

THE FUNCTIONS OF A COTTON MERCHANT

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**By Paul A. Ruh, President
Cotton Market and Risk Management Consulting, Inc.
Former President, Paul Reinhart, Inc.
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A. THE HISTORY OF COTTON TRADING

Cotton has been used as a textile fiber for thousands of years. Cotton material has been found in ancient burial sites in China, Mexico and India. The fiber was introduced in Europe by Arab traders in the Middle Ages.

Commercial production of cotton was originally started in Egypt, India and Peru. In the 18th century, cotton was first planted in the southern United States. It took certain developments to turn cotton into a major textile fiber. These include the invention of the spinning machine in England in 1764, and soon after that, the development of the power loom. As far as raw cotton is concerned, the most important invention was the cotton gin, developed by Eli Whitney in the U.S. in 1793. This freed cotton from the laborious process of removing the fiber from the seed by hand, a job performed by slaves on the southern cotton plantations.

During the first half of the 19th century, American cotton played an increasingly important role in the world supply of cotton. On the consumption side, the largest concentration of cotton spinning and weaving was in Lancashire, England, followed by Switzerland, at one time the largest cotton importing country in Continental Europe. But, textile industries were soon started all over. Major trading places for raw cotton were Liverpool (England), Bremen (Germany), Le Havre (France), and Winterthur (Switzerland).

The Civil War in the U.S. (1860 - 1865) disrupted cotton trading and practically destroyed the cotton growing industry in the U.S. Blockade of the southern ports and the destruction of cotton plantations in the course of the war cut the consuming countries in Europe from their main source of supply and drove prices to extremely high levels. Eventually, cotton was imported from other origins, such as Egypt, India, the Middle East and South America. Once the Civil War in the U.S. was over, cotton production came back in the South, but only very slowly. The old plantation system had depended on slave labor, which was gone forever after 1865.

Cotton trading in the U.S. is about 200 years old. In the early years, cotton was probably handled by general traders along with other agricultural products. The development of a specialized cotton trade started around 1850. For example, the formerly prominent trading house of McFadden was founded in 1852. To facilitate trading in cotton, the New York Cotton Exchange was founded in 1870 and another exchange was established in New Orleans in 1871. At that time, the U.S. cotton crop was about 4.5 million bales, of which some 2.5 million were shipped to the cotton mills of Lancashire, England.

The European cotton trade can also look back on a 200-year history. Paul Reinhart in Switzerland was founded in 1788 at the peak of the cottage industry phase of textile production. The company's basic activities were importing of cotton, trading in cotton yarn and exporting cotton cloth from Switzerland. Some trading houses in Liverpool go back almost that far. The first cotton shipment was received there in 1709.

In Liverpool, a cotton brokers association was founded in 1841, which led to the Liverpool Cotton Association (LCA) in 1882 and included cotton brokers and merchants. (In order to reflect the importance of this organization better for the worldwide cotton trade, it was re-named International Cotton Association, ICA, in 2004). Similar associations were created at about the same time in Germany, France and other European countries. These cotton exchanges were necessary in order to develop an orderly system for the trading of cotton. This included the development of quality standards, trading terms and arbitration rules for the settlement of disputes. The Liverpool merchants dominated the world trade in cotton for several decades. Some major houses had branches in the U.S. and other producing

countries. Bremen, Germany, also became a major center of the cotton trade, supplying not only Germany but also Eastern Europe, including Russia.

In the U.S., cotton merchants started operating mostly in cotton-producing states like Texas, Alabama and Mississippi. From 1900 until WWII, the firm of Anderson, Clayton dominated the world cotton trade like no other firm before or after. But, as the firm grew enormously in the years between the world wars, it went more and more into ginning, warehousing, cottonseed oil, food and other industrial products. Cotton merchandising was de-emphasized, and eventually abandoned altogether. As mentioned, McFadden, was at one time the most famous name in U.S. cotton merchandising, but when the McFadden family died out in the 1970's, the firm was sold several times, and eventually taken over by another merchant. This is actually quite common. Cotton trading is a highly specialized, personalized and risky business. It is not for everybody. Many well-known cotton trading firms have disappeared because the owner died or retired, and his heirs were not interested in or capable of continuing the business. Many others were forced to close down because of huge losses. Looking simply at the risk-reward relationship, cotton trading is not a very attractive proposition any more, particularly when comparing it to returns investors have obtained in mutual funds, high tech and other stocks in recent years (with the exception of 2001 and 2002, of course). For this reason, very few newcomers have entered the cotton trading business over the last ten years.

Cotton trading is not suitable for public ownership. This is the same in other commodities. Due to the seasonal nature of the business, and the unpredictable profit or loss outlook, trading firms are privately held. Apart from the large Japanese trading houses, the only publicly traded cotton and grain company that I can recall was Cook Industries of Memphis. The firm ran into trouble in the 70's and closed down.

