

SURVIVING IN A VOLATILE ENVIRONMENT

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This topic goes to the heart of the current crisis in the Australian cotton marketing system.

The cotton industry is currently in a state of shock. This shock stems from the collapse in both the Australian dollar and the US cotton futures market.

A number of growers have not survived. Many more are looking at massive losses due to buying the Australian dollar forward and not selling cotton futures forward.

Big swings in markets highlight bad marketing practices.

Hopefully the industry can learn from this difficult time.

More importantly, we can only hope that the litigation currently underway will not destroy the Australian cotton marketing system as we know it and enjoy it today.

The Australian cotton marketing system is arguably the most advanced agricultural marketing systems in the world.

The current crisis centres on the collapse of the Australian dollar, the collapse of the cotton price and the selling (hedging) practices of scores of cotton growers.

These growers had bought (hedged) the Australian dollar in the 60-65 US cent area, some out for five years. They saw that as good income protection.

But they did not sell (hedge) the US dollar cotton price. Over the past 18 months it slipped to a 30 year low.

A number of cotton growers are now bankrupt. So far industry-wide bad debts could top \$A30 million.

Now, a number of cotton growers are refusing to honour contracts with cotton merchants. The cotton merchants, like Namoi Cotton, Queensland Cotton, Dunavant and Colly are left holding the can.

So this is a difficult time, but an important time, to talk about how to survive in a volatile environment.

But before doing so I want to talk to you about how I look at the cotton market.

I believe that the major price trends in the cotton market, indeed in all commodity markets, are set by major events - by front page news - not by the news on the business pages or news specific to the cotton industry.

I will point out some interesting relationships with broad macro-economic trends – trends not often discussed in the industry.

I will try to explain why the cotton market tanked and I will also give you a view on where the market might be going.

But in this section about the cotton market, the point I really want to impress upon you as growers, is that it just doesn't matter to you where the market goes.

All you can do is sell it when it is high.

This then leads me to the second section of this presentation – and this is surprisingly short, because it is surprisingly simple.

This is the section about marketing your cotton – a critical component of surviving.

All growers have to do is sell their cotton in A\$/bale.

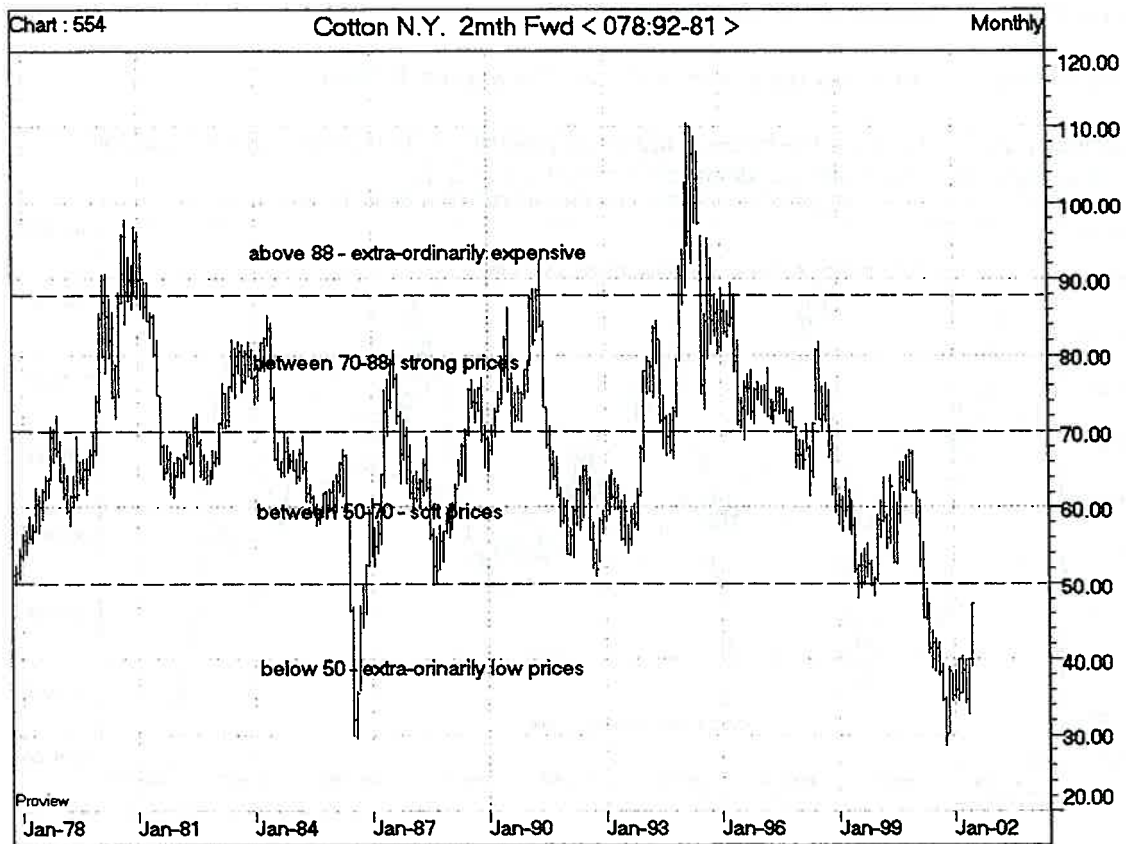
But to this later.

