: "What if the market had been against the buyers? How much would they have been able to bear the loss without causing a contractual problem? Unfortunately, I don't know the answer.

World Cotton Balance Sheet												
	U.S.				China				World			
In millions of 480lb bales	07/08	08/09	09/10	10/11	07/08	08/09	09/10	10/11	07/08	08/09	09/10	10/11
Beginning Stocks	9.5	10.1	6.3	2.9	20.5	20.5	22.4	15.2	62.3	60.7	60.5	43.8
Production	19.2	12.8	12.2	18.3	37.0	36.7	32.0	29.5	119.7	107.1	101.3	115.0
Supply	28.7	22.9	18.5	21.3	69.1	64.2	65.3	60.2	181.9	167.8	161.9	158.8
Demand	18.2	16.8	15.5	19.4	51.1	44.1	50.0	47.1	123.3	110.1	118.5	116.6
Ending Stocks	10.1	6.3	2.9	1.9	20.5	22.4	15.2	13.2	60.7	60.5	43.8	42.3

*2010/11 March estimated



ICE COTTON WEEKLY CONTINUATION CHART

Disciplined cotton merchants have added Call & Put options into hedging strategies so as to protect their contracts in trading both Futures and the cash market. In respect of contract fulfillment, in our view, either a buyer or a seller's attempt to re-negotiate prices is practically a breach of contract. A shipper's proposal to buy back a contract at a discount to the prevailing market price also dents the effort to sustain 'sanctity of contract' and could be misleading to many new buyers who lack international trading experience. Cotton spinning mills should realise the importance of selecting reliable sources of supply and suppliers with strong finances who follow strictly the hedging operation. As an end-user, stability of cost and consistency of quality, together with production flexibility, are vital requirements for success.

Study of the correlation between NY Futures and China's Zheng Zhou Futures is essential. The latter is relatively young and needs time to develop. But what about ICE Futures? Cindy Walters of Calcot Ltd. stated well in one of her market comments: "Prior to cotton's electronic market, it used to be that a limit move session would almost always have some event to warrant such a move. Limit move now just seem to convey a day-to-day change in sentiment." A limit move today is 7 cents/lb and a maximum daily range is 14 cents, which could be the price fluctuation of a whole year that we used to know. What, then, can textile industries do to cope with the unprecedented challenges?

I remember Keats Kajiay, my late mentor, who once advised buyers: " For total estimated demands, please buy 1/3 forward contract at a fixed-price, 1/3 on-call and leave the balance 1/3 to buy spot cotton for nearby shipments." Stormy waters lie ahead, but, the steering wheel is in a brave captain's own hands.

Bon voyage !

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CONTACT DETAILS
SGS Société Générale de Surveillance S.A.
1 place des Alpes
P.O. Box 212
CH-1211 Geneva 1
Switzerland

Tel: +41 22 739 92 11
Fax: +41 22 739 98 10
E-mail: cotton.switzerland@sgs.com
www.fibres.sgs.com

Long-term View for International Cotton Trade

The Development of Forward Cotton Trade in China

By General Manager: Fu Changjian,
Vice-General Manager: Deng Ang
Chang Zhou World Cotton Co., Ltd.

With the violent ups and downs of cotton prices in 2010/11, a new phenomenon in the international cotton trade has attracted industry professionals. From late October 2010, well before sowing of 2011/12 crop cotton, Chinese buyers signed a great deal of forward import contracts with international shippers. According to statistics from the US Department of Agriculture (USDA), by April 15th, 2011, U.S upland cotton sales registrations had reached 1.126 million tonnes, of which 398,000 tonnes were to China. The amount and the length of time involved in these forward purchases are unprecedented. Until now, 'high cotton prices, high risk, high potential profit, and long-term contract' means that international cotton trading has entered a period that demands participants to be visionary.

Analysis of reasons for signing forward contracts

A) Recently, wide gaps have developed between international spot prices of cotton and forward contract prices. The pricing model employed by international cotton shippers has involved applying a 'basis' to the relevant ICE cotton futures contract month. Since huge spreads have existed between nearby and forward contracts in the ICE market (the spread between March 2011, and January 2012 at one point exceeded 80 cents per lb), quotations for new crop shipment in January 2012 have been far below those for March 2011, and the relatively low prices appeared extremely attractive to cotton buyers.

B) A wide gap exists between forward cotton prices and production costs in some countries. At the end of 2010, US cotton growers were expecting to sell 2011/12 crop cotton to shippers for over 100.00 cents per lb, already very lucrative, and production costs are lower than in Africa, Australia and India.

C) A wide difference in price has also prevailed between the forward import price and China's futures market, creating space for hedging. In early February, 2011, the January contract on the Zhengzhou exchange fluctuated between RMB 29,000 and 30,000, whereas US SM, 1-1/8", was offered for January 2012 shipment at the equivalent of between RMB24,500 and 26,000. At that time, buying U.S cotton, or cotton from other countries, and selling the corresponding January 2012 contract at ZCE offered a huge profit potential.

D) Momentum for buying cotton one year in advance has also been derived from the signs of a progressive rebound in the global economy, the long-term shortage of China's domestic cotton supply, continuing appreciation of the RMB against the US Dollar, and expectations that the state reserves will be replenished.

Problems with forward trade

Although the price of these large-scale forward purchases is high by historical comparison, it is still much lower than this year's imported cotton cost. It is too early to make a judgment as to whether the exercise will prove to have been financially successful. In the market, risk is the shadow of profit, while the seemingly higher-profit contract is also the seat of higher risk. While we wish success, we need to communicate the risks and issues that might exist to our peers.

A) Uncertainty in delivery

The pricing model used by international cotton shippers will not ensure fully the timeliness,

quantities and quality of delivery. Generally, shippers either secure their sources of supply before selling to their customers or employ futures strategies to allow them to sell before they have a determined cotton source.

Delivery could be rendered uncertain if spot prices should far exceed the agreed selling price, if contract difficulties arise between the cotton supplier and the international shipper, if governments intervene (such as in India last year), if political instability prevails (such as recently in West Africa) or if natural disasters occur that affect production volume or quality. In such circumstances, international shippers may try to buy back contracts (although agreement to negotiate contract settlement requires free will on both sides, the operating schedules of textile mills stand to be affected).

B) Inequality of Deposit Trading

The most fundamental principle of contracting is equal treatment of buyer and seller. In the sales contracts of new crop cotton that have been signed for 2011 and 2012, nearly all international dealers seem to coordinate without negotiation that all of them require buyers to pay a deposit of 10% to 20% on signing contracts and that the amount of deposit is variable, in case of market movement. This is intended partly to offset the traders exposure to changes in margin calls. As buyers, however, China's enterprises have tied up considerable funds, have placed faith in the reputation of the sellers and rarely have effective measures to ensure their legal rights, if sellers should break contracts. The abnormal existence of a deposit requirement unilaterally safeguards the seller, which highlights the inequalities in forward contracts.

It should be noted, moreover, that, there are defects in the deposit purchasing method. Some international cotton dealers require importers to remit deposits to the account of their subsidiaries in China in the form of RMB, but the cotton sales contracts are signed with domestic buyers under the name of foreign organisations. Hence the corporate body receiving the deposit is completely and legally different from the one signing the sales contracts. This increases the potential complexity of settling any disputes that may arise. Also, there are international cotton dealers who demand importers to remit deposits directly to foreign accounts in the form of US dollars. If the RMB maintains its long-term appreciation, the buyer may suffer significant exchange rate losses on the sum of US dollars purchased in advance.

C) Market risks

Default is of course part of the risk. Another risk comes from the market.

For buyers engaging in hedging, spot prices of domestic and foreign cotton at some point will diverge, and futures prices and spot prices will deviate from each other, particularly in the delivery month. If international cotton prices are far below domestic cotton prices, hedging might result in losses. It is not impossible that such a situation emerges. Historically, international cotton prices have been mostly lower than domestic cotton prices, especially at times when cotton planting area increases extensively and bumper harvests are in prospect around the world. In addition, cotton futures this year have attracted an inflow of capital from investment funds, resulting in the dramatic fluctuation of prices. If speculative capital violently pulls futures prices in one direction or the other in the short term, enterprises taking part in forward trade hedging may be exposed to greater risk.

