U.S. Commodities Markets

The Next Big Risk

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- During the first half of 2022 (H1-22) U.S. cotton prices fundamentally overperformed as the global cotton and textile demand structure between developed and developing nations experienced a regime changing realignment that deemphasized Chinese cotton and yarn.
- The protracted Texas drought can push state cotton production below MY 11/12 low of 3.5 mb which will materially influence MY 22/23 domestic supplies and prices.
- Broad central bank commitment to raise interest rates to contain inflation can amplify headwinds for consumer retail demand during H2-22 and 2023.
- We see favorable supply and demand fundamentals for U.S. cotton which can help support H2-22 and H1-23 prices.

H1-22 U.S. cotton prices were defined by markedly contrasting narratives

H1-22 started with a myriad of bullish inputs that included the U.S. ban on Xinjiang cotton, Chinese zero-COVID policy that raised the cost of local textile production and an over-preforming U.S. export program. The last 2 months of H1-22 were the direct opposite. Domestic inflationary pressures combined with the rising probability of a recession, sharply increasing interesting rates, along with rising corporate bond yields the helped reduce liquidity in the commodity sector characterized the shift in cotton sentiment.

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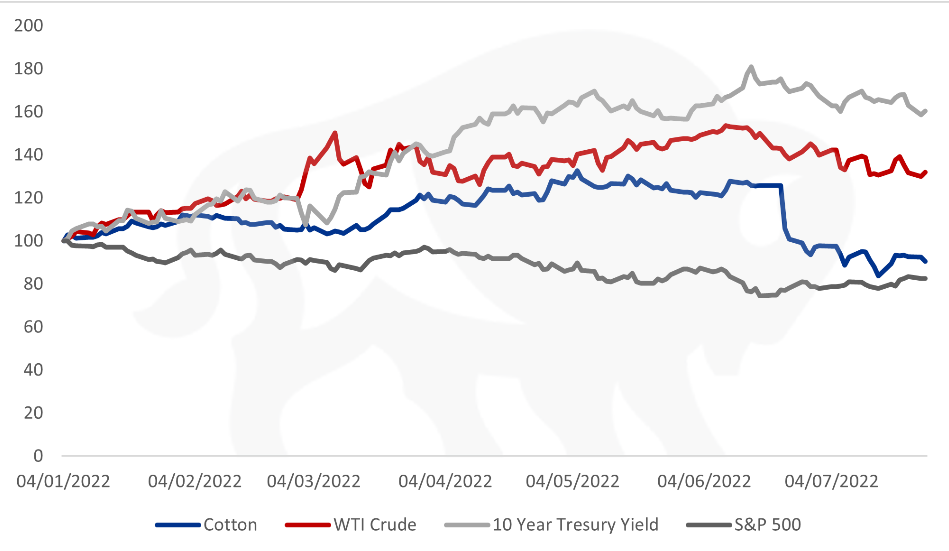
Supported by strong export demand for U.S. cotton, global investment flows into commodities, and a weak basis against the A-Index, the prompt ICE futures contract peaked at an 11-year high of $1.51/lb in May. By the end of June, the risk asset rotation away from commodities gained momentum, fueled by a surging probability

Year To Date Futures Performance



Source: Hilltop Securities, Bloomberg

The historically strong basis of old crop MY 21/22 futures contracts and new crop MY 22/23 futures contracts against the A-Index during H1-22 was a supportive input.

of a recession and government treasury yields rising to attractive levels. Despite the increasingly bullish U.S. cotton fundamentals, the prompt ICE cotton contract declined to $1.04/lb, -14.2%YTD.

During H1-22 U.S. cotton futures were undervalued relative to the A-Index

USDA weekly export sales data for MY 21/22 and MY 22/23 has been historically strong and reinforces the demand for US cotton.