Firstly lets have a look at the cotton market.

1. THE COTTON PRICE

- **STRUGGLING UP FROM 30 YEAR LOWS BUT STILL SUB 50 US CENTS/LB.**

- **WHAT WENT WRONG?**



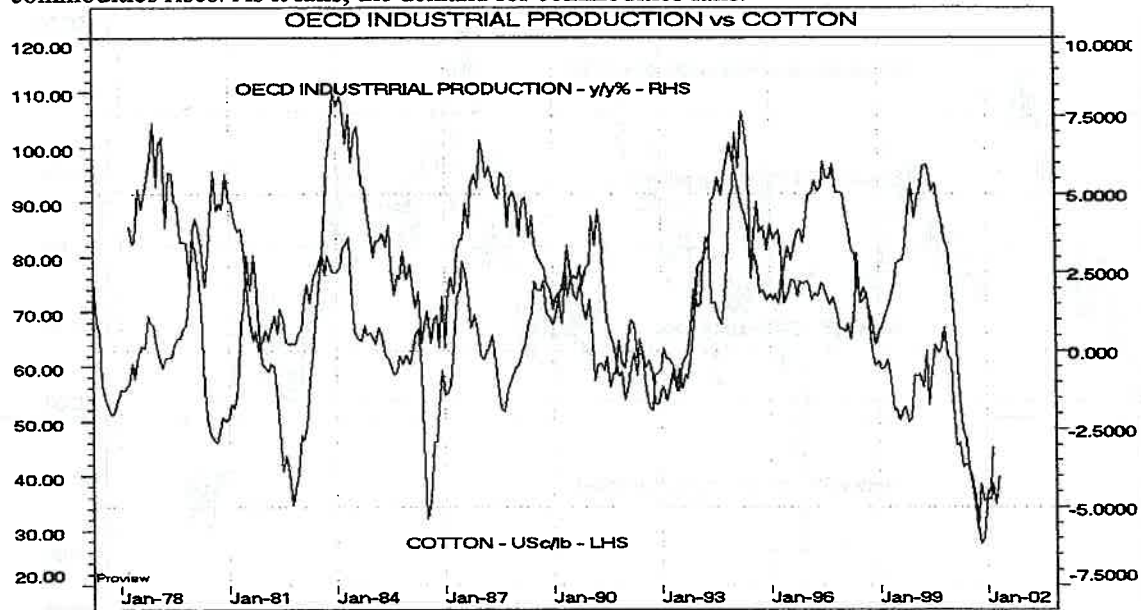
WHAT WENT WRONG?

- A. GLOBAL SYNCHRONISED RECESSION IN 2001 – THE FIRST SINCE 1975
- B. AN ALMOST 50% SURGE IN THE US\$ FROM 1995
- C. SUPPLY DISTORTIONS – WHY NO RESPONSE TO HISTORICALLY LOW PRICES
 - US FARM BILL
 - CURRENCIES

A. GLOBAL SYNCHRONISED RECESSION

Commodity prices are led by big economic trends. Cotton is no different.