Since WWII, the world cotton trade has been dominated by U.S. merchants and the industry has gone through a long period of consolidation. Just like the grain and the coffee trade, we have today a small handful of very large cotton trading firms who annually handle several million bales each on a worldwide basis. These companies are heavily capitalized, and typically have warehousing and ginning operations in addition to cotton trading. The

mid-size firms that were very active 20 and 30 years ago have mostly disappeared, but there are still, and always will be, small traders who specialize in certain niche markets.

Besides the U.S. merchants, there are several major players in Europe, and a few of the big Japanese trading houses still handle cotton. One of the largest traders in Australia entered the arena of international cotton trading about six years ago. More recently, the importance of the U.S. cotton market has attracted two new players from Australia and England who have opened shop in the U.S. through taking over small and medium-sized cotton trading companies. On the other hand, the influence of the Japanese firms has diminished over time, as their domestic raw cotton consumption has shrunk by more than 70% over the last 25 years or so, but they now supply an increasing volume of cotton to Japanese joint ventures and other mills in Southeast Asia. The exit of many large Japanese trading houses from the cotton trade gives a textbook example of how not to do the cotton business. Just going after volume and market share does not contribute positively to the bottom line of any commodity trading company. Margins per bale are much more important!

I have already mentioned the founding of cotton exchanges and associations in Europe. It has also become necessary to have associations to represent the interests of the trade with governments, which have always been heavily involved with agriculture all over the world. In the U.S., the oldest cotton trade organization is the Texas Cotton Association, founded in 1911 and the American Cotton Shippers Association was created in 1924. Cotton merchants are one of the seven segments of the National Cotton Council, founded in 1939. Both of these national organizations are headquartered here in Memphis.

Throughout this 200-year history, the world cotton trade has had a reputation for honesty and integrity. If growers and consumers of cotton could not rely on the performance of the cotton trade, regardless of circumstances, trading of cotton for forward delivery would be impossible.

B. TRENDS IN THE WORLD'S FIBER CONSUMPTION

At the turn of the century, cotton had an 80% share of the world textile fiber market. Of course, at that time there were no manmade fibers (MMF). By the end of WWII in August of 1945, cotton stood at 75% of the fiber market, with other natural fibers accounting for about 10%. Manufactured fibers had risen to 15% by that time. In the 1960's and 70's when polyester became available in volume, cotton's market share declined drastically. This had less to do with price but with the fact that polyester was a novelty, and consumers wanted to try a fiber with new features, like "wash-and-wear" that caught everybody's attention. I remember that in those days cotton was literally fighting for its survival as a major textile fiber. Not only MMF people thought they could drive cotton completely out of business, I still remember my boss telling me in the mid 1960's that cotton had no future anymore. Cotton's share of the world fiber market declined to almost 55% in 1970 from 68% in 1960.

Cotton's share of the fiber market held at about 50% from 1976 to 1986, then fell under 50% for the first time in 1987 and has eroded further ever since. In 2004, cotton's share of the world fiber market was 39%, down from 49% in 1991 when the world consumed 175 million bale equivalents of all kinds of fiber. Total fiber demand in 2004 was 261 million bale equivalents, a 49% increase from 1991. During that same period, cotton consumption increased by only 17.4 million bales, from 85.3 to 102.7 million, compared with an increase of 68.9 million bale equivalents for all other fibers combined. In calendar year 2003, world consumption of polyester, at 103.0 million bale equivalents, exceeded cotton at 97.7 million bales for the first time. Even though cotton consumption will set a record high in 2004, 102.7 million bales, early forecasts indicate that polyester will maintain its lead at 111.0 million in the world fiber consumption, but with cotton regaining some of its market share.

This drop in market share over the years is due to price, fashion and the lack of buying power of the population in many parts of the world. In fact, cotton actually gained market share in some high-income countries (U.S., Europe and Japan), but not enough to offset losses in developing countries around the world. Due to a huge increase in MMF

production capacity worldwide, particularly in China, MMF prices had gone into a steep decline, but the combination of record-high crude oil prices (they recently passed the \$60.00 mark per barrel) and the low cotton prices during 2004 have again increased the competitiveness of cotton versus polyester.

There is just no way that cotton can compete with MMF prices. To hold on to its present market share, or even regain some recent losses, cotton must depend on consumer preference. For this reason, the cotton industry has to promote cotton at the consumer level. It is too bad that the U.S. (and Australia to some extent) is the only country that spends millions of dollars on worldwide promotion through Cotton Council International and Cotton Incorporated. Other cotton-producing countries enjoy the benefits of these efforts without contributing a dollar.

The good news is that there is an almost unlimited potential for an increase in the world's cotton use if we consider that the per capita consumption in Asia is just about 13 lbs., compared to the world average of 20 lbs. and 65 lbs. for the industrialized countries, respectively. Doubling the per capita consumption in Asia would produce an additional demand of 33 million bales!