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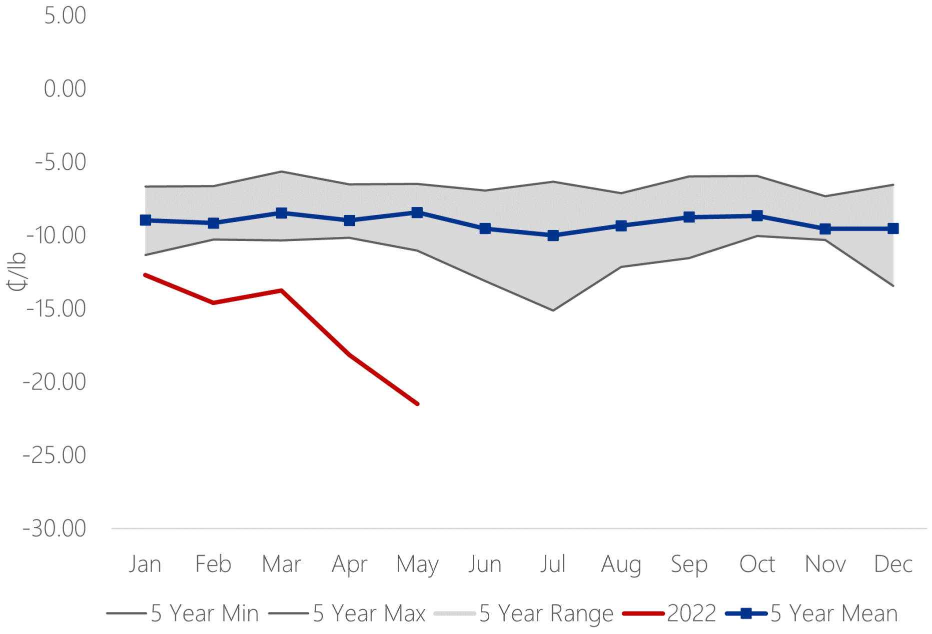
5 Year Historical Monthly CT1 – Cotlook A Index Spread

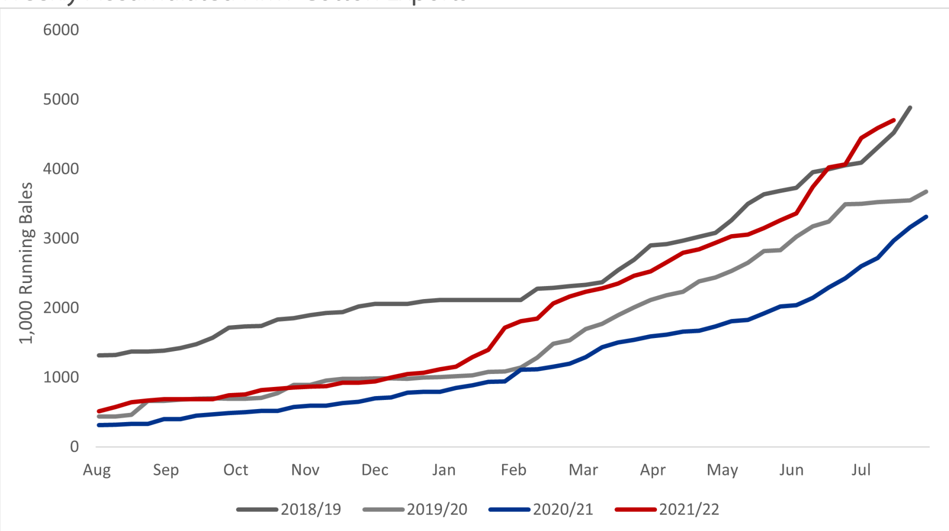


Source: USDA, Hilltop Securities

Looking ahead to H2-22 and 2023 we see the record strong basis to the MY 22/23 futures contracts as a signal that U.S. export demand as a percentage of total supplies can be understated and subject to revisions.

Inclusion of U.S. cotton as a component of the A-Index (average of the five "cheapest" global CFR prices to Asia) as domestic MY 21/22 and MY 22/23 ending stocks were tightening underpinned the relative value of U.S. cotton and the demand for U.S. cotton in the global market. USDA weekly export sales data for MY 21/22 and MY 22/23 have been historically strong and reinforces the demand for US cotton.

Weekly Accumulated NMY Cotton Exports



Source: Hilltop Securities, USDA

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Looking ahead to H2-22 and 2023 we see the record strong basis to the MY 22/23 futures contracts as a signal that U.S. export demand as a percentage of total supplies can be understated and subject to revisions.

The ban on Xinjiang cotton was the defining demand characteristic of H1-22.

Because USDA uses a 10-year average for abandonment and a 5-year average for the yield estimate, we see room for material production declines and view the 15.50mb production estimate as unachievable.