For domestic buyers with lower purchase costs who do not take part in hedging, despite the prospect of price support at a level of 19,800 yuan per tonne from the activities of the state reserve, bumper cotton harvests around the world could result in imported cotton prices being below the state reserve price.

Pricing power in international cotton trade

If there are problems with the basis and system of international cotton trade pricing, in the execution of forward or short term contracts, both buyers and sellers will be exposed to significant risks. For a long time, the ICE market has dictated prices in the international cotton trading, as many international cotton traders use the ICE for hedging purposes, and they also determine cotton sales quotations based on ICE cotton futures prices.

The skyrocketing price at the beginning of 2008, which was detached from fundamentals, brought immense pressure on the international trade in terms of increasing margin calls, and the rupture of financial lines is still clear in the mind. Merely three years later, the ICE market has once again tested the financial capabilities of international cotton dealers. From the end of 2010 to the begin of 2011, the activities of speculative funds detached ICE cotton futures prices from the fundamentals of world cotton, especially from those of China. Offers to supply imported based wholly on the ICE market have been unable to reflect China's domestic market situation, forming a gap of tens of thousands RMB with actual transaction prices. This has resulted in tough times recently for international cotton shippers in China. Even the relatively cheaper new crop offers have appeared, at times, to be expensive compared with the January 2012 Zhengzhou futures contract. In consequence,, the pace of forward buying has declined. It can be imagined that excessive speculation in ICE cotton futures has had a heavy impact on other cotton-importing counties. In particular, since US cotton stocks are running extremely low, excessive ON-CALL sales set the scene for a squeeze in the ICE market. Until recently, speculative capital inflows have been extremely active; importers and U.S domestic textile factories using ON-CALL purchases have felt the pinch the most.

The futures market is rarely short of a huge amount of speculative capital. Excessive inflows of such capital have resulted in the deviation of ICE futures prices from world cotton market fundamentals, and have already impacted the normal world cotton trade order. Hence, people have begun to question the world cotton pricing model based on the ICE market. In the long run, surely, there will be problems in determining world cotton prices according to the US cotton futures market. International shippers must therefore consider revising their current pricing model. This topic is worthy of consideration by cotton professionals worldwide, with the aim of securing a secure, credible, healthy, and effective pricing system for world cotton trade.

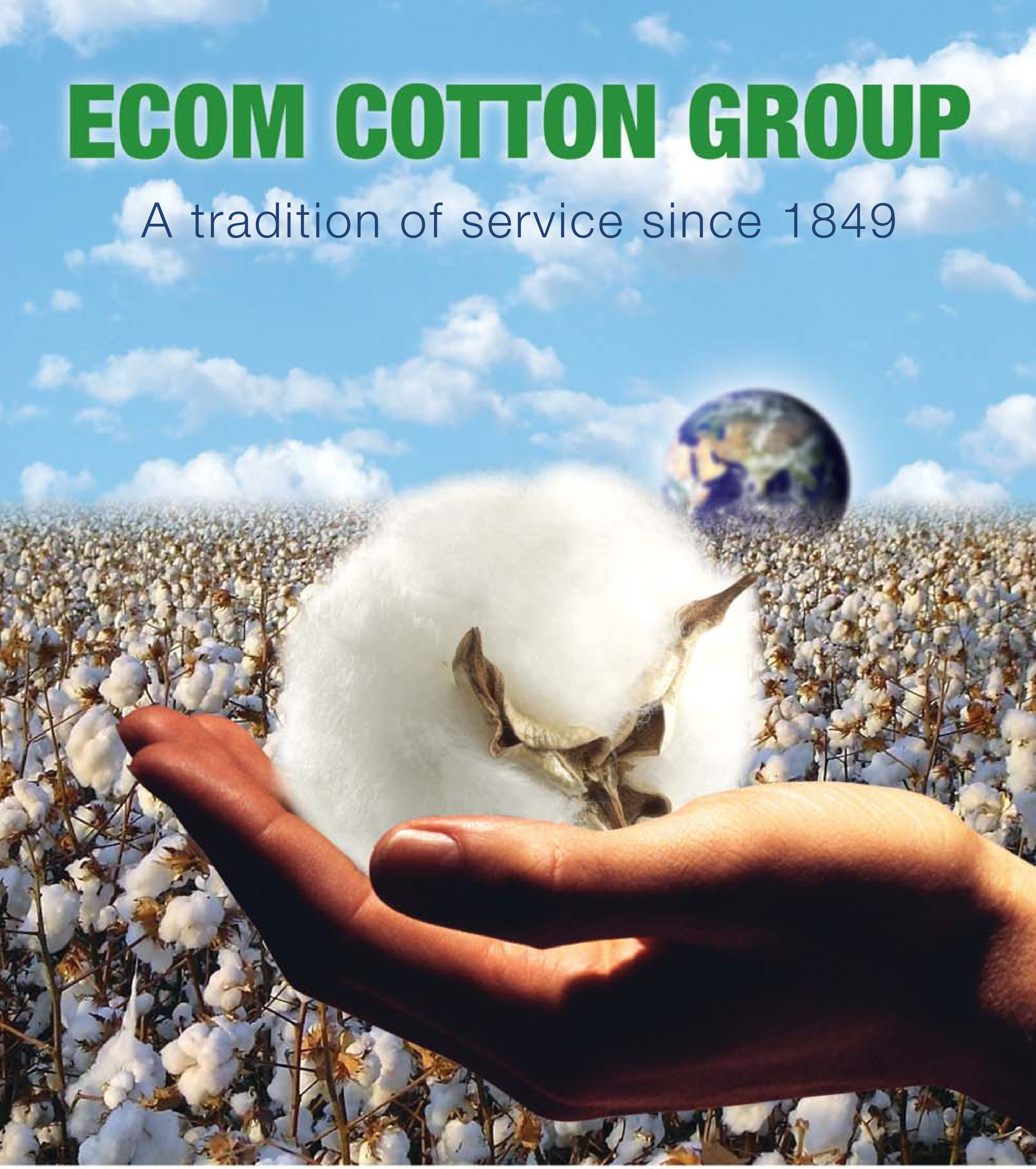
Suggestions on forward cotton trade

A. A buyer choosing international cotton suppliers should not look merely for the cheapest offers, but should prefer those dealers with tremendous strength and good reputations to sign forward contracts. Be aware of those that expand irrationally, and avoid those who have oversold. China's buyers should keep good control of the cost of importing cotton, be cautious and make effective use of hedging tools. On the premise of limited capital allocation, use hedging in the light of a realistic judgment of the market. Try to avoid ON-CALL BASIS purchases, especially when US cotton is in tight supply.

B. International cotton shippers should consider distinguishing between pricing models; exports to China could be covered by hedging at the ZCE and or CNCE markets, to enable quotations that do not deviate excessively from the fundamentals applicable in China.

C. Buyers and sellers around the world should seek an impartial and fair platform to perform margin-based trade, and work together to improve the order in world cotton trade.

Written on April 18, 2011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Re-thinking of Principles and Practices for Hedging

By Du Ying, Vice Director,
Cotton Research Centre, Wanda Futures Ltd.

Although cotton prices surged by over 100% in 2010/11, numerous domestic cotton-related enterprises have been unable to gain high profits, or have even faced heavy losses. Lack of hedging strategies and mechanisms, rigid structures, and excessive speculation are the general issues that have faced domestic cotton-related enterprises in 2010/11. We herein explore the principles and structures of commodity hedging for the benefit of all.

Principles of Hedging

Hedging is referred to as futures trading activities in order to avoid spot commodity price risks. It entails purchasing or selling a futures contract that is identical to the spot commodity market in its amount, but opposite in trade direction, so as to offset the actual risks that may arise from changes in spot commodity market prices, by selling or purchasing the futures contract at a later date.

Core of Hedging -- Trading Principles to Obey

a. Identical commodity types should only be hedged through the relevant futures contract.
b. Identical amounts of a commodity should be hedged, i.e., the amount to be hedged should not exceed that which corresponds to the underlying commodity, or commodity order (such as yarn).
c. The futures month to be used for hedging should be the nearest to the date of settlement for a sale or purchase contract in the relevant commodity.
d. Opposite in trade direction: enterprises should only sell short when they have cotton or yarn in stock, or purchase a long position only against cotton orders or yarn sales contracts.
e. Capital requirement: the surging prices of ICE cotton futures in March, 2008, and during the 2010/11 season, have proven the requirement for sufficient capital to be available against positions hedged in the futures market.

