MEXICO : CAN A FULL SUPPLY CHAIN DEVELOP

CAN MEXICO TAKE MARKET SHARE FROM CHINA

WILL SPECIAL ECONOMIC ZONE STIMULATE FDI

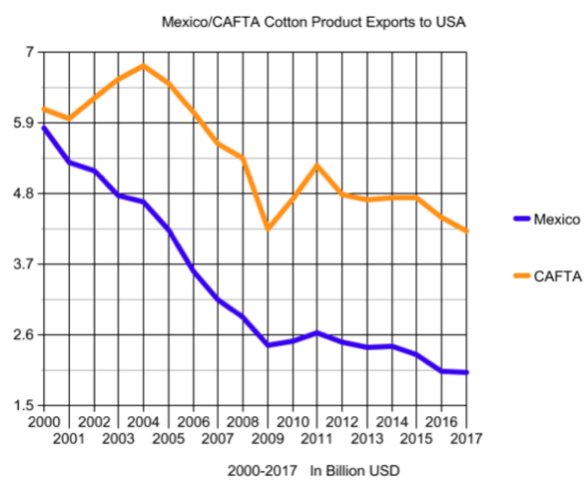
WILL US RETAILER / BRANDS CHANGE THEIR SUPPLY CHAINS?

JERNIGAN GLOBAL

KNOWLEDGE IS THE NEW CAPITAL

SEARCH FOR NORTH AMERICAN COTTON SUPPLY CHAIN:

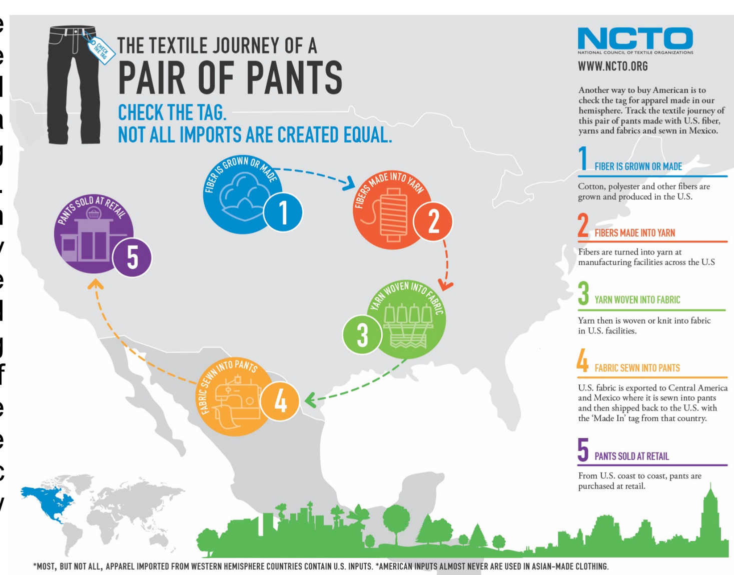
MEXICO & CAFTA EXPORTS OF COTTON PRODUCTS TO USA UNDER PRESSURE



Excitement occurred last week regarding the new US/Mexico trade agreement which will replace NAFTA (unless Canada rejoins) putting to rest, at least in agriculture circles, the idea that the trade dispute would further endanger world trade flows in cotton. The discussion around the new agreement caused us to take a closer look at the textile and apparel components of the agreement and its potential for cotton. We begin with this question, “Why has no robust cotton textile apparel supply chain developed anywhere in the Americas”? This fact is extremely surprising and needs to be seriously discussed. Did you know the Americas have a population of 1.2 billion people which puts the region near India with 1.235 billion, just below China at 1.42 billion people and more than double the EU’s 510 million inhabitants? Moreover, the region has a GDP more than double that of China. Yet, if one were to look for a ring spun, high count yarn spinner in the region you would be lucky to find 150,000 bales of consumption. A trip to any department store in the entire region would reveal an apparel section which is likely dominated by imports from outside the region. Last week we discussed in detail the hurdle being faced by the Brazilian textile industry which should be filling much of the void, however, its domestic market is under assault from imports. For the entire region the freight cost would appear to be a key factor in keeping Brazil from being overrun with imports. China must ship the apparel 18,555 kilometers, 11,530 miles, from Shanghai to Santos port, the same as two round trips between Los Angles and New York. If it is cotton apparel the cotton was likely produced from either Xinjiang cotton or from imported cotton, each of which made quite a long journey as well. Adding to the discussion is the fact that with the Real/USD weakness the minimum wage in China and Brazil is near the same level before social cost and taxes.