C. THE COTTON TRADE

World trade takes place when goods cross a national border. That means cotton has to move from one country to another to be considered as traded internationally. Over the last two seasons and making an estimate for 2005/06, international trade in cotton, imports and exports, have averaged about 35.0 million bales. Cotton merchants are vitally interested in free and open exports and imports of cotton worldwide. In countries like Brazil, Pakistan, China, Turkey, Mexico, India, etc., international traders can participate in both imports and exports. On the other hand, we cannot sell Chinese cotton to mills in China, or Indian cotton to mills in India. Trading in those countries is handled by government organizations (Central Asia, Syria, etc.), the domestic cotton trade (India, Turkey and Pakistan) or both (China).

During the 2003/04, 2004/05 and 2005/06 (est.) seasons, an average of 107 million bales of cotton are expected to be grown in about 80 countries around the world. 73% of the world crop is produced in the five largest markets: China, the U.S., India, Pakistan and Central Asia (the former Soviet Union). The experiences of the last three seasons have added new uncertainties to determine the size of the future U.S. and world cotton crops. After a decade of relatively flat yields, new records have been set in each of the past three seasons. The challenge now is to figure out how much of the increased yield was the result of better-than-average growing conditions (weather) and how much was due to other factors, most notably the improved (genetically modified) seed varieties. The latter are now widely used in the U.S., China, Australia, India and other producing countries.

Cotton is consumed in more than 100 countries, with annual consumption running from 38 million bales in China (in 2004/05) to as little as 1000 bales (Armenia and Nicaragua for example). Consumption during the same three seasons is projected to average 106 million bales. The six largest consumers account for over 75% of world consumption. They are China, India, Pakistan, Turkey, the U.S. and Brazil. Much of the world's cotton consumption takes place in countries where cotton is also produced. In fact, most of the growth in consumption over the past ten years has been in cotton-producing countries. This development has turned former large cotton exporters like China, Mexico, Turkey, India and Pakistan into net importers of the fiber. I can see similar developments in Uzbekistan and other republics in Central Asia in the future.

Taking care of quality imbalances is another reason for world trade. In India and Pakistan, for example, the textile industry is becoming a major supplier of yarn, fabric and apparel to the Far East, Europe and the U.S. In order to produce top quality textile products, mills depend more and more on imports of U.S. cotton, including pima, and Australian, which have a very low rate of contamination and/or allow spinners to produce a very special yarn. At the same time, Pakistan and India continue to export some of their lower grade or shorter staple raw cotton to the Far East.

World trade in cotton has been rather stagnant in the past 25 years. It passed 20 million bales for the first time in the 1970/71 season (23.5 million bales traded) and reached

a temporary peak in 1988/89 with 33.5 million bales. The average of the last three years has been about 35.0 million bales, just 33% of total production. The largest exporters are the U.S., Central Asia, West/Central Africa, Australia, Brazil and Greece/Spain. After participating for several years in the export market, China is now, by far, the largest cotton importer of the world (estimated at 15.0 million bales in 2005/06).

Where do cotton merchants fit into this picture?

Cotton merchants are the necessary link between farmers and textile mills. The most important single function of a cotton merchant is that of a market maker. By buying cotton from farmers when they want to sell, and selling cotton to the mills when they want to buy, the merchant effectively creates a market where cotton can be bought and sold at all times. Cotton is traded as much as 24 months forward. Due to the risk inherent in all commodity transactions, this requires a great deal of confidence on the part of all parties involved: producers, textile mills and merchants.

Cotton merchants have a vital interest in free trade of cotton across national borders. As mentioned earlier, no international merchant can sell Chinese cotton to textile mills in China or wants to participate in the cotton movement within India or Pakistan. But when the U.S., China, India, Pakistan, Brazil, Turkey and Mexico import and/or export cotton, and when cotton-producing countries in Africa, the republics of Central Asia or Australia and Syria sell their cotton for export, the international cotton trade is very much a participant.

D. WHAT ARE COTTON MERCHANTS?

Cotton merchants are market makers who provide service and information. We are in the “people” business; the most valuable asset in a cotton company is its people and their integrity. We are not speculators, buying cotton at a low price and selling high, as many people may think. Similar to all other commodities, margins are razor-thin. To be able to buy, we have to pay the highest price of the day to a producer and, since competition is very tough, to sell we must do so at the lowest price. We will see later how cotton merchants can

make this work. Most cotton merchants are private companies, primarily located in the U.S., Europe, Australia and Japan. Some are owned today by the big grain merchants. Others are family-owned and operated. Less than ten firms can be considered leading international merchants, handling, or capable of handling, a million bales or more. We are not including here cooperatives in the U.S. and elsewhere, which also handle very large volumes of cotton, but mostly in their home territories.

As I said before, the cotton trade has become more concentrated over time. There are fewer but larger trading firms than what we had, say, twenty years ago. Even at today's still depressed price of \$300.00 a bale, cotton merchants require huge amounts of capital to finance their operations. They need a high tolerance for risk in view of the greatly increased volatility in the market. For this reason, there have been almost no new players coming into the business recently, but we have lost several large merchants in just the last five years or so.