Hedging under Surging Cotton Prices in 2010/11

Conservative hedging strategy

- Selling hedges

When Zhengzhou cotton futures are above the cost of lint and expected profit, futures should be sold. This is a typical operation commonly followed by big international traders. It is relatively conservative, low in risk, and when combined with basis trading, can further expand profits.

- Buying hedges

When futures are less than costs, enterprises should sell yarn and purchase a long hedge in the futures market, so as to lock-in material costs and profits. Afterwards, profits can be increased by spread trading.

Radical hedging strategy

Paradigm for making hedging decisions:

Before hedging is decided, the possible losses in the spot commodity market should be assessed, including the probabilities for differing price trends in the spot commodity market and the potential magnitude of spot market price change.

- Selling hedges

Probability of Losses from Decline in Cotton Price = Probability of Price Decline X Magnitude of Price Decline

Magnitude of Losses from Decline in Prices = Probability of Price Decline X Magnitude of Price Decline X Total Commodity Value

In 2010/11, when cotton prices at the Zhengzhou exchange climbed to 34,000RMB per ton, an analysis gave a 50% probability prices would decline, and a 30 percent chance they would increase. The potential price drop was assessed as being 26,000 RMB (minus 23.53%) and the potential maximum value was put at 40,000 RMB (plus 17.64 percent). The hedging strategy to follow would have been as follows:

Probability of Losses from Decline in Cotton Price = Probability of Price Decline X Magnitude of Price Decline = 50% X 23.53% = 11.765 %

Size of Losses from Decline in Prices = Probability of Losses of Stocks from Decline in Cotton Price X Total Commodity Value = 34,000 X 11.765% = 4,000RMB per ton

On the preceding data, probability of a decline in market price leading to losses would be 11.765%, with a risk magnitude of 4,000RMB per ton. If the stocks are hedged, there will be a risk aversion of 4,000RMB per ton. At the same time, the possibility of obtaining potential profits has been abandoned, thus, the cost of hedging includes the profit that might otherwise be gained in the spot commodity market.

Probability of Profit from Rise in Cotton Price = Probability of Price Rise X Magnitude of Price Rise = 30% X 17.64% = 5.292%.

Size of Profit from Rise in Prices = Probability of Profit from Rise in Cotton Prices = Total Commodity Value = 5.292% X 34,000 =1,800RMB per ton.

On the preceding data, the probability of attaining excess earnings in the futures market is 5.292%. If market prices rise and reach the expected level, the increased earnings will be 1,800RMB per ton.

From the preceding analysis, our potential profit is merely 1,800RMB per ton, while the risk is up to 4,000RMB per ton; and the ratio of cost of hedging to risk is 1:2.22. In this scenario, enterprises are advised to sell over 50% of stocks to hedge against the risk of cotton prices declining.

Buying Hedges

Only if enterprises have yarn or cotton sales orders should they buy futures to hedge raw materials.

Probability of Cost Increase from Rise in Cotton Price = Probability of Price Rise X Magnitude of Price Rise Magnitude of Cost Increase from Rise in Prices = Probability of Cost Increase from Rise in Cotton Prices X Total Commodity Value

At the beginning of April, 2011, the September cotton contract on the Zhengzhou Exchange was around 28,000RMB per ton. If the analysis is that the probability of spot cotton prices rising is 50%, and that the price might rise to 35,000RMB per ton (25% increase), while the probability of a price decrease is 40%, with a lowest price of 24,000RMB per ton (14.28% decline), the hedging strategy would be as follows:

Probability of Cost Increase from Rise in Cotton Price = Probability of Price Rise X Magnitude of Price Increase = 50% X 25% = 12.5%

Magnitude of Cost Increase from Rise in Prices = Probability of Cost Increase from Rise in Cotton Prices X Total Commodity Value = 12.5% X 28,000 = 3,500RMB per ton.

On the preceding data, the probability of cost increase from a rise in market prices would be 12.5%, to a magnitude of 3,500RMB per ton. If a long hedge is purchased for materials that correspond to the order, a risk aversion would be enjoyed of that amount. But, at the same time, the possibility would be abandoned of a reduction in cost if prices should decline. Therefore, the cost of hedging is how much the price might fall in the spot commodity market.

Probability of Cost Decrease from Price Decline = Probability of Price Decline X Magnitude of Price Decline = 40% X 14.28% = 5.71%.

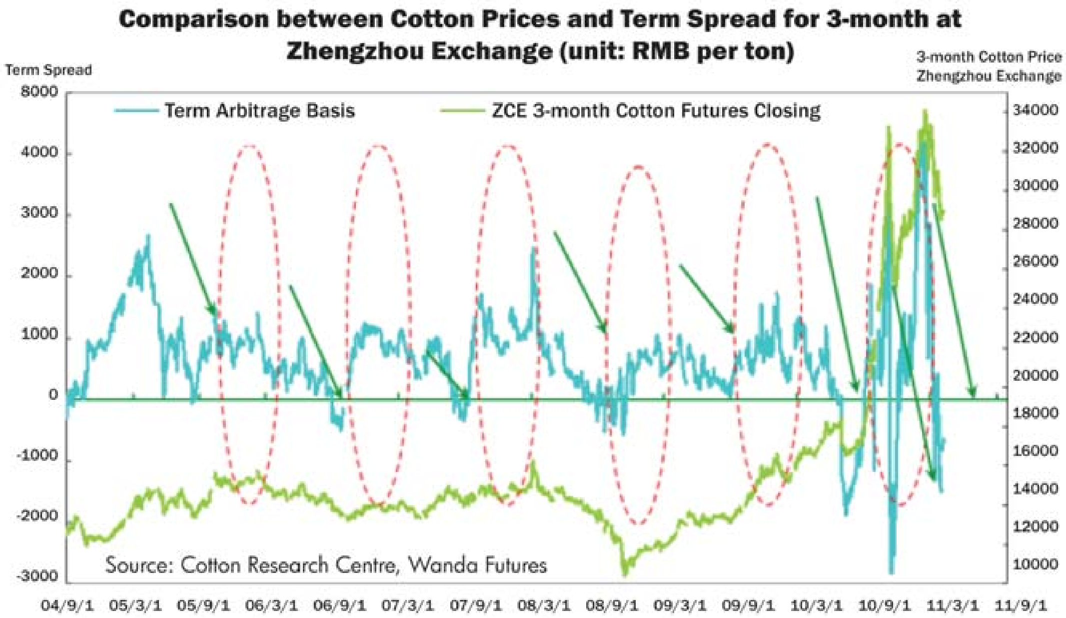
Magnitude of Cost Decrease from Price Decline = Probability of Cost Decrease from Price Decline X Total Commodity Value = 5.71% X 2,800 = 1,600RMB per ton.

From the above analysis, the cost of hedging would be 1,600RMB, whereas the risk aversion would be 3,500RMB per ton, giving a ratio of cost to profit of 1:2.19. In this situation, textile enterprises would be advised to hedge materials corresponding to the order, so as to lock-in profit and cover the cost of materials.

Keep Pace with the Times, Improve Profits through Spread

From the first chart on the next page, it can be seen that before 2010/11, the term spread in Zhengzhou futures was between 500 and 2,500 RMB per ton. The spread is typically at its highest level during the period from October through to the following March. After March, futures at the

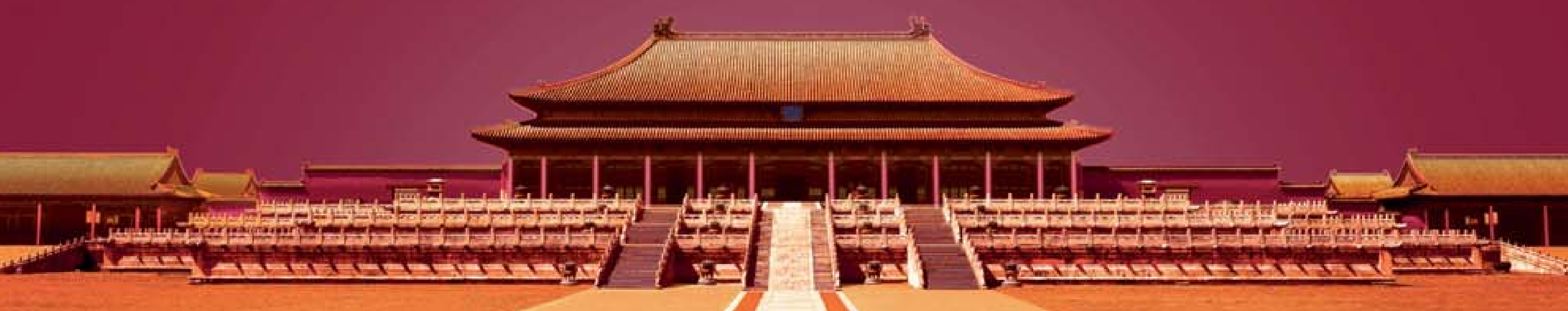
Zhengzhou exchange begin to close the gap with spot commodity market prices, and the term spread begins to narrow. Thus, we think the best time for selling hedges is from October to March, while that for buying hedges is from March to September, which is also the best time to close out positions for hedge sales.