Given the excitement that once met the NAFTA and then CAFTA trade agreements it is remarkable that neither agreement lived up to its potential, especially in regard to cotton textiles and apparel. In 2000, prior to China's entry to WTO, Mexico exported 5.816 billion USD worth of cotton products to the US and that same year the CAFTA region exported 6.108 billion USD of cotton products to the US. This equaled about 4.5 bales of cotton with about 3 million bales or more of US cotton. This represents nearly one third of US cotton consumption at retail that year. Since that time the exports of cotton apparel to the USA from Mexico has collapsed and fallen by a third from CAFTA. In 2017 Mexico only exported 2.018 billion USD worth of cotton products which reflected more than a 65% decline from 2000 and a 19.6% decline from 2010. The US imported 13.2 billion USD of cotton products from China in 2017. CAFTA exports of cotton products to the US totaled 4.218 billion USD which is a 31% decline from 2000 and a 10.7% decline from 2010.

The failure of the region's exports to rebound when China's production cost increased raises lots of questions. Most of the exporters from countries within these agreements offer 2 or 3 day shipment schedules versus 45 days or longer from China. In recent weeks we have covered the troubles plaguing the CAFTA region so this week we are going to look at Mexico and examine why the country's apparel industry has failed to maintain business in the US. We will discuss the question; "Could the new US/Mexico trade agreement set the stage for a Mexican cotton textile and apparel supply chain"? The new trade agreement has drawn an array of comments from all the experts - praising it, voicing complaints, while others predict the agreement will accomplish little and benefit few. The anti-Trump sentiment was made clear by many groups. However, regarding agriculture the agreement was a clear winner ending months of fears that the brisk trade in cotton, corn, pork and other products would be put in jeopardy by an end of the agreement. Zero tariffs continue for all agriculture products. Much hype occurred prior to the agreement from both the USA and the newly elected Mexican President but at the end of the day both sides negotiated in a very serious manner in spite of the media drama. After reviewing a lot of the analysis of the agreement and putting all bias aside we found hope that something much larger may be in play.



On the Mexican side, it was strange to see all the critics on the Left take issue with the cooperation of both the current and incoming Mexican Presidents to arrange a deal despite the comments the incoming President had made on the campaign trail. It has raised hopes that incoming Mexican President Obrador will govern pragmatically and also suggests that with a deal in place he could begin his administration focused on his campaign promises of fighting corruption, poverty and crime. As details of the agreement have emerged it appears the trade agreement, unlike NAFTA, is more about the creation of a North American Bloc than a free trade agreement and the new provisions may actually help the new president in his goals.

Trade agreements are of course very complicated and the importance of each is always in the details, even though there is always a lot of positive and negative commentary before the details of the agreement is released. A review of the analysis reveals one of the reasons the agreement has been criticized by Republican law makers. The agreement appears to attempt to end the original intent of the NAFTA agreement, which was to allow US companies to outsource US jobs to Mexico at much lower labor costs and also to use Mexico as a transshipment stop for Chinese products and parts on their way to the US duty free. It should be remembered the NAFTA agreement went into effect January 1, 1994, nearly 25 years ago, when the world was a much different place. Since that time China, multinational companies and number of other groups have mastered how to exploit the loopholes in the original agreement maximize profits by moving products duty free into the US. It seems quite illogical to think the original agreement should not be revised after a time period, just think of the technological advances since it was signed. For the textile and apparel sector the agreement clearly needs a major revamp and for cotton it's crucial to revitalize North American cotton consumption.