Cotton merchants can be divided into groups, as follows:

- International merchants, handling most major cotton growths, who can buy and sell large quantities and are able to deliver other origins if there is a problem in one producing country.
- Regional merchants, dealing only in a few selected growths, such as U.S., Central Asian, West African, Greek, Australian or East African, etc.
- Local merchants, handling only cotton from their own country or a region within it.
- FOB merchants/brokers, usually handling cotton on commission.
- Long and Extra Long staple cotton traders.

All of these have specific functions. The big, international merchant uses his large organization, financial strength and know-how to buy and sell cotton all over the world. The regional merchants do the same but on a smaller scale, usually concentrating their efforts in a limited number of markets. Local merchants exist in almost all cotton-producing countries, trading cotton for both export and the domestic market. Finally, FOB merchants or brokers in the U.S. form the link between farmers and the large merchants, buying cotton in the interior markets and selling it to the big merchants. These FOB merchants perform very important functions. In addition to being the link between the grower/gin and the merchant, they act as consultants to growers in many aspects of their business: what variety to grow, when and to whom to sell. They also advise producers on the U.S. Farm Bill, the use of the CCC loan and when to redeem it. For the rest of this presentation, we will concentrate on the first group, the international merchants.

E. WHAT IS THE ADDED VALUE COTTON MERCHANTS PROVIDE?

Before going any further, we have to see why merchants are necessary at all. Why does the farmer not sell directly to the spinning mills? Why do the spinners not buy their cotton directly from farmers or cooperatives?

Experience shows that farmers rarely sell when mills wish to buy; and mills do not buy cotton when the farmers want to sell. In the old days, U.S. farmers used to sell their cotton either at or before planting time to lock in a price; or when the cotton crop had shown some progress; or after the harvest was completed; or any combination thereof. At times of low prices, things are different in the U.S. Under the Farm Bill, U.S. growers cannot afford to sell their cotton ahead of the harvest because that is when they can also fix the government payments. Spinning mills have no set pattern of buying cotton. They are guided by the level of cotton prices, the yarn and textile markets, their own order book, etc. Growing and spinning cotton are industrial enterprises. Farmers and spinners should not be speculating. Once a profit can be locked in, the price should be fixed. Since these buying and selling periods do not coincide, the cotton merchant steps in and provides a market for both sides.

That means that merchants will always have a price when farmers want to sell; and they will always be prepared to sell, any quantity, any quality for any delivery period, when the mills want to buy.

In addition to market making, there are other vital functions performed by the cotton merchant:

For the cotton grower:

- Buying all qualities produced
- Buying total quantity produced on contracted acres
- Competitive pricing, fixed or “on call”
- Minimum Price Guarantee Contracts
- Forward contracting at any time, up to 2 years ahead
- Taking delivery as cotton is produced
- Prompt payment against delivery, at origin
- Speaking the producers’ language
- Up-to-date market information, advice on selling/fixing and option strategies
- Explaining the influence of the U.S. Farm Bill on their marketing
- Financing and foreign exchange
- Brokerage services, including futures and options

For the spinning mill:

- Supplying cotton according to the exact specifications (HVI lay-downs in the U.S.)
- Contract exactly determined quantities
- In the case of U.S. cotton, advance information of HVI results
- Holding large stocks of physical cotton
- Selling as far ahead as the mills wish to buy, up to 2 years
- Competitive pricing, fixed or “on call”
- Maximum Price Guarantee Contracts
- Selling cash on delivery or with credit terms up to 180 days
- In some cases, selling with rejection clause, or selection of actual samples
- Delivery in regular monthly, weekly or even daily shipments (“just-in-time”)

- Offering a wide selection of growths, as alternatives
- Speaking the mill buyers' language
- Up-to-date market information, advice on buying/fixing and option strategies
- Foreign exchange
- Brokerage services, including futures and options

Farmers and spinners must be able to rely completely on the merchant's guarantee of performance, regardless of market conditions. With today's high volatility in prices, this is no small matter. For that reason, a merchant's reputation is extremely important. This is especially true for forward contracts, i.e., purchases and sales contemplating delivery of the cotton far in the future. A growing majority of both farmers and textile mills have come to realize that their only protection lies in the integrity of their contract partner, the merchant. Therefore, they have become much more selective as to whom they do their business with.

When it comes to selling or buying, price is always very important. But, it should not be the only consideration. Both cotton growers and spinners have to decide when they want to sell or buy cotton. Once they have decided to enter into a contract, they want to be sure that the contract will be honored, even if prices change a great deal between the date of contract and the actual delivery time. Dealing with an unreliable partner could mean that the highest price contracted may turn out to be a poor sale for the grower; and, the lowest price may become an expensive purchase for the spinner.

