

1995 Cotton Management Economic Notes

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Early Cotton = Bigger Carrot for 95

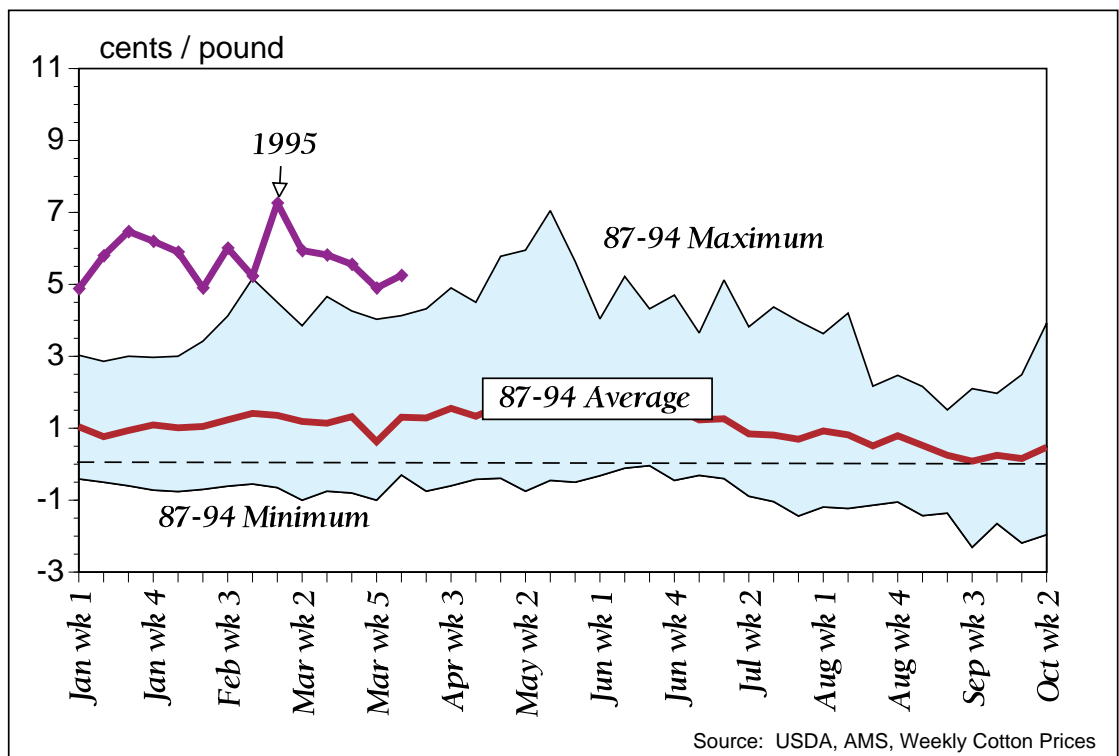
Some reasons for having an early planting and crop termination date are to maximize fruiting before the monsoon season and avoid late season whitefly pressures. But another reason for being early this year is the market. Futures prices for nearby cotton contracts are remarkably higher than they are for the "new crop" December contract. May futures are currently 20¢ higher than December prices due to tight "old crop" supplies.

These tight supplies are also reflected in the difference between October and December futures prices since most US cotton producing areas are unable to harvest, gin,

and ship their cotton by the second week in October. As shown in the figure below, the spread between these contracts has historically been about 1¢/lb. for this time of the year. But the October 95 contract has been a solid 5¢/lb. ahead of the December 95 futures all spring.



October minus December Futures Spread, 1987-1995



Source: USDA, AMS, Weekly Cotton Prices

Recent Prices

April 6, 1995

	<u>Upland</u> (¢/lb)	<u>Pima (ELS)</u> (¢/lb)
Spot - uncompressed	102.97	115.00
May '95 Futures	102.22	
Oct '95 Futures	84.83	
Dec '95 Futures	79.15	
Adj. World Price	93.09	

Note: Upland Spot for Desert SW grade 31-3, staple 35, add 300 points for compressed bales, Pima Spot for DSW grade 03, staple 46, 3/23/95.

The spread between these contracts is the largest that the market has seen in recent times. This premium for earliness has important implications for managing the 95 cotton season, particularly for areas in the low desert that can make an October delivery date.

What are some of the key elements of an early market strategy? First, the wide price spread between October and December futures is most tangible for the producer that forward prices via the futures market or a forward contract. The futures market is a good indicator of what to expect for future spot prices but not a

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guarantee. That is, planning on a market premium for earliness may not be realized without a forward contract or hedge due to changes in market conditions. It is interesting to note that in only **two of the last eight years has the difference between October and December contracts increased** from March to October. This indicates that the anticipation of tight "old crop" supplies generally fades as the "new crop" prospects start to solidify. Selling in the futures market or forward contracting is the most sure way to capitalize on this market premium for earliness.

What Price to Expect

What is the realized price to expect when hedging with futures? The figure below describes the seasonal basis (DSW 31/35 spot minus Futures) for October and December contracts. Note that the basis figures are for uncompressed bales — add about 3¢ to the basis for compressed bales. On average, the basis is 2 to 3 cents/lb. for the spring months and declines below zero when the "new crop" starts to come on-line in September. These basis relationships exhibit "normal carrying costs" of interest and storage associated with keeping cotton in storage. Current basis numbers of over 20¢/lb. are predominantly exhibiting tight "old crop" supplies rather than carrying costs of storage.

The relevant basis for calculating a final realized price is the basis at maturity or one to two weeks before maturity. As shown in the figure to the right, this basis has averaged about -.75¢/lb for DSW 31/35 cotton. Using closing futures prices on 4/06/95, a basis of -.75¢ implies a realized price of 84.08¢ (84.83-.75) and 78.4¢ (79.15-.75) when hedging with futures for October and December delivery, respectively. Although the basis is not guaranteed to be -.75¢ this fall, the maturity basis is much more predict-

able than the overall price level. Broker fees and potential margin expenses will reduce these prices slightly. If for some reason delivery is not possible until after the futures contract matures, you can maintain price level protection by rolling to the next contract but you will probably lose the "earliness premium."

Bottom Line

A 5.6¢/lb. premium translates to about a 7% increase in price and 7% increase in total revenues assuming no change in yields. But for a break-even price of 84¢ this price premium for earliness translates a loss into a profit. With a break-even price of 75¢ and target yield of 1,200 lbs/acre, this 7% increase in price translates to over a **250% increase in profits** per acre -- assuming no change in yield or production costs. If your water, insecticide, and defoliation costs for extending the season are \$50/acre you would need an **additional yield of 185 lbs/acre to break-even given the current premium** for October vs. December delivery. This estimate of 185 lbs/acre places a value of cottonseed at \$115/ton and added harvest and ginning costs of \$.20/lb. No change in lint quality is assumed. Increasing the cost of extending the season from \$50 to \$100 per acre requires an additional **262 lbs.** of lint yield to break-even.

Average Basis (DSW 31/35 minus Futures) for October and December Futures, 1987-1994