As expected the new agreement is heavily focused on autos and one new stipulation requires 40 - 45% of the content of autos entering the US duty free must be manufactured by workers being paid an average of at least 16 USD an hour. This drew criticism that the US government was setting labor rates while others viewed this as a very innovative feature. Instead of limiting auto exports from Mexico or setting quotas it provided an incentive to use more US workers and to also pay Mexican workers more which would influence the average hourly wage cost. This is quite a novel approach and looks to be a good solution; in many globalized industries we have witnessed a race to the bottom in wage rates all to benefit profit margins. This perhaps is an attempt to actually start to address this issue and may have been one of the attractions to Mexico. The agreement further states that 75% of the car's components must be made in Mexico or the US to receive duty free access. It also provided a special provision called a side letter which states that all cars made in Mexico which meet the requirements of the agreement will have duty free access even if the US applies a general 25% duty on auto imports under Section 232 of the US Trade Law. This suggests to us this is more about a regional trading bloc and not simply a free trade agreement.

For the cotton and the textile apparel sector the more important parts of the agreement appears to be setting the stage to create the condition to draw supply chains back from China. Concerning the cotton textile supply chains, the agreement will require additional work to stimulate a revival but new strong foundations have been laid which may be used in additional agreements, as with the EU. The origin requirement appears aimed at countries that either transship or use Mexico as an assembly center. New rules were put in place to assure only those products using additional US or Mexican parts will receive the tariff benefit. The agreement has a certification for local producers which seem to be aimed at preventing transshipments in textiles. The section on intellectual property addresses treatments of copyright clauses on common names and trademark protection. The agreement also provides a limit to any government's ability to require disclosure of priority code or algorithms. This feature appeared to provide a blueprint to what is being sought in an agreement with China.

The agreement has new environmental provisions which include features which appear to be focused on China. One such feature states that Mexico and the US agree to prohibit "shark-finning" which is the process of cutting fins of sharks and then leaving the shark to die. It also prohibits illegal and unregulated fishing. In regard to labor issues, the agreement calls for allowing for collective bargaining. Strong protection is included for all intellectual property and access to financial records. Both of these items are aimed at pulling companies from China where a big problem has emerged with Chinese companies which have gone public on US markets and are refusing access to financial records. Overall, the agreement appears focusing on providing companies investing in Mexico with the protections they do not receive in China.

The base agreement has set the stage for a revision in the textile and apparel provisions. However, for that to happen an understanding of what features are contained in the current NAFTA agreement. The current agreement focuses on the following features:

- Fiber Forward - Fiber must be formed in the Free Trade Agreement (FTA) member territory. Natural fibers such as wool or cotton must be grown in the territory. Man-made fibers must be extruded in the trading area.

- Yarn Forward - Fibers may be produced in any country but each component, starting with the yarn used to make the textiles or apparel, must be formed within the FTA. This rule is sometimes called “triple transformation” as it requires that spinning of the yarn or thread, weaving or knitting of the fabric and assembly of the final product all occur within the region.

- Fabric Forward - Producers may use fibers and yarns from any country but fabric must be knitted or woven in FTA member countries.

- Cut and Sew - Only the cutting and sewing of the finished article must occur in FTA member countries, which provides maximum flexibility for sourcing.

A concession was given to the apparel sector which allows duty-free access for limited quantities of wool, cotton and man-made fiber apparel made with yarn or fabric produced or obtained from outside the NAFTA region, thereby permitting the use of some yarns and fabrics from China and other Asian suppliers. In most years since 2010 Mexico has come close to exporting the maximum allowable amount of cotton and man-made fiber apparel with duty-free foreign content. Apparel produced in the NAFTA region also benefits from duty-free access to the United States even if certain inputs, such as sewing threads, pocketing, and narrow elastics, are not made in the NAFTA countries. NAFTA also has a de minimis threshold that permits up to 7% of a garment’s content, by weight, to come from outside the NAFTA region. According to some sources a few changes were noted to this feature.

Simply put, the current terms of the agreement, as it relates to fostering the development of a cotton supply chain, has not allowed Mexico to remain completive in the US market. When we ask the question why a host of reasons are given. We will attempt to explore these and how they may be addressed in the future to develop a viable supply chain. To solve these problems will require bold measures on the part of both the US and Mexico.