By the same token, cotton merchants will also want to be sure with whom they do business. A contract default by either the farmer or the mill can be extremely costly since the merchant has entered into a hedge transaction, which will have to be covered at a loss. Cotton merchants usually rely on their agents in the various world markets for information on the financial and moral standing of their suppliers and customers. In addition, many trade associations keep so-called "default lists," circulating the names of mills who have failed to honor a contract or an arbitration award. This is done as a warning to other exporters. Losses incurred by merchants for contracts not honored increase the cost of doing business. A very careful selection of contract partners will allow traders to work with lower margins;

this will eventually benefit producers and consumers. The adherence to the principle of sanctity of contracts is therefore in everybody's best interest.

F. INFORMATION GATHERING

In order to buy and sell cotton, merchants require up-to-the-minute information on all factors that could affect the price of cotton. They have to analyze the supply and demand for cotton and competing fibers, not only in their home territories, but worldwide. Primary sources of statistical information include

- the U.S. Department of Agriculture (USDA)
- the U.S. Department of Commerce
- the International Cotton Advisory Committee (ICAC)
- Cotlook, Liverpool
- the National Cotton Council (NCC) of the U.S.
- foreign governments
- United Nations, Industrial Division, New York
- private sources, which include the merchant's own organization, customers and suppliers, buying and selling agents, country buyers, etc.
- brokerage houses, news wire services and providers of instant futures/options quotes
- the Internet

Primary factors that need to be considered in the global market picture include production and consumption statistics, estimated carryover levels, government and private stocks, and the ratio of ending stocks to consumption, as well as China's cotton trade balance. These all have a direct impact on the price of cotton. In many countries, statistics are either not available or very unreliable. The U.S. government tries hard to provide exact statistical information to the cotton industry. Government programs and actions for cotton and other commodities (U.S. Farm Bills, changes in Chinese commodity and/or economic policies, etc.) can have profound long and/or short-term effects on the market. The weather can play havoc with prices too (the El Niño phenomenon during the 1998/99 season with a drought in Texas and excessive rains in California. Poor weather in China in 2003 and the drought in Australia are other examples).

Secondary factors that influence the market include the state of the world or regional economies and of the textile industry in particular, as well as prices of competing fibers, such as polyester. Other elements are the cost of cotton production, including the cost and availability of irrigation water. Yield improvements through better seed varieties (GMO's), advanced harvesting and ginning methods may influence prices and qualities. Finally, prices for competing crops (such as soybeans, corn, rice and sorghum), fashion trends, and government programs can also affect cotton prices. The elimination of textile quotas in January 2005 had a negative effect on cotton prices at the end of last year.

Additional considerations in the general picture are, for example, the U.S. \$ exchange rate, the outlook for inflation and interest rates and political and economic developments around the world. Prime examples are the break-up of the former Soviet Union in 1989 and the Asian economic and currency crisis of 1997. Both had a profoundly depressing influence on world cotton prices. It is also somewhat important whether the price level of cotton is relatively high or low. Very often, activity by speculators or option traders on the New York Board of Trade may also have a significant influence on prices, but these are normally of a short-term nature. The SARS outbreak in the Far East in 2003 is another example of what an apparently unrelated event can do to cotton prices.

Finally, we have long-term factors, which over time may affect the cotton price: oil prices (they influence the price of synthetic fibers and add or decrease discretionary spending for many families), availability of land and water resources, and the increase of the world population.

To sum up, almost anything going on around the world can have some influence on the price of cotton. Therefore, it is necessary for cotton merchants to be very well informed. Only with all the facts at his command can an international cotton merchant form a mental picture of the price outlook and act accordingly.

G. FORECASTING COTTON PRICES

Cotton merchants try to estimate the direction of cotton prices. This is important for managing their own operations, and particularly for making recommendations to their customers and suppliers. Obviously, there is no exact, scientific way to calculate where cotton prices will be in the weeks, months or years ahead. Forecasting is an art based on experience. Some traders are very good at this over time, but everybody has to know that markets are bigger and more powerful than any one person or company. When trying to determine the course of prices, the merchant will take all known factors into account and adjust his mental picture every day for new developments.

Among the information and tools available for price forecasting, we can consider

- New York cotton futures
- the level and composition of the certificated stock tenderable in New York
- the positions of speculators at the NYBOT
- the Cotlook Indices (“A” and “B”)
- over the counter (O-T-C) swaps in London and at The SEAM
- the basis
- production cost
- the U.S. loan level
- the effects of government payments to producers and exporters
- minimum export prices fixed by producing countries
- planting intentions for new crop
- crop progress
- supply/demand statistics and expectations
- mill coverage
- weather reports
- market information on cotton trading around the world (China!)
- technical analysis, including chart patterns
- currency developments
- crude oil prices

Even taking every known factor into consideration, different traders will come to different conclusions. This, of course, is what makes the market. Nobody is always right, but to be successful, a cotton trader has to be correct more often than not. Information is the key to making correct decisions.

H. PRICING OF COTTON

Cotton merchants must be prepared to buy and sell cotton at any time. The larger international merchants are departmentalized. While the top management controls the company policy regarding buying and selling, as well as the taking of market positions, these companies have traders who are in charge of certain production areas as well as selling markets. Management will have a general price idea, but the fine points of day-by-day buying and selling are in the hands of those traders. The latter also have to know the ever-changing cost of shipping cotton from point of origin to various export markets around the world, as well as what exactly is going on in “their” markets every day.