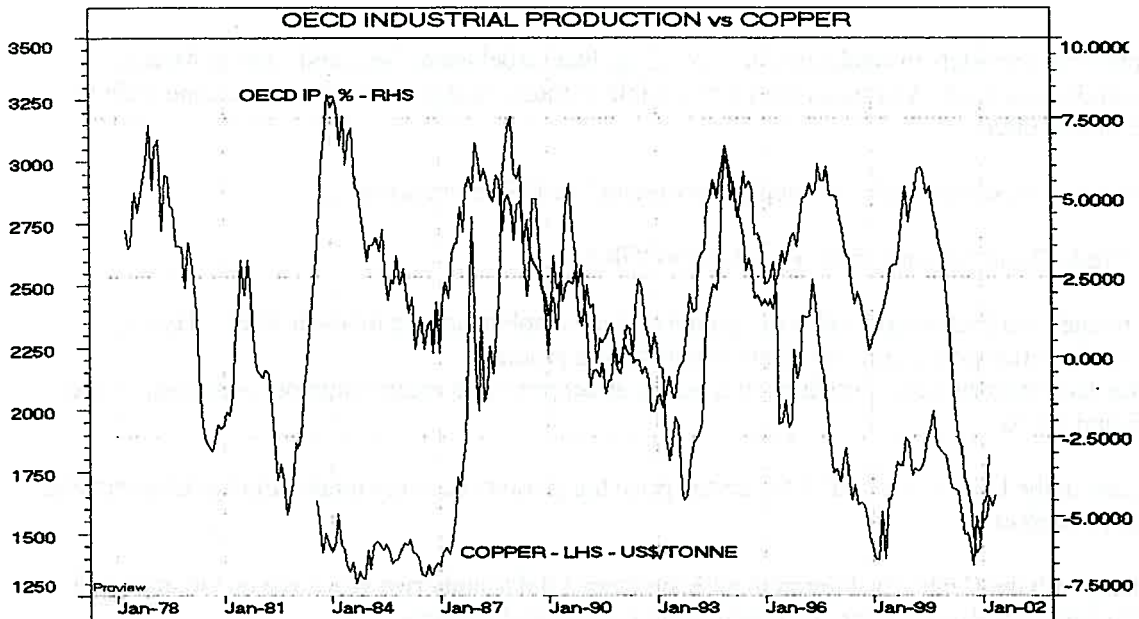
A primary driver of commodity prices is industrial production. As this rises, the demand for commodities rises. As it falls, the demand for commodities falls.



O.E.C.D. industrial production during the 2000-2001 recession declined at its sharpest rate since the mid 1970s.

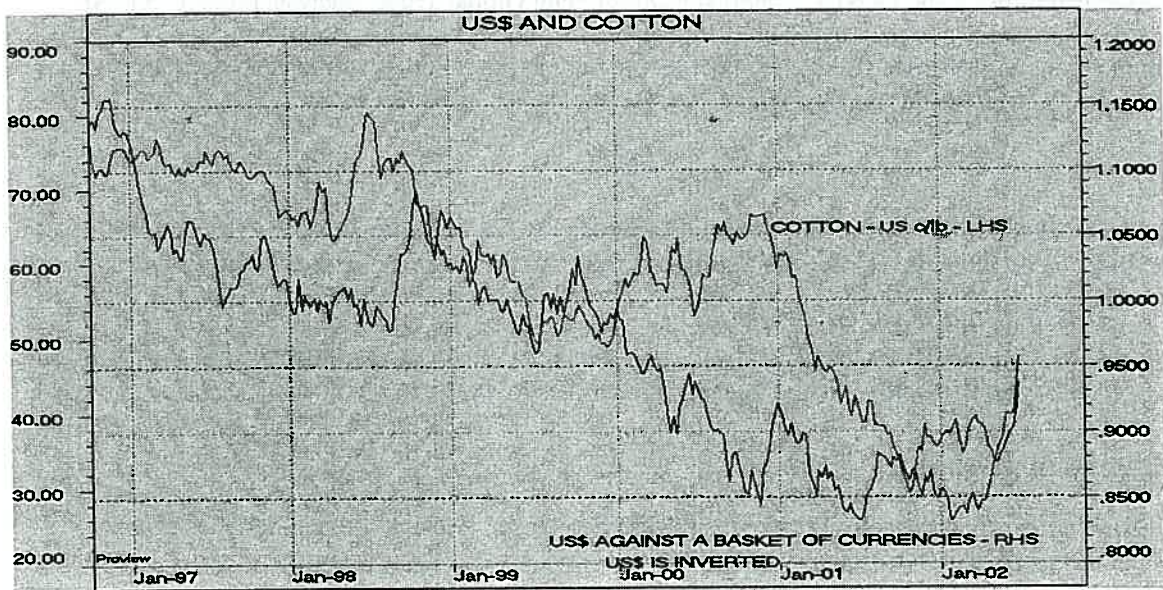
And understandably – this was the first synchronized global recession since then.