In 2010/11, cotton prices reached a record high, and the spread pattern changed. The chart below demonstrates that the term spread for 2010/11 has been between minus 3,000 and plus 4,000RMB per ton, that is, at the peak, cotton futures prices were 4,000RMB per ton above the spot commodity market index, and at the lowest point, at 3,000RMB per ton below that index. Thus, mastering changes in the spread pattern means extra profit, by being able to buy the spot commodity and sell futures when the spread is high or when futures inversion appears sell the spot commodity, and buy futures to hedge closing positions, bringing additional profit.

For example, at the beginning of November, 2010, the May contract had surpassed 33,000RMB per ton, while at that time, the spot commodity index was no more than 30,000RMB per ton. Enterprises could sell short hedge at the Zhengzhou exchange and lock-in a gross profit of 3,000RMB per ton.

In mid-December, futures plunged to 24,500RMB per ton under policy pressure, against a spot commodity price which reached a lowest point of about 26,000RMB per ton. Closing short positions would have produced a profit of 8,500RMB per ton, and spot commodity sales would be concluded at 26,000, with a loss of 4,000RMB per ton, leaving a net gain of 4,500RMB per ton, far beyond the planned profit. It can be seen from the term spread chart for 2010/11 that there have been two such opportunities in the market; the best opportunity for enterprises to eliminate hedge positions is when the term spread inverts, when excess profit is attainable, which is a typical instrument in international cotton pricing. Through rational hedge transaction, on the premise of hedging, excess profit is attainable, placing enterprises in an invulnerable position. Otherwise, excessive speculation and a strategy operated from insufficient awareness of the market would not avert overall market risks. Cotton-related enterprises are urged to stay away from speculation and to employ cotton futures reasonably for steady development.



Comparison of Investment Value of Cotton Against Other Commodities

By Ren Xinpu,
Yong'an Futures Co., Ltd.

Worldwide price fluctuation of raw cotton

If we consider the movement of the ICE cotton futures contract as a price index, we find that since 1975 futures have moved in two different ranges. The first was from 30 to 100 US cents per lb and the second from 100 to 175 US cents per lb, with a continuing upward bias.

Increased demand and a relaxed financial policy attributed to the higher cotton price from the years 2010 to 2011.

The last two years have witnessed an increase in cotton prices to comparable levels at home and abroad. Demand increased while production fell in both China and Pakistan. Evidence shows that before the global financial crisis, cotton consumption showed weakness. However, after the crisis the recovery was vibrant.

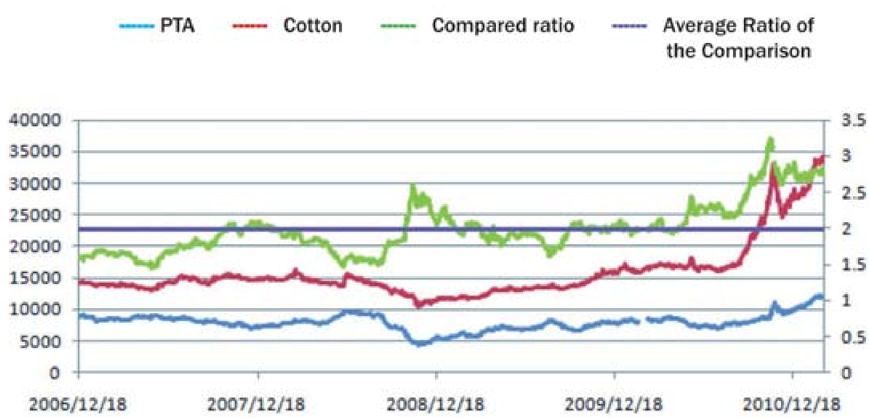
A relaxed financial policy contributed to the increase in cotton prices from 2009. Urgent economic measures were put in place to stimulate the economy. The USA M2 (measure of the amount of money in circulation) has increased by 6.36% in the two years since 2009. By comparison Chinese money supply M2 has had an absolute increase of 48.27%. This incredible acceleration in the rate of currency supply also influenced the rise in the raw cotton price.

Comparison of investment value of cotton and other commodities.

(1) Cotton against PTA

The graph shows that the difference in parity can be classified into three periods. First, it changes from 1.6218 to 2.0231 from January 2007 to October 2008. Secondly, it changes from 2.20231 to 2.0842 from October 2008 to May 2010. Thirdly, there is then a distinct upward trend from 2.0842 to 3.2449. Generally, the Zhengzhou main cotton contract exerts a big influence upon the price of the PTA main contract and they both show a similar changing trend. When we select an investment opportunity then the price of the Zhengzhou main cotton contract can be used to chart price predictions as this cotton contract is a leading price indicator.

Parity between ZCE cotton main contract and PTA



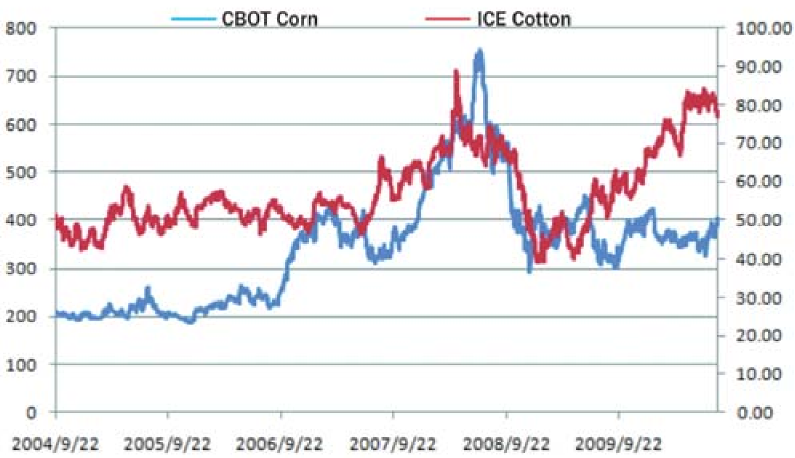
(2) Cotton and Corn

Since the global financial crisis of 2008 the graph vividly demonstrates the violent fluctuation of cotton and corn prices in the US market. However, post the crisis, the cotton and corn price entered a new era with upward movements in prices.

If we look at the opportunity of investment, then USA cotton takes priority to USA corn. The same phenomenon is mirrored in the Chinese market. Between 2009 and 2010 there were huge investment opportunities in cotton but little in corn. This can be shown to be the result of Government policies and regulations. Typically, bureaucracy always tends to favour growing grains. Also, although cotton's unit of output is higher than that of corn, farmers' mind-set and habits favour growing corn. The movement of the workforce from rural to urban areas is another explanation.

According to a February 2011 survey made by the Department of Agriculture, farmers intend to decrease the area given to soybean (by 11.2%), to increase corn (2.1%), rice (1.9%) and cotton (5.4%). For cotton, particular aeras show the following increases – Yangtze River by 5.7%; the Yellow River by 7.7% and Western Parts by 2.1%.

Tendency of Corn CBOT and Cotton ICE



ZCE Cotton Price Index and DCE Corn Price Index

(3) Cotton and Wheat

The changes in wheat prices show relatively little movement compared to cotton. The commodity undergoes similar government influences to corn, the same farmer's habits and has its own characteristics. There is much territory devoted to growing wheat and local demand can usually be covered without the need to import. Prices generally remain stable and, consequently, there are few investment opportunities available.