There are two price indicators that apply to most of the upland cotton traded around the world:

- the New York Board of Trade No. 2 Contract
- the Cotlook “A” Index

The daily trading on the NYBOT is the most important single price indicator for cotton in the world. In the U.S., all cotton, with the exception of Extra Long Staple cotton (ELS) is based on NYK futures. Foreign growths normally move in the general direction of New York, but never follow it on a day-to-day basis. Since cotton futures are traded 24 months forward, it is possible to price cotton for two complete seasons. This enables merchants to buy cotton from farmers even before it is planted. It is possible to sell to spinning mills as far ahead as they wish to buy.

The difference between the NYK futures price and the actual cotton price is called the “BASIS” (at origin, FOB vessel, delivered mill or wherever). The basis does not fluctuate day by day. Its movement depends on many factors, including supply and demand for a particular quality in a certain country or region, the weather, the outturn of the crop, competing growths, spinning value, availability of Step-2 certificates, shipping cost, etc.

In the U.S., domestic mills usually buy their cotton “on call,” that is, at a fixed basis “on” or “off” NYK futures. Contracts for delivery over a longer period are based “on the cover.” For example, Memphis SLM 1-1/16” for delivery from November 2005 through October 2006 may be priced at 150 on Dec05/Mch/May/July/Dec06 for the respective delivery months. On the export markets, an increasing number of mills are taking advantage of the benefits offered by buying “on call.” What are these benefits? 1) Mills can purchase and secure the specific quality required by them for the entire year without having to fix the price and 2) they can fix the price in NYK at any time when prices are low or as they are selling their finished goods. Since normally a low basis does not coincide with a low New York market, it can be advantageous for mills to separate the two components of the fixed purchase price.

Non-U.S. growths also look to NYK futures for guidance, but are not really based on the futures prices day by day; for them the daily Liverpool quotes, the lowest five of which make up the Cotlook “A” Index, are almost as significant. The Index reflects the prices of various growths quoted Cost and Freight (CFR) Far Eastern ports. The prices are collected daily from merchants and other sources all over the world. Even though the Index is established by a private company in Liverpool, UK, the CIF North European Index is accepted by the U.S. government as the official indicator of the world price of cotton; it is the best available measuring stick for world prices and for the relative competitiveness of U.S. cotton.

The Cotlook “A” Index has gained additional importance as large volumes of Central Asian cotton are traded “on call” the Uzbekistan quote of the Cotlook “A” Index (CIF North Europe values). The same applies to Spanish and Greek cotton. In the past, some Eastern European countries used to buy based on the “A” Index. The “O-T-C” market in London and

The SEAM in Memphis allow traders to actually buy and sell the Cotlook “A” Index at any time for future settlement. In addition, the Step-2 is now also traded over The SEAM.

As to buying and selling prices, there is fierce competition both at the farm and at the mill level. Even the largest merchants cannot dictate the price. They must compete with everybody else. As mentioned earlier, prices paid to growers and sales prices to spinners will always reflect the best available in the market. It takes the highest price to buy cotton, and the lowest price to sell. This is why profit margins in the cotton trade are always very thin.

A frequently asked question by mill buyers is: why do different merchants offer different prices for, apparently, the same quality and shipment? Of course, there are many different reasons, just to name a few: Opposing market opinions is an obvious one. Also, the merchant who has the requested quality in stock may offer it at a more attractive price compared to others who would have to cover it in the “cash” market in case the sale materializes. A quality with guaranteed USDA Green Card HVI class will most likely be priced higher than an offer on “description.” Buyers should also watch out for the “fine print” in many offers regarding weights (certified or landed), micronaire and GPT tolerances (NCL or UCL), crop year guarantee, clearly specified origins (not just “M/O/T” or “West African”), points of delivery (CIF, CIP, DAF, DDP) and who pays bank charges and who covers the cotton insurance, including country damage, and from which point. Another important difference may be the merchants’ view on the amount of the Step-2 payment at time of shipment.

I. HEDGING AND THE NEW YORK FUTURES MARKET

The sophisticated and professional trading of cotton the way it is done today would not be possible without a futures market where hedge transactions can be made to offset the risk involved in purchases and sales in the spot market. Therefore, the merchant can only perform his basic function of market-maker if there is a reliable and liquid futures market, established in countries without foreign exchange control and with laws that allow foreign entities to repatriate their hedge and other profits made on exchange transactions without any

tax consequences. In the past twenty-five years, call and put options have come into use as an additional tool for risk management.