To bring a level of accountability, transparency, traceability and social responsibility into the cotton supply chain, the U.S. based Uygur Forced Labor Prevention Act (UFLPA) came into force during June. The goal of the legislation is to prohibit any product that is "partially or wholly made in Xinjiang" where China's practice of detaining and forcing Uyghurs into labor in the region is widespread. Xinjiang accounts for 85% of China's cotton exports. Although China is in the process of transitioning to more automated cotton production techniques to help mitigate concerns about forced labor the process will take time. We believe that the ban by the U.S. and other OECD countries has created a systemic change in the global cotton trade that can be beneficial to U.S. exports as global mills and textile manufactures are compelled to use "clean cotton."

Traceability is the industry standard and is helping US exports.

We believe that the increased global supplies, ex-China, can result in enhanced Pakistan, Bangladesh, and Vietnam demand

During H1-22 China represented 25.8% of weekly U.S. upland export sales. During Q1-22 specifically, those sales rose to 31.5% amounting to the strongest quarter in 10 years. We believe that over the short and medium-run, local Chinese and regional Southeast Asian mills will want to preserve relationships with western apparel firms. This strategy has already resulted in decreasing Chinese cotton and yarn demand and increased imports from Australia, Brazil, and the U.S.. Inside of this global demand shift we see increased mill and textile demand for U.S. cotton. While the traceability of cotton at the mill and textile production levels is still nascent, we believe that mills and clothing manufactures with western centric order books will not incur both reputation and revenue risks by using Chinese yarn.

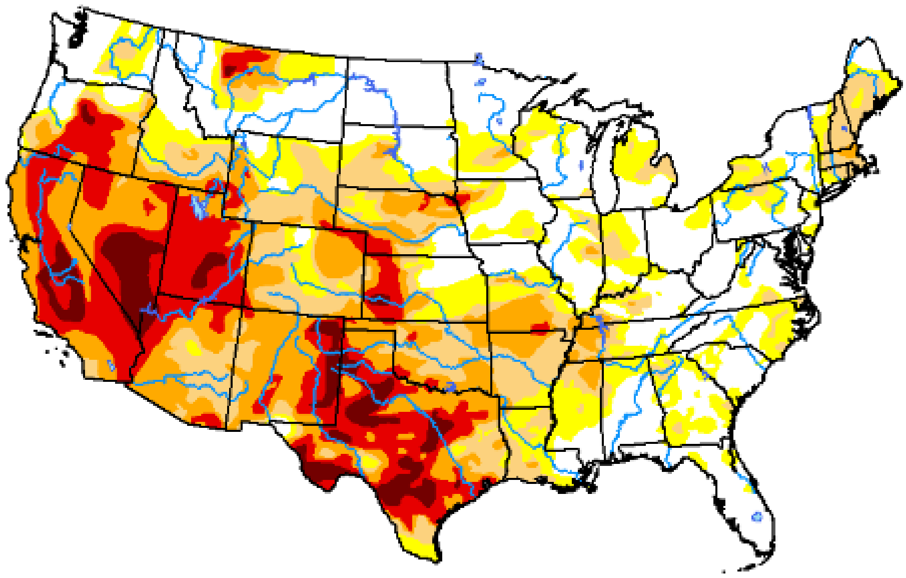
A developing U.S. supply shock.

The lingering and unrelenting drought in Texas, Oklahoma and Kansas has not shown any signs of abating. In particular, we expect to see below trend yields, record abandonment and anemic production in Texas. Ahead of NASS's August Crop Production report we forecast a 3.5-3.7mb, -56% YoY, production potential in Texas as the lack of rain and the sustained heat threaten both irrigated and non-irrigated crops. We believe that Oklahoma can produce a .350 mb crop, -53.9% YoY, while Kansas will likely experience less of a material decline.

We believe that strong inflation and higher lending rates can suppress H2-22 U.S. clothing sales which would be a negative for U.S. cotton futures prices.