(4) Different influential factors of cotton and other

Commodity	Cotton	PTA	Corn	Wheat	Soybean	Sugar
Supply factors	1.domestic stock 2.domestic output 3.imports (30%)	1.domestic stock 2.domestic output 3.import (30%)	1.domestic stock 2.domestic output 3.import (a bit)	1.domestic stock 2.domestic output 3.import (none)	1.domestic stock 2.domestic output 3.import (82.8%)	1.domestic stock 2.domestic output 3.import (a bit)
Demand	Domestic demand,	Domestic demand, No exports	Domestic demand, No exports	Domestic demand, No exports	Domestic demand, No exports	Domestic demand, No exports
Influence from relative goods	Cotton and pta have mutual affect	Cotton and pta have mutual affect	Corn, wheat and soybean have mutual affect	Corn, wheat and soybean have mutual affect	Corn, wheat and soybean have mutual affect	Rice acreage is affected by Cane and beet
Economic cycle	The same	The same	The same	The same	The same	The same
Financial policies	The same	The same	The same	The same	The same	The same
Fiscal policies	The same	The same	The same	The same	The same	The same
RMB exchange rate	The same	The same	The same	The same	The same	The same
US dollar index	The same	The same	The same	The same	The same	The same
Industrial policies	poor support	none	Powerful support	Powerful support	Powerful support	Poor support
Political factors	The same	The same	The same	The same	The same	The same
Conventional factors	Different influence	Different influence	Different influence	Different influence	Different influence	Different influence
Psychological factors	Different influence	Different influence	Different influence	Different influence	Different influence	Different influence
Weather	Different growth period result in different influence	Different growth period result in different influence	Different growth period result in different influence	Different growth period result in different influence	Different growth period result in different influence	Different growth period result in different influence
Linkage of collaborative markets	Different influence	Different influence	Different influence	Different influence	Different influence	Different influence

(5) The prospect of cotton and other agricultural products price rise.

Near-term Chinese Cotton consumption would seem to be weak. However, before September 2011, declining world stocks would indicate a tendency for the spot and futures prices to increase.

If we take into account the cotton acreage predictions from certain institutions, the USA will increase by 14.5%, India by 15% increase (12.65 million hectares) and China by 5% (78.28 million hectares). Assuming neutral weather considerations, the likelihood would seem likely to be increased output in 2011/12 and downward pressure on spot prices after September 2011.

Superposition of ZCE Cotton Price Index and ZCE Intensive Cotton Price Index

In the second quarter, PTA will adapt itself to the fundamentals and technical picture. This may result in futures prices for that material reducing under pressure from other goods.

US soybean prices were trapped in a range of 1340 to 1420 US cents during the first quarter and may continue in this range during the short term. This situation will only be broken if the price comes under pressure on the down side. It is possible that a 'bottom' of 1180 US cents may be touched in April or May.

In terms of the CBOT corn market during the second quarter, we expect prices to be up, rather than down. The tight supply situation may stimulate prices to their highs of 2008. Dalian corn futures may hit their highs but may hit a ceiling. Nevertheless, at a level of 2400 strong support will be forthcoming, so we confidently predict that second quarter Dalian Corn Futures will move towards a higher level.

Although raw sugar showed a rebound in March the surplus quantities worldwide will be a key element influencing a weakened trend in the near term. Zhengzhou sugar futures are limited by a pressure line in the long run showing a weaker pattern setting in.

"COTTON CHINA": A Vehicle for Upgrading the China Cotton Textile Industry

By Gao Fang, Executive Vice President and Secretary-General, China Cotton Association (CCA)

With the aims of advocating the concept of environmental protection, boosting cotton fibre consumption and the quality of China's cotton and cotton products, the China Cotton Association (CCA) introduced the logo of "COTTON CHINA" in 2010 and engaged in a series of propaganda activities under the themes "High Quality, Pure Cotton, and Environmental Protection".

The logo of COTTON CHINA is a quality-certificated trademark, registered by the Trademark Office of the State Administration for Industry & Commerce of China. Different to a common trademark, a quality-certificated trademark requires that products should reach a certain standard. COTTON CHINA labelled products convey the following characteristics:

中国棉花
COTTON CHINA

The character of Made in China: the domestic cotton content should be at least 60 percent.

The character of pure cotton: the cotton fibre content should be at least 95 percent.

The character of high quality: The intrinsic qualities and appearance of the relevant product should satisfy the high quality products index of the current State or industry standard, whilst meeting environmental protection and ecological requirements.

That is to say, the products certificated with the logo of COTTON CHINA should meet three requirements: those regarding raw cotton, those related to product's quality, and those related to ecology and the environment.

CCA has made numerous efforts to publicise the COTTON CHINA logo, including the development of brochures explaining its purpose and setting out requirements for its use, including technical requirements. In addition, CCA publishes the websitw www.cottontimes.org and has commiossioned pages on other websites, such as cottonchina.org (operated by Beijing Cotton Outlook), China Fashion, Cotton Story and Happy Time. Now that all preparations have been made, CCA has started to accept applications from enterprises wishing to use the logo and promote Chinese cotton.

China's huge cotton industry encompasses 100 million cotton farmers, 20 million textile workers and one million in related cotton circulation activities. As the world's biggest producer (annual production of around 6-8 million tons is almost

30% of the world total) and consumer (annual consumption of around 10 million tons is almost 40% of the world total), largest exporter (garment export value is around take 33% and textile products 26%), China enjoys numerous advantages. Besides its production advantage, China's cotton quality is in the mid-to-high level internationally. Farmers harvest cotton by hand in the traditional way. Cotton fibre length and quality are preserved, and the trash content is low. So, China's cotton is good in colour, high in grade, low in trash, long in staple, and has a low nep count and short fibre content. Xinjiang, the main producing region, enjoys natural advantages for cotton production, largeness of scale and flexible irrigation systems. Meanwhile, China's textile industry is integrated, mature and has experienced workers, and good technical capabilities, with the result that it can produce textile and clothing products that are competitive in price, with few quality deficiencies.

However, consumers have not fully understood the quality advantages of China's cotton. Admittedly, after the market opened up, quality management was allowed to slide and man-made factors affected the improvement of cotton quality.Design and brand building have yet to be tackled. There is still a long way to go to reach the point when the biggest cotton and textile country can replace "Made in China" with "Created in China" and "China Brand Name". Driving up volume will be increasingly problematical and the textile industry must pay attention to establishing brand names and producing high value-added products.

The entire industry chain stands to gain from the COTTON CHINA logo. The Association is happy to share successful experiences and make efforts to take the work forward. We hope to cooperate with enterprises as we move forward.

Our aims are to promote cotton, China's cotton industry and China's high quality cotton products. Through the public welfare promotion, non-profit and ordered operations, more consumers will consume more cotton, as well as recognize and use China's high quality cotton products. This will facilitate the endeavours of an integrated farm-industry-commerce chain to improve the quality of products and be honest and faithful for the benefit of consumers, producers, enterprises and all who are engaged in our industry, both at home and abroad.

"COTTON CHINA", Beginning of the Better Life

The International Cotton Trading Centre

A Platform for Import Cotton Business

By Yang Baofu, Assistant General Manager,
China National Cotton Exchange

I. International Cotton Trading Centre: Background

Over the past ten years, with the rapid development of the textile industry, China's cotton consumption has shown strong and stable growth. Cotton output, however, has developed at a slower pace than consumption. Therefore, imports have continued to rise. Currently, China annually imports 3 million tonnes of cotton, and is the biggest importer in the world.

However, the current situation is that most cotton importers are small and medium-sized enterprises, and these firms lack both a coordinated approach, and negotiating strength. Therefore, despite the fact that China is the major buyer of cotton on the international market, importers lack the power to influence prices. Compared with experienced international shippers, domestic cotton importers are short of experience and knowledge of international trade, and lack the ability to protect themselves in negotiations with their counterparties. An imbalance in the availability of information is another major reason why some enterprises adopt a passive role.

In order to improve the trading structure as it relates to cotton imports, to simplify import procedures and unify cotton import orders, the China Co-operative Group decided to set up the International Cotton Trade Centre in Nantong Industrial Zone. The International Cotton Trade Centre will rely on the service platform of the China National Cotton Exchange (CNCE). It will endeavour to draw support from government policy, and establish a service platform, whose elements will include trading and assorted service systems, a cotton training school, inspection and arbitration. The role of the centre will be to provide guidance, so as to promote the integration of the international and domestic cotton markets, and thus contribute to a strengthening of China's cotton industry.