I have already pointed out that selling by growers and buying by spinners does not normally coincide. It is, therefore, necessary for cotton merchants to hedge their purchases and sales with a counter-transaction in New York. By faithfully hedging every purchase and sale of physical cotton, the merchant can eliminate the market risk. What cannot be hedged, of course, is the basis risk. NYK futures are based on SLM 1-1/16" (41-4-34) micronaire 3.5-4.9 NCL, minimum GPT 25. The basis for other qualities can and does fluctuate against the futures contract, sometimes a great deal, depending on their availability.

For non-U.S. cotton, NYK futures do not offer an effective hedge, but futures can still be used as a temporary offset against purchases and sales. As a rule of thumb, prices of non-U.S. cotton tend to adjust by about 50% of the daily movement in NYK. Traders in non-U.S. cottons have to find other ways to manage their risks and to minimize their exposure: buying put or call options; or by off-setting a purchase of, say, Central Asian cotton with a sale of another foreign growth, West African for example. The O-T-C swaps markets in London and at The SEAM are additional tools available for hedging. The reason why New York does not serve as a good hedge for foreign cotton is because of the different directions prices of U.S. and foreign cotton may take in one season. A tight supply situation for tenderable cotton in the U.S. can drive NYK prices way above world market levels.

The NYK futures market basically has two sets of traders: hedgers and speculators. Hedgers include the entire cotton industry, from the farmer, to the merchant, to the mill. All of these groups use the market for hedging. On the other side, speculators can be divided into four groups: individual speculators, commodity and Index funds, the "locals" on the floor of the NYBOT and option traders. The exchange publishes the "spec/hedge" report every Tuesday: what percentage of the Open Interest (i.e. the sum of all open trades) is held by hedgers and speculators. The trade pays a lot of attention to these figures, as they can provide important leads to the future course of the market. Speculators are needed to provide liquidity to any commodity market. They look at technical analysis/charts for clues as to the

direction of the market while hedgers usually consider “fundamentals,” that is, supply and demand.

Since the 1970’s, the volatility in the futures markets has increased a great deal. Larger merchants are taking larger positions in both futures and actuals. The arrival of commodity and Index funds has brought huge amounts of speculative capital into all the commodity markets. Since these funds tend to be chart players, technical analysis has become more important. Finally, the increased use of cotton options has led to even greater volatility. A look at any weekly or yearly price chart clearly shows the tremendous volatility in cotton prices. This is a fact, regardless of whether or not such volatility serves a useful purpose for the industry. The more volatility, the more important it is to have a reliable futures market to hedge the risks. The NYBOT No. 2 Contract has proven over more than a century that it is such a market. And, I want to emphasize again how important it is for growers and textile mills to have reliable trading partners who do not only know how to manage their risks, but in effect hedge their operations in order not to be exposed to huge market losses. They must also have enough capital to pay large margin calls, when required.

Options are also a useful tool to hedge against market moves or to benefit from them. But, in contrast to futures, there is a big difference in the risk factor between selling and buying of options. As a hedge vehicle, only purchases of options should be considered: calls to benefit from a rise in the market, puts to benefit from, or protect against, a decline in prices. Sales of options are almost always speculative and best left to professional traders. Merchants offer so-called guaranteed minimum or maximum price contracts, which are based on option purchases. However, due to the perceived high premiums involved, these contracts are unfortunately not utilized as much as one might expect when looking at the price volatility and the need for producers and consumers to protect themselves in the volatile markets all commodities have experienced since the early 70’s.

J. E-TRADE

Four years ago, I barely mentioned this subject. Buying and selling on the Internet probably is the fastest growing business in the U.S. What makes it so easy and convenient? Buyers know exactly what they want to buy, like a certain book, a DVD, a digital camera or apparel illustrated in a catalog or on the home page of the seller. The same applies to an airline ticket. The deal is always for immediate delivery and with credit card payment, so sellers do not have to be concerned about getting paid. There is no need for buyers and sellers to know each other.

E-trade in cotton is nothing new. For over 20 years now, the TELCOT system in Lubbock, Texas, (which was later integrated into The SEAM) has offered cotton recaps based on USDA HVI class. Buyers know exactly what they buy and the seller is paid within 24 hours, so there is little or no risk on either side.

Trading cotton on the Internet for future delivery is a different story. Most growers and mill buyers still want to know the reliability of the company they are dealing with and who will respond in case any problem arises later on. E-trade in cotton made a big step forward in February of 2003 when The SEAM's International Marketplace was launched. The volume of physical cotton traded, mostly West African, Brazilian, Central Asian and Greek, has increased steadily. It is becoming a very popular vehicle for smaller traders to secure certain growths they are not able to buy - for one reason or another - directly at origin. Also here, it is important to know your trading partner, as these trades are not guaranteed by The SEAM.

K. POSITIONS

As outlined above, it is possible to eliminate most market risks by hedging. However, some cotton merchants still take "positions," that is, they buy and sell for their own account, in other words, they speculate. Due to the intense competition in the market place, these merchants try to enhance their financial result by taking on additional risks, as it is difficult to cover the overhead and make a profit purely on basis trading. Positions can be taken either in the futures market, in physicals or in the Cotlook A Index. Merchants can

also take market positions by buying or selling put and call options. By being long or short, the merchant speculates on either rising or falling prices.