SEGMENTED SUPPLY CHAIN

For many brands and retailers Chinese companies offer a turnkey, one stop solution to sourcing by offering a full supply chain from design, tech pack to finished product from one company. In the words of one major brand, “The Chinese company understands customer service”. Product quotes can be provided in 24 - 48 hours and not weeks. China has experienced record fixed asset investment in the textile and apparel industry for 20 years and even in 2017 it was the largest destination for new textile equipment. Even today companies are innovating, upgrading and putting themselves in a position to meet the needs of tomorrow's customer. This is true in natural fibers and man-made fibers. Mexico's supply chain offers few competing turnkey, fully integrated operations. Most operations in Mexico are segmented, as is the case in much of the world, which means that brands and retailers usually deal with the apparel company which provides the fabric samples. This makes it very difficult for any brand or retailer to know its supply chains which also inhibits the use of cotton and especially US cotton. Then even the Mexican apparel companies outsource the cut and sew operations. This is the same situation in Brazil and other markets and leads to many problems. It also a key driver to maintaining low wages which does not allow the work force to benefit from any improvement in wages or living conditions. The motivation to outsource is also linked to Mexican companies desire to limit capital expenditures and the liability of security associated with maintaining a large workforce. Security is a major issue in all components of the supply chain.

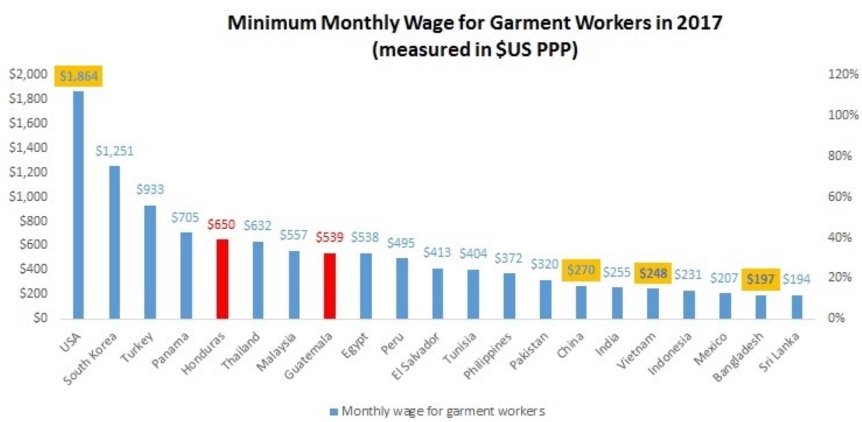
A few fully integrated companies have emerged that are first class and offer operations on par with Chinese companies. One such company now offers a supply chain from spinning all the way to design and has become a significant force in the export market, not only to the US but all of Latin America. This group and its turnkey operation has been a big boost to the development of local designers.

SECURITY

This brings us to a major issue which needs to be addressed for Mexico's supply chain to flourish. Using the US State Department security ranking as a guide security is the number one issue. On a scale of 1 - 4 with 4 meaning "do not travel", a designation given to Syria, Yemen and Afghanistan, five Mexican states have a 4 ranking - Tamaulipas (Located on the Texas border), Guerrero, Michoacán, Sinaloa and Colima. Some apparel companies are located in these states as shown on the map in this week's issue. Eleven additional states have a 3 ranking, "extreme caution", which includes all border states of the US, Coahuila, Chihuahua and Sonora. Two very important textile and apparel states have a 3 ranking, Estado De Mexico and San Louis Potosi. The other largest textile and apparel producing states of Distrito Federal, Hidalgo, Puebla and Tiaxcala all have only a 2 ranking. Tiaxcala has the title as the safest state in Mexico. The security issue has two focuses, first, it inhibits US buyers from visiting companies and secondly, it creates challenges for the companies themselves relating personnel issues. The second security issue concerns transportation of products. 80% of Mexico's apparel exports are shipped by truck which is more expensive. Cargo theft is a series problem; the data indicates that a truck in Mexico is 20 times more likely to experience theft than in the US. Insurance to cover transportation is also more complicated since Mexican trucking companies are small and do not provide insurance on shipments which forces shippers to obtain insurance and sometimes coverage is a problem. Trucking constrains are also an issue as the trucks are generally old with small shipping capacities. Due to US regulations some of the older trucks may not be allowed to cross the border (unable to safely operate on US roads) and some reloading to US trucks may have to occur at the border adding to time and cost.