II. The operation of the International Cotton Trade Centre

1. Import cotton trading platform

In accordance with the characteristics of China's cotton import market, this trading platform is mainly to provide the following two trading models:

Firstly, auction trading, whereby imported cotton can be sold via auction in this trading system. Cotton buyers can conclude purchases with the lowest intra-day bid.

Secondly, the on-line supermarket. CNCE's existing on-line supermarket is focused mainly on domestic cotton, or on imported cotton that has already cleared customs. Trading of 'consignment' lots has been prevalent in the cotton market, and the ICTC will make provision for such business within its on-line cotton supermarket. Other services provided by the Centre will include forwarding and the supervision of logistics. The Centre will list 'consignment' cotton in the on-line supermarket system, and thus offer a value-added service to international cotton shippers, as well as providing domestic cotton buyers with an efficient means of sourcing cotton.

2. Associated service platform

1) Finance service: in order to ease the financial pressures on contracting parties and take full advantage of the CNCE's current finance service and logistics supervision platform, the Centre will make available financing and Letter of Credit services to buyers, and provide a warehouse receipt mortgage service for sellers. The seller stocks imported cotton in the appointed supervising warehouse, and can then apply for mortgage credit from the banks; buyers can buy the imported cotton stocked in the supervision warehouses, or make use of the financing service by trading contracts, in order to enhance the circulation of funds.

2) Storage and logistics service: the Centre will take advantage of the current CNCE warehouse facilities and information system, and the bonded warehouses in the ports, to set up a series of logistics supervision systems for imported cotton, combining information collection, electronic supervision and stock management, in order to provide a forwarding service for import agents.

3) Information service: the CNCE's domestic cotton trading platform and information platform play a major role in China's cotton industry. The Centre will take full advantage of these resources, and provide an analysis of trading data, including the complex quotations for imported cotton, publish a price index for imported cotton, as well as offering consultancy services.

In addition, the ICTC will set up an exhibition centre to provide exhibiting and promotional opportunities for international shippers, including the display of cotton standards and samples from the major cotton-producing countries. A cotton inspection centre will be also established, at which imported cotton fibre can be inspected. In addition, training will be undertaken, in order to create a body of expertise in the international aspects of the cotton industry.

III. Timetable for creation of the Centre

The Centre will be established within two years. Work will commence in June 2011 and be completed by June 2013. It will be developed according to the principles of "step-by-step" implementation, and operation during construction.

The Impact of Policy on the Cotton Market

By Zhang Songjia, Analyst,
Beijing Cotton Outlook

As we know, as an important agricultural commodity, cotton links tens of millions of cotton farmers and textile workers. Therefore, the movement of cotton prices is a matter of great concern to the authorities, and a major objective of policy adjustments. In 2010/11, the cotton market has been profoundly influenced by frequent macro-policy adjustments, whose aim was to fight against inflation. Meanwhile, direct policy interventions were also carried out, in order to curb the volatility of the cotton market, which was caused by the increasing shortage of supply.

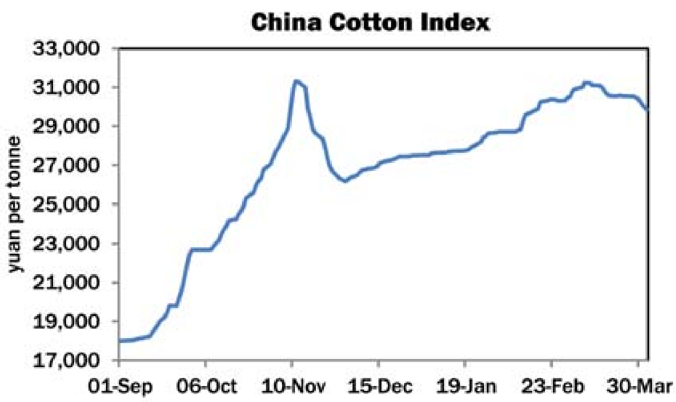
Impact of macro-economy

Since the world financial crisis in 2008, countries have carried out several measures to stimulate economic growth and curb inflation. The role of the authorities and the importance of macro-control measures in maintaining market stability and keeping economic growth on track have thus increased greatly. In the view of cotton industry, since cotton is linked with several sectors, including agriculture, industry and commerce, prices are greatly influenced by macro-policy adjustments. However, cotton prices are also influenced by economic policy and the situation of consumers in major textile importing countries.

In early November 2010, China's central government took a series of macro-adjustment steps, in response to the release of October economic data. The Consumer Price Index (CPI)grew by 4.4 percent, year-on-year, recording a 24-months high, which reflected increasing inflationary pressures. In the past year, prices of bulk agricultural commodities, including corn and cotton, continually reached record levels. Speculation was one of the major reasons for this volatility. In order to restrict liquidity and lessen speculation, the authorities adopted a series of measures which included raising the bank reserve requirement ratio, the announcement of direct price intervention measures, and strengthened supervision of futures markets. These combined measures had a significant impact on commodity markets. Commodity prices showed a clear decline, and speculative funds were withdrawn from the market.

Cotton prices fell sharply, in accordance with the above-mentioned policies. The China Cotton Index declined from 31,302 yuan per tonne on November 11, to 26,164 yuan per tonne on December 1, down by 16 percent in little over two weeks. During the same period, seed cotton prices also retreated, from 14.12 to 11.94 yuan per kilo, a decrease of 23 percent, which was faster than the decline of lint prices. Market sentiment turned cautious, and the volume of transactions became much lighter.

The cotton market saw another period of decline after the 2011 Lunar New Year holiday, which was also closely related to macro-control



policy. During the People's Congress in early March, Mr Wen Jiabao, China's Premier, identified "maintaining the general price level as basically stable" as the government's first priority for 2011. During the first four months of the year, the central government lifted the bank reserve requirement ratio four times, and raised the benchmark interest rate twice. The pressure of inflation, however, remained quite high. It is expected that the future tightening policies will continue to bring pressure to bear on the cotton market.

Since China's textile industry exports a huge volume of goods to the world market, economic policies and the pattern of consumption in textile importing countries also have a direct indirect influence on China's cotton consumption. World textile consumption started to recover under stimulation of policy measures taken by the western countries, such as the Untied States. China's textile and clothing exports rose 23.6 percent in 2010. Since 2011, however, the developed countries, such as the European Union and Japan have also faced inflationary pressures, caused by the rising cost of energy and raw materials. The EU raised the benchmark bank interest rate in early April, which may also have a certain impact on textile consumption.

Impact of cotton policy

Currently, most of the steps taken by China's government affect elements such as import quotas, state reserves, credit loans from the Agricultural Development bank, amongst others, in order to adjust cotton supply and demand, and stabilize the market. In recent years, the reasoned and efficient use of macro-control measures has played an active role in promoting market stability.

Cotton import quota: this season, China's cotton output and fiber quality were adversely affected by unfavorable weather conditions, and textile consumption was also struggling in the recovery period following the financial crisis. With the expectation of an increasing shortage of supply, the government allocated 2.6 million tonnes of import quota at the end of 2010, of which 894,000 tonnes was tariff-rated duty quota (TRQ, one percent duty) and 1.7 million tonnes represented 'sliding-scale' duty quota.

Compared with past years, both the volume and the speed of the import quota allocation were enhanced. Before 2010, the authorities normally allocated TRQ at the end of the previous year, and released sliding duty quotas in several stages, according to the market situation. Therefore, the

need such a system, incorporating a kind of 'minimum support price', in order to safeguard cotton planting.

The impact of textile policy

The stable future development of the textile industry will be important not only for employment but also for foreign trade, as well as economic development. Therefore, textile policy has to consider both the modernization of the industry and its stability.

import activity of traders would be greatly influenced by the quota allocation, and they had to give up some good import opportunities. The early allocation of 2.594 million tonnes of import quota for 2011 allowed traders to manage their business opportunities in a more reasonable manner.

State reserves: the rotation of cotton in and out of the state reserves is a means to intervene in the market in a prompt and efficient way. Since 2009, the government has rotated state reserve cotton several times, involving a cumulative total of 3.64 million tonnes, in order to curb rapidly rising cotton prices. The process also brought the volume held in the state reserves to a record low level, and reduced the scope for further macro-control measures. This, in turn, became a major factor causing prices to reach historic highs late in 2010. The situation underlines the importance of a timely rotation of state reserves.