Cotton is not alone – compare the impact on copper.



B. CURRENCIES

THE GREAT CURRENCY SQUEEZE –



As the US\$ surged, cotton collapsed.

WHY?

Cotton for importers in weaker currency countries, like euroland, Japan, Indonesia or Korea, becomes more expensive.

Cotton for exporters in weak currency countries, like Uzbekistan, West and Central Africa, Australia and South America, remains profitable in those weaker currencies despite the slide in US cotton prices.

So there has been virtually no supply response to low US cotton prices.

C. Trade Distortions and the US FARM PROGRAM

Subsidies and trade barriers also distort the normal supply response to lower prices. That is, normally when prices fall, less of the commodity is produced.

Over half of world cotton production receives direct price and income support, especially in the US and China.

Today in the US about a half of the cotton price the grower receives comes from the Government, not the market.

Along with the Centre for International Economics I did a study two years ago on the impact of all subsidies and restrictions on cotton, yarns, textiles and clothing –

1. under the Multifibre Agreement (MFA) and the Agreement on Textiles and Clothing (ATC) – if all restrictions were removed, world cotton consumption would increase by nearly 1% and the incomes of Australian growers would rise by an estimated \$A16m or about \$11,000 per grower.

2. Removal of price and income support subsidies (using Global Trade Analysis Project – GTAP - model) is estimated to add \$A177m to the net income of the Australian cotton industry. (US / China production declines and non-subsidised production rises. For Australia, resources willing, cotton production would rise by 44 per cent and net incomes by 53 per cent.)

US production subsidies alone cost \$A65m – and this was the old less generous scheme.

The New 2002 Farm Program returns to direct market related subsidies and away from the 1996 Act that at least attempted to decouple subsidies from the market price. In that Act it was mainly income support.

The new program has also been expanded. Another \$US74 billion has been added to the program to bring it to \$US171 billion over ten years.

WHERE FROM HERE ?

The first issue is that the cotton market has already collapsed. Most of the bad-news issues like global recession, massive cotton supplies and large stocks are in the price now.

The second thing is that cotton sub 50 US c/lb is historically cheap cotton.