LABOR COST

Mexico now enjoys a major advantage in wages as indicated in a 2017 study by PRI (see chart). The study revealed that Mexican apparel workers earn less than most major sourcing designations, including Vietnam and China. In 2012 Mexico



became cheaper than China and today that margin has increased to a monthly minimum rate of 207 USD for Mexico vs 270 for China. Most average wages are higher. The Mexican minimum wage in apparel is now less than half that of most of the CAFTA region; 539 USD in Guatemala and 560 in Honduras and 413 in El Salvador (Nicaragua was not included in the study). Estimates suggest that 30 - 40% of garments final cost is related to labor. These are minimum wages and actual costs are much higher when all benefits are included and the competition for workers in some areas is considered. One study indicated that due to the competition for workers some in China are now earning 3 - 4 times the minimum wage nearing 600 - 800 USD a month or more while in Mexico it may reach 450 - 500 USD a month.

SHIPPING TIME AND COST

Mexico is perfectly suited for just in time delivery to the USA but at the moment there are several hurdles to overcome. First, most of the exports have to move by truck. Trucking cost and capacity is an issue. The value of US/Mexico trade by truck increased 20.1 percent in April to $35.9 billion, according to the BTS. At Laredo, Texas, the largest US border crossing by truck volume, truck traffic jumped 15.3 percent year over year in May to $19.9 billion. Mexican shipping companies are small with the typical company owning less than 100 trucks and an estimated 1 in 4 trucks are owner operated. In many cases the trucks are old and having a hard time meeting new safety rules. Security is an issue as discussed earlier. Most goods are trans-loaded at the border from Mexican to US trucking companies. A new Mexican law now requires that all double tractor trailers meet new certification requirements, a rule which will further reduce truck capacity. Another new law is going to affect forcing Mexican truckers to take rest breaks. It is not clear how much of the capacity is being used by the booming auto sector but demand for US/Mexico intermodal rail shipping is increasing. The rail service only serves certain areas. Kansas City Southern railway has invested in Mexico and has opened a cross border facility at Laredo. Rail traffic has been boosted by the steel tariffs the US placed on Chinese product. US made steel are being shipped to Mexico for use in the auto sector instead of using imported Chinese product.

The freight issue needs work to improve efficiency for the textile and apparel sector. For example, on a port to port basis a 20 foot container this week could be booked at 1670 USD from Shanghai to Los Angles. A 28 foot truck from Puebla to the Laredo border where it has to be trans-loaded cost 1,325 USD. Cost on a door to door basis would change this but it illustrates how competitive the ocean freight between the US and China is vs the cost of a much more inefficient trucking system.

CUSTOMER SERVICE AND DOMESTIC MARKET

Many of the Mexican exporters have not invested the personnel and time to develop the US market while CAFTA exporters have a major presence in the US, some of which are owned by US groups or have deep ties in the US. This has made it very easy for medium and small brands and retailers to source from the CAFTA region. Mexican exporters in contrast appear concerned about security which limits their willingness to embrace the internet and extensive marketing. Thus, brands and retailers face major hurdles in finding companies to work with. Slow response to customer questions and demand is also sighted as a problem with the exporters not embracing an outward customer service model. This extends to timely shipments and quick response to any problems. In our survey of brands and retailers sourcing in Mexico or CAFTA, CAFTA won on customer service and willingness to meet customer needs.

There are, of course, exceptions and good relationships have developed between the Los Angeles apparel community and an expanding textile and apparel center in Tijuana and Ensenada which have recently seen robust demand. This region offers the southern California market speed to market with a 2 - 3 week turnaround. The region has also developed deep relationships in California which has help enhance their customer service. Several major contract manufacturing groups have established themselves in Tijuana and further south in the Baja region and offer services from design to finished product. The driving miles between the LA warehouses to the Tijuana plants is only 140 miles and 205 miles to Ensenada. This has served to boost small to medium sized US designers and retailers in the region because of the ability to handle smaller orders. The larger orders normally flow to the larger groups in Puebla and other regions.

Another reason for the lack of interest in expanding US exports is an expanding domestic apparel market which has been the focus of many companies' attention. The Mexican apparel market was strong in 2017, the sector appeared to bottom in 2013 and has grown each year since, and will expand by 5.8% in 2018. Security appears to be the largest inhibitor to further growth. Another is the fact that one retail group is estimated to control more than 20% of the domestic market.

