Southern Cotton Growers, Inc.
REPRESENTING COTTON PRODUCERS THROUGHOUT ALABAMA, FLORIDA, GEORGIA, NORTH CAROLINA, SOUTH CAROLINA AND VIRGINIA

COTTON MARKETING NEWS

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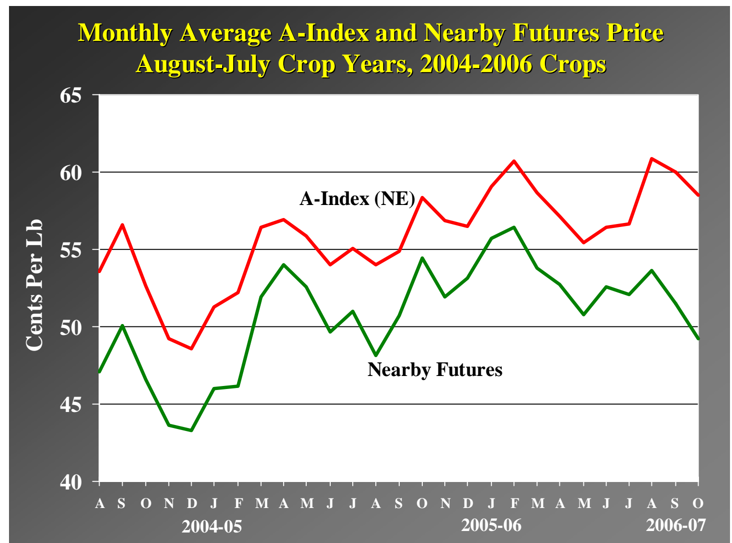
http://www.griffin.uga.edu/caes/cotton

World-US Price Spread Widening



The Loan Deficiency Payment (LDP) is calculated from the A-Index (what can commonly be referred to as the "world price"). Depending on how the producer markets his/her cotton, the producer will either (1) receive an LDP, forgo the Loan, and sell the cotton, or (2) place the cotton in Loan and later redeem the cotton realizing a Loan Gain, or (3) place the cotton in Loan and later receive a merchant equity payment through an Option To Purchase agreement.

The "total money" received by the cotton producer depends on a very important relationship– the "spread" between the A-Index (the world price) and US price. In his September 29, 2006 _Cotton Market Comments_, Dr. Carl Anderson, Professor Emeritus and Cotton Marketing Specialist- Texas A and M, discusses the recent decline in US cotton futures relative to the A-Index. It is highly recommended reading and can be found on the web through Cotton, Inc. at the following address: http://www.cottoninc.com/CottonMarketComments/ Look under the archived titles for "Market Prices Indicate Adequate Cotton Supply Expected".

I want to follow-up on Dr. Anderson's comments and further discuss this "spread" relationship, recent changes, and the implications this has for the cotton producer.

The above chart shows monthly average US cotton futures prices and A-index beginning in August 2004 with the 2004 crop and up to October 2006 with this year's crop (October 2006 is for the first half the month only). Note that the US and world price tend to move together and that the "spread" has averaged mostly about 5-6 cents per pound. _The fact that they move together is important– because as US prices go down, so does the A-Index which results in a larger LDP to offset the lower US price. This is an important safety net for the producer_.

What has happened in recent months is that, while they are still moving together, the spread has widened from the more typical 5 to 6 cents to currently about 8 to 9 cents. In other words, US prices (cotton futures prices) have weakened about 3 to 4 cents per pound in relation to the A-Index or world price. This widening of the "spread" does not change the LDP but, because of weaker US prices, results in less total money received by the producer. When this spread widens, either the A-Index (world price) is going up (LDP going down) in relation to US prices or US prices are falling in relation to the world price. Neither is good.

The example below illustrates approximately the current situation. Total money to the producer currently has dropped about 3 cents due to the wider spread. Had the A-Index declined as US futures declined and maintained the typical 5 to 6-cent spread, the lower A-Index would have resulted in a larger LDP and offset the lower cash market to the producer. Or, had US prices simply been able to maintain the 5 to 6-cent spread rather than weakening, total money would have been unchanged.

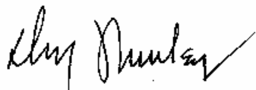
Example of Futures, Cash Price, and LDP
Depending on A-Index Spread, Approximate 10/20/06

	Typical Spread	Current Spread
A-Index	57.40	57.40
Minus Spread	-5.50	-8.19
New York Futures Price	51.90	49.21
Basis [1]	-2.25	-2.25
Local Cash Price	49.65	46.96
Adjusted World Price (AWP) [2]	41.30	41.30
LDP [3]	10.70	10.70
Total Cash Plus LDP	60.35	57.66

1/ Grade 41-4/34, Southeast. Source: USDA-AMS
2/ A-Index minus the "adjustment" for grade and location of 16.1 cents/lb
3/ Loan Rate (52 cents/lb) minus the AWP

Effective August 1, the Step 2 provision (a subsidy paid to US exporters and mills) was eliminated as the result of Brazil's successful complaint in WTO against the US cotton program. There is evidence that the loss of Step 2 has weakened US cotton prices in relation to world prices.

This widening of the "spread" could be due to the loss of the Step 2 provision. Without the Step 2 payment, US cotton would need to be cheaper to remain as competitive on the export market. This spread could change (could improve/narrow?) as we move through the marketing year. Producers should be aware that their "total money" depends not on local prices or LDP alone but on the combination of the A-Index, the "spread", and the local cash basis and how these move in relation to each other. Because the spread has widened, the producer has lost money. The producer can improve his/her position by taking advantage of opportunities when the spread and basis narrow. The current basis is relatively attractive.



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