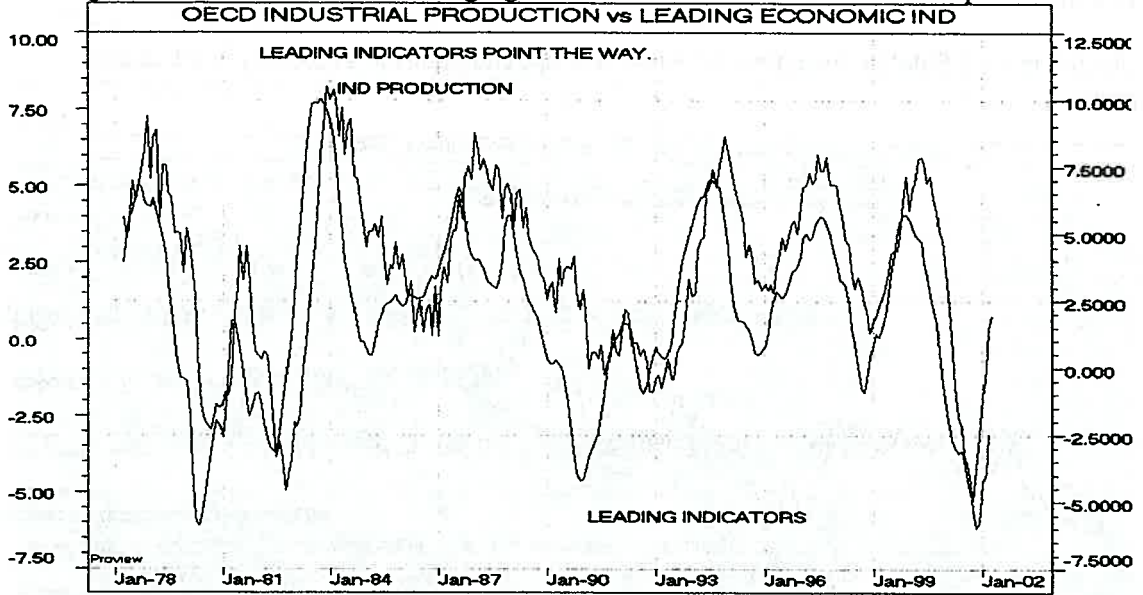
On these two grounds alone we suspect the cotton market will move higher.

But also the global economy is picking-up and the US dollar is falling. These factors also support a price recovery.

While US and international cotton stocks may be falling, they remain oppressively high. This plus continued subsidization will keep a lid on rallies near term.

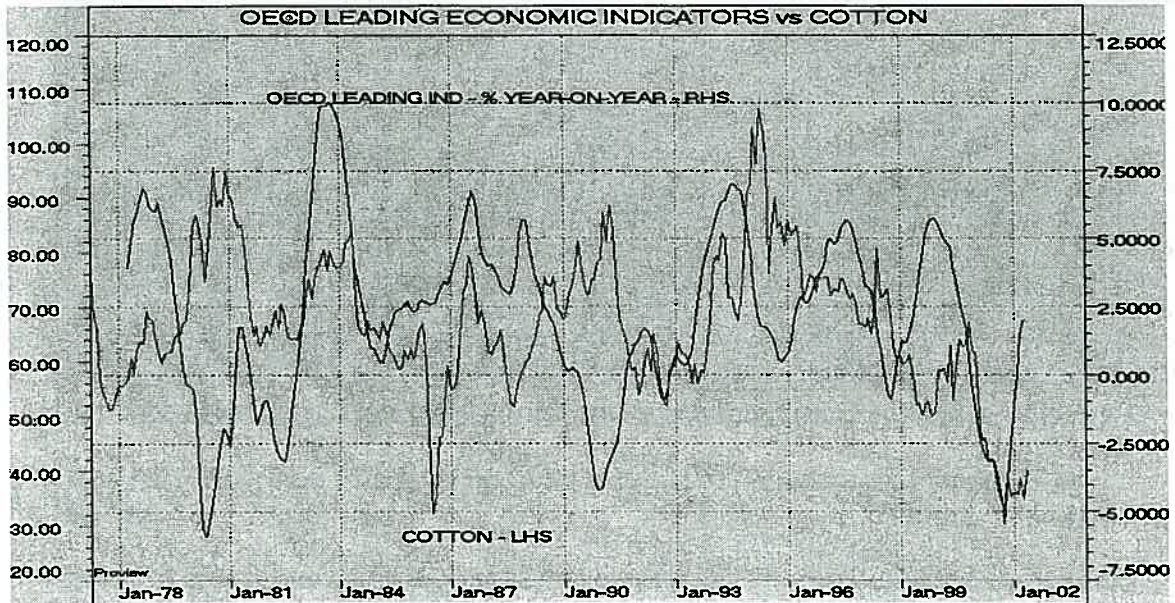
A. THE MACRO PICTURE IS POSITIVE

Leading economic indicators are a strong signal of the future direction of industrial production.



Industrial production is the primary driver of all industrial commodity prices.

It has a significant influence on the direction of cotton prices as well.