LACK OF MAJOR FOREIGN FIXED ASSET INVESTMENT

While US firms did set up operations in Mexico when NAFTA went into effect they have not expanded choosing instead to put greater emphasis on CAFTA despite the higher labor cost. Mexico has never attracted large investments from the major Asian powerhouse groups from South Korea, Taiwan or now Chinese. Mexico realized 29.7 billion USD in total fixed asset investment in 2017 and US companies provided 61.3% of all investment followed by Spain 11% and Netherlands 10%. Japan is the largest Asian investor but accounted for only 3% while South Korea, Taiwan and China did not make the list. This lack of investment in textiles and apparel has contributed to the limited growth in the textile and apparel industry.

TRANSSHIPMENTS AND CORRUPTION

The Mexican market has long been overwhelmed with illegal imports of apparel from China which has caused significant problems for domestic retailers. Nothing has changed and the problem remains. The issue is important to the agreement but NAFTA contained no textile specific enforcement language. NAFTA did not provide US Customs with the ability to make unannounced visits and NAFTA did not provide Customs with the ability to make visits based on non-originating claims. Under CAFTA-DR this was addressed and Customs can not only

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conduct surprise site visits to Central American producers suspected of illegal transshipment they also have the ability to make visits whether or not a claim under the FTA is made for a duty-break.

CHANGES TO EXISTING NAFTA AGREEMENT-TEXTILE SPECIFIC

The final agreement has not been released because it may or may not need final congressional approval. The Trade Representative Office did release the following changes as it relates to textiles.
The provisions are:
(Direct from USTR)
Promote greater use of Made-in-the-USA fibers, yarns and fabrics by:

1. Limiting rules which allow for some use of non-NAFTA inputs in textile and apparel trade.
2. Requiring that sewing thread, pocketing fabric, narrow elastic bands and coated fabric, when incorporated in apparel and other finished products, be made in the region for those finished products to qualify for trade benefits.
3. Establish a textiles chapter for United States/Mexico trade, including textile-specific verification and customs cooperation provisions, which provide new tools for strengthening Customs enforcement and preventing fraud and circumvention in this important sector.

One area which was not addressed was trade preference provisions. These provisions allow apparel manufactures to use yarn and fabric from outside Mexico or USA to be used in a garment and still receive duty free treatment.

NEW POTENTIAL FOR MEXICO

As we discussed in the opening commentary, the fact that a region with a population as large as India and near that of China does not have a robust full service supply chain in textiles and apparel is really beyond our scope of understanding. Speed to market pressure is increasing due to consumer’s taste becoming more fluid and the increasing demand for greater supply chain transparency means regional supply chains become more and more important. The news of a lawsuit between a major

Fast Fashion group and unpaid apparel workers illustrates that the race to the bottom in wages is over whether or not all players realize it. Environmental responsibility and social responsibility are increasing and this means new investment in the supply chain are going to be required. The days of thinking of Mexico as simply cut and sew center are gone, imports of cotton product from Mexico are down 65.3% from the 2000 peak. The loss of momentum has continued into 2018 but we are told companies are now receiving a surge in interest as supply chains switch out of China. Mexico has been known as the go to location for denim apparel. Denim apparel is enjoying robust demand and in the first half 2018 US blue denim apparel imports are up over 8% reaching 1.681 billion USD. Despite its location Mexico is the second largest supplier but its exports have fallen 2.73%. China is the top supplier with imports up 5.53% and Bangladesh is the third largest supplier with imports up 16.16% as its heavy investment in the sector pays off. Vietnam is now the fourth supplier with imports surging 44.8%, this growth includes increased use of denim fabric from China. Pakistan is the fifth largest supplier with imports up 13.3%. Chinese denim is flowing duty free into the US from Cambodia which is the 7th largest supplier with the volume up 32.37%.