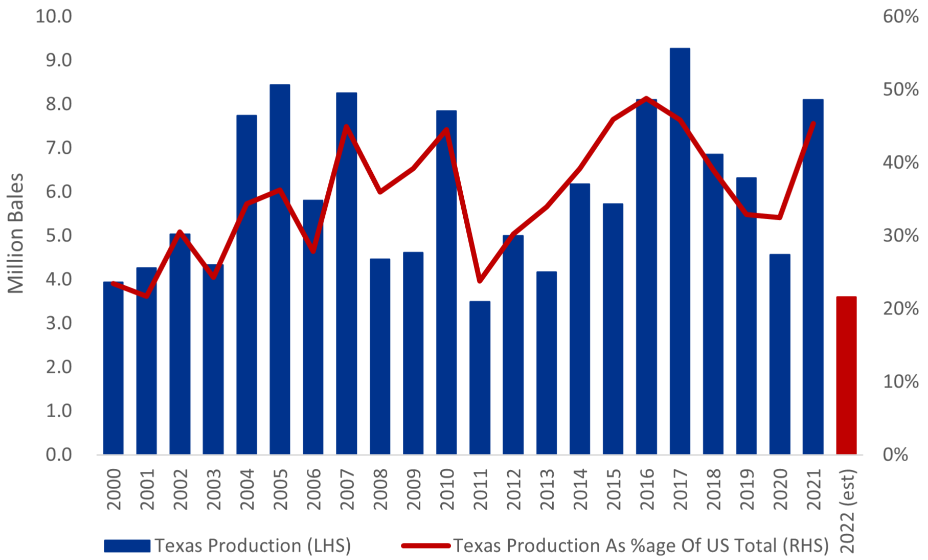
July 21, 2022 U.S. Drought Monitor

Heading into H2-22, we believe that decreasing U.S. cotton supplies and historically strong export sales should support prices.



Source: The National Drought Mitigation Center at the University of Nebraska-Lincoln, USDA, and NOAA.

Annual Texas Cotton Production



Source: Hilltop Securities, USDA

July data suggests U.S. MY 22/23 production at 13.8-14.0 mb

If this range is realized, U.S. production would be the smallest crop since MY 14/15. In the July WASDE the USDA estimated MY 22/23 U.S. production at 15.50 mb, -1 mb from the June report and -2.02 mb YoY. Because USDA's uses a 10-year average for abandonment and a 5-year average for the yield estimate, we see room for material production declines and view the 15.50 mb production estimate as unachievable. Despite the looming disaster in Texas, the early yield and production estimates in the midsouth and southeast are encouraging and can help offset some of the losses.

A recovery in MY 22/23 global production ex-China can help ease price pressures.

Global MY 22/23 cotton production is estimated at 120.0 mb, +3.4% YoY. World less China production is forecast at 92.6 mb, +3.5% YoY. India production is estimated at 27.5 mb, +12.5% YoY, while Brazilian production and Pakistani production are forecast to rise by 5.6% YoY and 3.3% YoY respectively. Because western serving textile and clothing firms are specifically demanding yarn that is not sourced from Xinjiang, we believe that the increased global supplies, ex-China, can result in enhanced Pakistan, Bangladesh and Vietnam demand.

A healthy labor market helped H1-22 U.S. clothing sales, but the environment is slowing.

During H1-22 the strength of both domestic and global economies helped generate strong global mill and downstream consumer demand. Data shows that as U.S. hourly wages rose and the labor market exhibited historical strength, clothing and apparel sales experienced a strong H1-22 period. That being said, recent retail sales data illustrates that consumer spending at clothing and clothing accessory stores peaked in April and is decelerating at an accelerating pace. While June traditionally represents a slow month for U.S. clothing sales, we believe that strong inflation and higher lending rates can suppress H2-22 U.S. clothing sales which would be a negative for U.S. cotton futures prices.

Fed's commitment to lowering inflation can create headwinds.

With the Fed aggressively using "restrictive" monetary policy to tame domestic inflationary pressures, the risks of both a statistical and real economic recession are amplified. In particular, the Fed is keen on slowing wage growth and incrementally increasing the unemployment rate to help mitigate domestic inflation. Each of these macro variables are structurally negative inputs for domestic cotton demand.

Summary:

Heading into H2-22, we believe that decreasing U.S. cotton supplies and historically strong export sales should support prices. We also see the inclusion of U.S. cotton in the A-Index, along declining and recalibrating global demand for Chinese cotton and yarn as positive fundamental inputs. Looking ahead to MY 23/24, we see the November '23/December '23 soy/cotton and the December '22 corn/cotton futures ratios favoring "food over fiber" which can limit U.S. planted cotton acres. Unless the U.S. consumer materially slows clothing purchases, or the effects of ban on Xinjiang cotton starts to slow, we maintain a favorable price outlook for U.S. cotton. Our 3/6/12 month price outlook is: $113/$112/$117.