For U.S. cotton, where prices are closely tied to the futures market, it is easy to take positions in futures, either on the long or on the short side. The advantage is that there is always a price at which one can buy or to sell in New York, which may not necessarily be the case when trying to dispose of a long in physicals, or to cover a short position. Also, all trades at the NYBOT are guaranteed through margin calls that brokerage houses collect daily in the form of original and variation margins from traders suffering losses in their operations.

Basis positions in the true sense work best with U.S. cotton. In the normal course of their business, U.S. merchants can be long or short a very large quantity of physical cotton, fully hedged in NYK. The objective is to be always able to buy and sell, and to benefit from a change in the basis. For example, the basis for California SJV cotton normally fluctuates a great deal within a season. If the merchant thinks that SJV cotton is cheap, relative to the futures market, he can take a basis long position and make a profit if the basis for SJV goes up. Conversely, if a merchant feels that Texas-type low grades will be in surplus, he may sell this cotton short, protect himself against the market risk by buying futures, and then benefit if the basis for the low-grade cotton declines.

For non-U.S. cotton, merchants take positions in actual cotton: Long or short positions held outright or partially hedged in New York futures or with options. Short positions in physicals can be taken with a reduced risk by including an option to supply the same cotton from two or more origins. While mills usually demand a discount for such optional contracts, the advantage for the seller is that he is not obliged to supply a specific quality of a specific growth, which may or may not be available at a reasonable price and/or in volume. Another tool to take positions is through the over-the-counter (O-T-C) swaps trading in London or at The SEAM.

In the case of non-U.S. cotton, a pure basis position does not work, particularly at times of a small U.S. crop. The price movements of cotton outside the U.S. do not closely follow the futures market. Sometimes the risk is actually increased by selling futures as a

“hedge” against long positions in non-U.S. cotton. In the worst case, the merchant can end up with two losing positions: a loss on the physical cotton bought in foreign growths (long position) because the level of foreign prices dropped and another loss on the hedge in New York (short position), because, for some reason, U.S. prices and, consequently, the New York market went up.

Both market and basis positions should be directly related to the size and capital of a merchant. The bigger the equity and credit lines available, the larger will be the annual trading volume and the positions firms can afford to take.

L. SUMMARY

Cotton merchants form a necessary link between the cotton grower and the spinning mill. They provide a ready market for the grower, for his entire crop or part of it and they supply spinners with cotton according to the mills’ exact specifications, delivery and payment terms. If merchants were not performing an indispensable function, they would not exist anymore.

Again, whether you are a grower, a spinner or a merchant, I cannot emphasize enough: know your contract partner. The merchant’s integrity and financial strength are your only protection at times of rapidly changing prices and market conditions. The size of the merchant you are dealing with is not that important, what counts is his integrity, his financial means in relationship to the volume handled and his commitment to always hedge his market exposure.

The steep decline in cotton prices in 2004/05, which I think nobody could foresee, once again put tremendous strain on the industry and the cotton marketing system. Producers are suffering, but the ones who sold their cotton to merchants a long time ago (like many producers in Australia) and at much higher prices, are now enjoying the real benefits of the cotton trade and of forward contracting in particular. In a rising market, mills who have

bought at lower prices will benefit from the reliability of the cotton trade. Cotton merchants will receive and deliver cotton purchased or sold at prices contracted, exactly according to the contract terms wherever the market may be, in six, twelve or twenty-four months.

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Cotton Production, Consumption, Exports & Imports

2003/04 to 2005/06 - 3 year average (USDA)

(in million bales of 480 lbs.)

<u>Production</u>		<u>Consumption</u>		<u>Exports</u>		<u>Imports</u>	
China	25.600	China	37.000	U. S.	13.920	China	10.111
U. S.	20.336	India	14.767	Central Asia	5.440	Turkey	3.057
India	15.800	Pakistan	10.267	West/Cent. Africa	4.454	EU 25*	3.023
Pakistan	9.517	Turkey	6.733	Australia	2.352	Indonesia	2.283
Central Asia	7.367	U. S.	6.107	Brazil	1.655	Thailand	1.926
Brazil	6.372	Brazil	4.117	Greece/Spain	1.528	Bangladesh	1.655
West/Cent. Africa	4.952	EU 25*	3.539	India	.742	Mexico	1.653
Turkey	3.983	Indonesia	2.233	Syria	.733	Russia	1.450
Australia	2.367	Mexico	2.033	Egypt	.583	Pakistan	1.333
Greece/Spain	2.137	Thailand	1.983	Pakistan	.483	So. Korea	1.225
Others	<u>8.538</u>	Others	<u>17.106</u>	Others	<u>3.208</u>	Others	<u>7.557</u>
Total	<u>106.967</u>	Total	<u>105.886</u>	Total	<u>35.099</u>	Total	<u>35.272</u>

*EU 25 = Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, United Kingdom

7/12/05