Much of the commentary we have seen so far after the announcement of a new agreement replacing NAFTA indicates the US apparel sector is concerned about the new requirements to source additional items as sewing thread, zippers, pockets etc. in the Mexico/US region. In addition, the ability in the future to use a large volume of yarn and fabric from outside the two countries is in doubt. We understand this concern but short-term pain may be required for the region to reach its potential. the conditions need to be created which will provide the stimulus for major new foreign direct investments (FDI) by South Korea, Taiwan, India, China and others which will create a complete supply chain. The increased local requirement for the parts will strengthen the supply chain, a major US thread company has been able to hold its own and expand as a result of the past requirement. Additional US investment is likely if the conditions are created for it.

Our assessment of the current agreement, the conditions in Mexico suggests the region has a great deal of potential to establish a North American supply chain to complement CAFTA. This will require the following:

1. Security - Came up in almost every discussion. FDI is not going to occur without the assurance that facilities, employees and shipments will be safe, US buyers can travel to location without fear and other risks are eliminated. This will take innovative thinking and cooperation between the US and Mexico.

2. Special Economic Zones - The first special economic zone occurred in Shannon, Ireland in 1959 and from there they received great fame after being introduced in China where they became very popular and stimulate the countries great economic miracle. Late in 2017 Mexico issued rules for the establishment of seven Special Economic Zones (SEZ). The zones are all located in the extreme Southern part of the Country which is also the poorest. These are located at Lazaro Cardinas , Puerto Chipas, Coatzacoalcos, and Progreso, in the states of Campeche, Tabasco and Salina Cruz, all located at ports. For the apparel sectors these SEZs are not close to existing apparel clusters, most are near 1,000 miles from Puebla. The Gulf of Mexico locations, however, do introduce a new possibility for quick shipments to the US by sea. These locations are approximately 3 to 4 day shipping time to the Port of Houston and this would reduce the high cost and time consuming expense of moving products by truck, as well as, a way to reduce theft and high jacking risk.

The government of Mexico announced an allocation of 50 billion Pesos, approximately 2.8 billion USD, for needed infrastructure in the SEZs. There have been no discussions regarding how security in the zones will be managed and what protections will be put in place to avoid extortion by the drug gangs. Another unknown is the available access to cheap electricity. An analysis of past SEZ success and failures reveal these zones will face several key challenges, first, they will need to be developed and managed with a mission of social responsibility. They cannot allow industries that pay

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extremely low ages but must focus on improving both wages and living conditions. This has been done in Honduras where 85% of all wages have to be paid to local workers. Second, an effective security system must be provided which cannot be corrupted and trans-shipments must have zero tolerance. Third, a strong rule of law must protect workers and companies alike. The use of SEZs have failed in many regions, such as the Dominican Republic, where the investment came and left while in China they have created the world's largest export engine. For Mexico the success of the textile and apparel sector will rest on drawing the FDI from the textile and apparel powerhouses of South Korea (already in region), Taiwan, China and India. The Zones will need to develop relationships with the US cotton, yarn and fabric sectors to stimulate the export of US cotton. This means the management of the zones will be important and must be incorruptible. Full supply chain investment including higher count combed ring spinning capacity. The current CAFTA region is focused on open end lower count yarns and is already operating with good coverage in this product range.

1. Full Supply Chain - the original NAFTA was crafted to outsource the labor expense from the US to Mexico, then came CAFTA which allowed for the remaining US cotton spinning and weaving industry to hold on. Now a there is an opportunity for developing a modern cotton focused, fully integrated supply chain which is not designed to hurt CAFTA but to complement it by expanding the product range that can be sourced in the Americas. The US is producing its highest quality cotton crop on record but despite this the value to the producer and the industry is not being realized because it is not being manufactured into the higher-end products anywhere in the entire hemisphere, except in Peru. Peru is expected to import 225,000 bales of cotton and consume only 300,000 bales. Peru produces excellent high quality cotton apparel which is an alternative to China and other markets, however, given the size of the US crop a higher count spinning base of several million bales is needed.

2. Cotton Focused - Mexico is a cotton producer and importer which makes the focus of the FDI in the cotton spinning sector valuable to both countries. The potential is for the diversion of 3 - 5 million bales of US exports to the region if the correct FDI can be achieved. Mexican cotton consumption peaked at 2,225,000 bales in 2001/02, the year in which China joined the WTO.