In order to stabilize cotton production, meet the expectations of cotton traders and consumers, protect the interests of cotton farmers and ensure an adequate cotton supply, the National Development and Reform Commission (NDRC) announced a temporary proposal for the state reserves in 2011, which will be effective from September 1, 2011 through March 31, 2012. The government will buy cotton for the state reserves if the market price reaches 19,800 yuan per tonne. This mechanism will be triggered, if the monitoring price has remained lower than the benchmark price for five consecutive days.

This proposal has historic significance, since for the first time purchasing for the state reserves will conform to a pre-ordained system. The early announcement of the purchasing price before the new season will help to stabilize expectations with regard to cotton planting and trading. The decision to set this floor price took into consideration factors including the cost of cultivating cotton, and the ratio between grain and cotton prices. The volatility of cotton prices has been quite unfavorable for cotton supply, and has greatly threatened the strategic security of the cotton textile industry. Cotton farmers

Since early 2011, conjecture has been prevalent in the market with regard to a reduction of the textile export rebate rate. After the shock of the global financial crisis, the central government raised the commodity export rebate rate seven times since August 2008, of which four times involved the textile and clothing exports. The rebate rate for textile exports was raised from 11 percent to 16 percent, clearly higher than for other traditional, labour-intensive industries. Since late 2009, with the recovery of the global economy, textile exports also bounced back. Since 2010 in particular, textile sales have turned active and textile production capacity has also expanded. The twelfth "Five-Year Plan" clarifies that priority will be given to supervision of the textile industry, which is regarded as having surplus capacity and creating a high level of pollution. The authorities have also set the rebalancing of the foreign trade surplus as one of the major tasks this year. Therefore, the export-oriented textile industry is expected to be adjusted through a reduction of the export rebate rate.

Market conjecture has showed different expectations regarding changes to the export rebate rate, ranging from one to five percentage points. However, observers expect that policy makers may postpone adjustment of the policy, in consideration of factors such as the continual appreciation of RMB, reducing consumption under the influence of inflation, and rising stocks of textile products. Recently, officials from the Ministry of Commerce (MOCA) have stated that a reduction in the export rebate rate for textiles would come sooner or later, but that research indicated that this year might not be the appropriate time to do this. Total commodity exports in the first quarter of the year showed a rare deficit, with the result that the adjustment of textile policy might be delayed. According to data, on the basis of 2010 exports volume, the value of the export rebate would be reduced by 65 billion US dollars, if the rebate rate were cut by 5 percentage points. This is equivalent of one third of the textile industry's profits, which would deal a severe blow to the sector.

Brazil: the country of cotton.

Photo: Carlos Rudiney / ABRAPA

OUR COTTON EXPANDS.
Over the last 12 years, Brazilian production has doubled and productivity tripled. Today Brazil plants over 1 million hectares producing 2 million tons of fiber.

OUR COTTON HAS QUALITY.
Our cotton reaches outstanding international standards, evaluated by classing instruments of the latest generation, and quoted in the A Index of Cotton Outlook.

OUR COTTON REACHES THE WORLD.
Today Brazil is the 4th largest cotton producer and the 5th largest world exporter.

OUR COTTON HAS IDENTITY.
All the bales carry bale tags with an identification code for rapid traceability.

OUR COTTON HAS A FUTURE.
Brazil has the largest area of arable land on the planet, and is growing cotton with social responsibility and protecting the environment.

Brazilian Cotton can be considered a benchmark of excellence and Abrapa is its official representative.

BRAZILIAN cotton

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Current Situation and Outlook for China's Cotton Textile Market

By Chen Xiaoyan and Ji Hong, Cotton Department, Galaxy Futures

Basic information of China's cotton textile market in 2010/2011

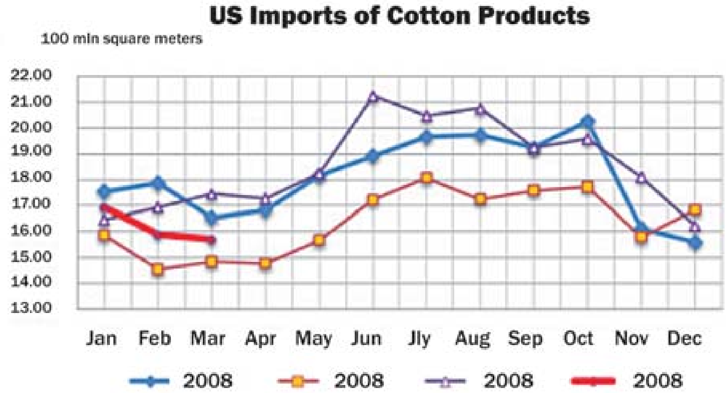
China's industry recovered progressively, and tended to stabilize in 2010. The textile industry's exports, consumption and investment returned to growth, and production was restored to the level prevailing before the financial crisis. Profits in the textile industry held generally steady. However, since December, owing to the high volatility of cotton prices, the sharp increase of labour costs and the appreciation of the RMB, business indicators have deteriorated, and profit margins have been hit hard. The textile industry's growth rate has declined. The rate of export growth has turned significantly lower. In contrast, rising income levels, supported by government policy, have contributed to the development of the domestic market. As the textile industry enters a phase of structural adjustment, transformation and upgrading, large enterprises and those with distinctive features show good competitive advantages.

A. Exports rose in the first half of 2010/11 and turned lower in the second half. The domestic market is promising

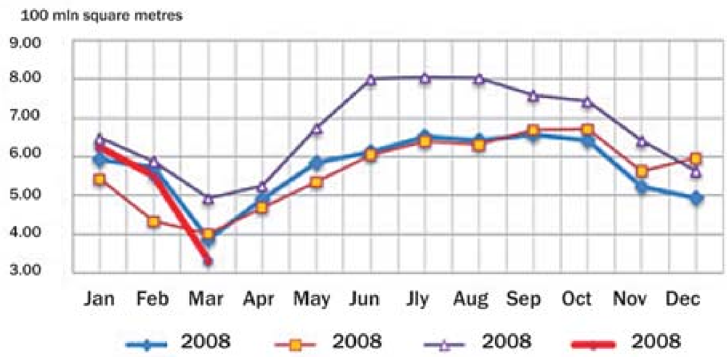
Referring to consumption, exports of cotton textile products has maintained a relatively rapid growth, but overseas demand has dropped remarkably, particularly in Europe and the United States.

Taking the US as an example, China's export volume of cotton goods to the US hit a record high in 2010, but dropped from the beginning of 2011, as US demand for imported cotton products diminished. There was a sharp decline in exports of the main cotton textile products, and orders for cotton underwear, shirts, trousers and knitted tops were lost to Bangladesh, Vietnam, Indonesia, Honduras and Myanmar. The export unit price of cotton products rose by 15/20 percent, due to increased cotton prices, while the rise in China was higher than that experienced by other countries.

US Imports of Cotton Products



US Imports of Cotton Products from China



In 2011, China's exports of cotton products will probably continue to grow. The increase in exports of textile products may exceed that of clothing.

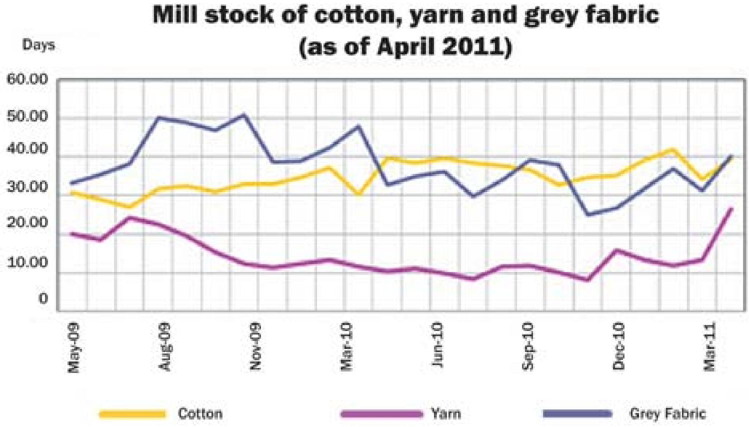
Domestic consumption is likely to recover slowly. During the first quarter 2011, total retail sales of consumer goods increased by 16.3 percent over the same quarter of 2010, 6 percentage points lower than clothing retail sales which increased by 22.3 percent. In addition, the sales volume of branded clothing enterprises continued to increase. Measures in the 12th Five-year Plan, such as raising disposable incomes encouraging consumer spending, actively developing electronic businesses (including on-line shopping), will boost domestic demand.