– well there are no gurus.

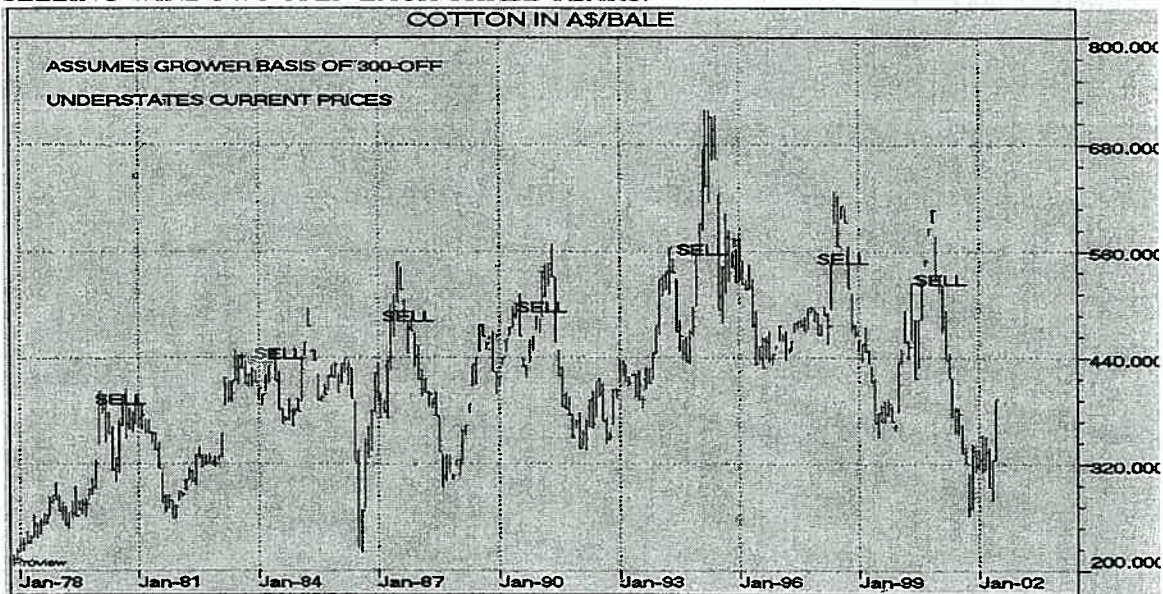
I am a pretty simple bloke and so I like to keep it simple. I like the second choice. I suppose I'm a bundler by nature.

I like selling cotton in A\$/bale.

What does this choice mean ?

It means that when the A\$/bale cotton price is high you sell cotton out as far as possible to lock in returns for years to come.

SELLING WINDOWS OPEN EACH THREE YEARS.



Over the past 20 years there has always been a selling window. This window has been opened either by rises in US cotton futures or by falls in the Australian dollar. The basis has also helped or hindered here and there.

Ironically, the average period between these selling windows is about three years. This is generally the term over which merchants are prepared to make a forward price to growers.

So back in May 2000 to March 2001, when cotton prices were well over \$A500/bale, growers could have sold forward their cotton (or at least as much as they feel safe selling given production/delivery risks) for the 2001 pick, the 2002 pick and perhaps the 2003 pick.

And many did.

This allowed them to avert the hideous slump in the US cotton market to 30 year lows last October.

It also ensured that they were never involved in the currency imbroglio, now facing many of the leggers.

So marketing cotton AND SURVIVING in a volatile environment -

GO TO THE INTERNET EVERY MORNING, CHECK OUT THE PRICE AT WHICH YOU CAN SELL YOUR COTTON AND IF YOU'RE HAPPY WITH THE PRICE SELL SOME.

Some people love markets and decide to be LEGGERS.

Now that's fine too, so long as they recognize that they are doing a lot more than selling A\$ cotton. They are trading markets – if they are long the Aussie and have not sold US cotton futures – they have a position not a hedge; they are short US cotton futures
They have a half hedge – that gives you about as much protection as a faulty condom.

And it is also just as silly as one of Australia's more colourful cotton marketers, although now some years out of the industry, who used to talk about double hedging.