In 2010, exports of textile products exports are likely to reach 200 billion dollars (RMB 13 trillion). Exports probably account for 40 percent of the textiles and garment market, while domestic sales perhaps represent 60 percent. The ratio of domestic sales may continue to increase, and the domestic market has further room to develop, with the help of stimulating policies.

B. Cotton textile industry slumps, cotton, yarn and cloth entering "de-inventory" cycle

As regards cotton textile plants, in the first half of 2010, both production and marketing of cotton textiles thrived. Cotton prices were rising steadily, influenced by those of yarn and cloth, stocks of which remained at a relatively low level, while mills increased cotton stocks. However, the rise in cotton price accelerated from September 2010, leading to a downturn in the textile industry and a progressive decline in added value, which is far below the national average. Exports of cotton textile products encountered a setback from the beginning of 2011. The sales-to-output ratio of yarn and grey cloth slipped significantly, and stocks have increased sharply since March 2011. Sluggish demand has resulted in difficulties in cotton distribution, and rising cotton stocks. It is obvious that high cotton prices held back demand from mills, and that market supply and demand changed. Besides, mills entered a "de-inventory" cycle and reduced the rate of replenishment, due to gloomy economic forecasts and expectations of high inflation.

Mill stock of cotton, yarn and grey fabric (as of April 2011)

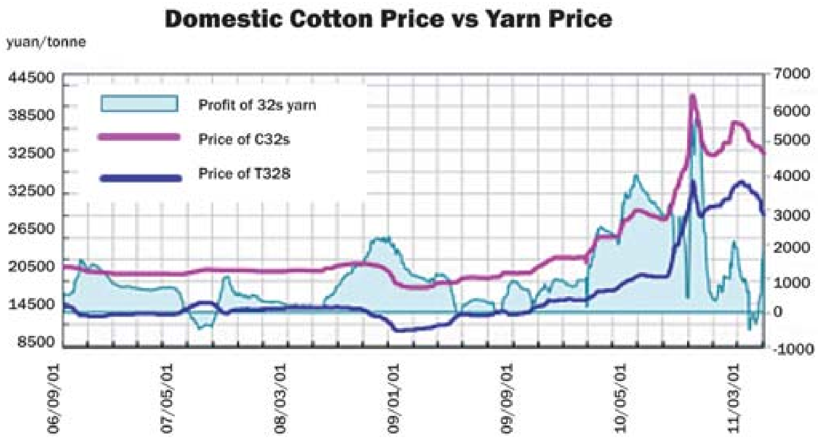


The Change of Growth Rate of Textile Industry Added Value (2006-2011)

C. Mills' profits increased in the first half of the year and declined in the second half. Lower cotton prices boosted profits

In 2010, the textile industry's profits generally rebounded. Gross profit margins increased to around 11 percent, from 9.8 percent at the beginning of 2009. Net profit margins rose from 2.6 percent to 4.7 percent. The average profit was better than in 2009, also better than pre-crisis levels.

As there was high volatility in cotton prices after the rapid rally, mills that had not hedged risks found difficulty in dealing with raw material price fluctuations. Most mills suffered a profit squeeze, and even incurred losses in March and April 2011, when the decline of yarn prices exceeded that of cotton. Some mills had to reduce operating capacity, in order to limit losses. A lot of small to medium-sized mills shut down in Shandong, Hebei and Hubei.



In terms of the industrial chain, the sharp decline of cotton prices led to overstocking, and the loss or even suspension of production. The decline also lowered spending on cotton, offering a good opportunity for mills to receive orders and purchase raw materials, making room for production in the second half and next year.

Situation and outlook of cotton textile in 2011/12

According to forecasts of the macro-economy and cotton prices, there may be four main features of the domestic cotton textile market in 2011/12. First, the proportion of domestic sales will go up and the export proportion will drop. Second, cotton consumption will be more flexible. Third, the cotton price has soared above RMB20,000 per tonne, and the irrational price difference between cotton and chemical fibres will provide good opportunities for the latter. Fourth, industry restructuring will intensify; large enterprises and those taking advantage of financial instruments will have more opportunities.

The general structure of the domestic cotton textile industry is "large in the middle and small at the two ends", which means that raw materials and consumption have a high dependency on imports, while plants confront problems of overcapacity. The cotton textile industry has to upgrade facilities and carry out structural adjustment, due to the rise in costs and volatility of raw materials, and the rapid appreciation of RMB. In such circumstances, the rate of capacity utilization in cotton textiles slips, mills arrange production plans according to orders, and the productivity of cotton textiles cannot be used to forecast cotton consumption. Cotton demand becomes more flexible and uncertain, as mills receive orders in a short-term and disparate manner.

The cotton price is more likely to remain above 20,000 yuan per tonne, since the Chinese government has adopted a temporary purchase policy for the second half this calendar year. As a result of high cotton prices, retail enterprises may use more chemical fibres, while the shift in the proportion of export and domestic sales will also restrain cotton consumption. Some chemical filament and short fibres will be developed and used more. Since spending on cotton accounts for more than 70 percent of production costs in the cotton textile industry, effectively controlling the risk of raw material price fluctuations ensures reliable orders and stable profits, and can also help enterprises to survive competition, and gain market share. In addition, there will be more development opportunities for large enterprises, which benefit from economies of scale and policy support.

China - An Opportunity to Avoid Contract Disputes

By Miss Helen Anderson,
Outlook Consulting Limited

It has been a feature of commercial contracting since the start of time. What if the price at which two parties agree to buy and sell a commodity at the date of contract is, at the time of delivery, significantly different from the price one party agreed to pay and one to receive for the goods?

In contractual terms, all internationally traded commodities have their particular vagaries, and perhaps none more so than agricultural commodities, pricing decisions and of course other key contract clauses on both sides being dependent on many factors outside specific individual party control - including weather fluctuations and government restrictions. As all readers of course know, the past months have seen some very dramatic moves in commodity pricing, perhaps none more evident than in cotton, arguably a very minor player in the agricultural scheme of things.

Across the cotton globe, we have seen bad weather, floods, drought, hurricanes, poor yields, government restrictions on exports. All of these issues, either individually or combined, have had an influence on the dramatic price fluctuations that the cotton world has experienced over the past months, and continue to do so.

In such dramatic trading times, and faced with problematic issues surrounding contractual performance on both the selling and buying side, the question frequently arises - Do any of these 'outside' factors influence or alter the contractual obligations and responsibilities as between the parties to a freely agreed contract?

Under English Law, to which a vast proportion of international cotton sales are made subject, by virtue of their incorporation of the Bylaws of the International Cotton Association, the free agreement of the contracting parties is paramount.

The parties to a commercial contract under English Law can agree pretty much as they please in constructing the deal between them. Thus it is of the utmost importance that what is agreed is clearly stated in the contract, not left to chance or doubtful interpretation. As the cotton experience of the past months has shown, it is all too often the case that unprecedented market movements caused by factors external to the contracting parties, late in the day, create issues of contract performance and often contract default.

Of course it is always advisable to have clarity in contracts before issues arise. Prevention is undoubtedly better than cure. Often, seeking early guidance on proper contract drafting can be both commercially and financially beneficial and certainly enhance a party's reputation as a responsible trading partner.

What if the price at which two parties agree to buy and sell a commodity at the date of contract is, at the time of delivery, significantly different from the price one party agreed to pay and one to receive for the goods? With good contract drafting and proper consideration of the implications of the clauses being agreed to, both parties have the option to minimise their risk and to be bound only by what they consider to be the elements of a sensible contractual deal.

Outlook Consulting Limited is available to assist with contract drafting and to give advice on the correct procedures to be followed under ICA Bylaws and Rules in case of dispute. Our team can assist both in English and in Mandarin. We are also qualified to act as arbitrators under the ICA Bylaws and Rules. For further information, please contact either Guo Rongmin (info@cotlook.com) or Helen Anderson (arbitration@cotlook.com).

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Tel : 44 (151) 644 6400 Fax : 44 (151) 644 8550 E-Mail : editor@cotlook.com World Wide Web : www.cotlook.com

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