3. Worker and Environmental Responsibility - When China developed its very successful economic zones no consideration was given to the environment. Now the country will spend the next 50 years attempting to undo the damage. Currently Vietnam is showing wisdom by attempting to approach new investment in the dyeing and finishing and fabric production cautiously. The correct incentive and requirements need to be applied to allow the new supply chain to develop with all the proper controls and safeguards. Furthermore, employee benefits and training programs should be used to create a deep connection between the companies and the communities. This has been successful in parts of the CAFTA region where the industry is one of the few to truly raise living standards.

ICE FUTURES REMAIN RANGEBOUND AS TRADE BATTLES CONTINUE

The cotton market continues to lack the excitement of the post-China and Turkey trade crisis period as the market attempted to move higher twice last week but both attempts failed. The first occurred on 8/27 with a range of 81.34 to 83.50 in Dec followed by a brief close above that high only to fail the next day with a range of 84.25 down to 82.15. Both were outside range reversals which have major technical importance. They illustrate that the spinning sector, as we have discussed before, has no confidence in chasing prices higher. Over the last several years the futures have not been able to develop a successful bull market without the spinners and speculators working together to move prices higher. Prior to the collapse of the normal trading patterns the spinners had confidence that prices had upside risk not just for today but for the next several seasons and this allowed them to move up the price level at which they would buy physical cotton and fix open On-Call sales. Chinese spinners actually were one of the drivers, as domestic consumption expanded and export orders improved they expected the country would soon be forced to return to the import market in volume. Today, their overall confidence is much more cautious and Turkish spinners are out of the market completely and the confidence of the remaining spinners has been shaken. Against this back drop the speculative long simply remains on the defensive, each time the market appears to be about to give the spec confidence again the spinners pull back new hedge selling appears and the rally fails.

Last week brought some relief as the US/Mexico trade deal was secured, however, any confidence this may have restored was shaken by a series of crisis across the Emerging Markets. Any one of these alone would be enough to rattle the market but collectively they removed other large importers, such as Indonesia, from the market, which was something the cotton market simply did not need. The crisis seemed to go from market to market and at the center was Argentina. Argentina asked the IMF to speed up the disbursement of its bailout and this set off a new panic with the Argentine Peso collapsing to a new record low daily of 41.3618 until finally stabilizing on Friday closing at 36.7235 after IMF reassured the market. For the year the Peso has lost over 98% of its value. Others following Argentina's lead was the South African Rand, Indian Rupee, Turkish Lira, Indonesian Rupee, Brazilian Real and others. The Indonesian Rupee fell to its lowest level since the 1998 crisis at 14,750 per USD while the Indian Rupee slid to a record 71.03. Overall, the free float of the currencies allows them to reflect the current state of emotion and fear in the economy. China has avoided this drama by the lack of a free float of the Yuan. Each country appears to have its own issues, in Brazil it's the upcoming election, Argentina's problems are centered on its debt being in USD and if it can pay, Indonesia it's their current account deficit and for South Africa its theft of commercial farmers land. Even the Aussie Dollar fell sharply. This series of events has impacted cotton consumption in the worst hit regions as local consumers feel the pain. It has also put pressure on most assets priced in USD.

As for cotton, it is expected that China will soon release the previous discussed sliding scale import quotas which will be used for Australian and other cotton. As the CFR price drops below 90 cent into the upper 80's US cotton with duty is nearing par with local Chinese cotton prices. Soybean reports are emerging that some cargos of US beans are being taken with the duty rebated, this is occurring as the Brazil basis soars and its export window closes. The continued cotton purchases by China suggest some unique window is open for some sales, it could be to mills in the special economic free zones but we are not sure. Chinese Reserve sales are entering the final month and 9,742,747 bales of 5 to 7 year old cotton have been sold in this round. We expect the Reserve to also return as an importer as well. US export sales are steady but not robust. Nearby mill stocks are being tightened by the recent slowdown in US shipments and the crisis in Brazilian export shipments. August exports from Brazil will be one of the smallest on record because of logistics issues.

The US crop is at the level of the USDA estimate or higher, the issue is now rain. Too much of a good thing, the 7 day forecast is rather wet for all US cotton from New Mexico east and this is not good. The crop now needs clear, dry weather or there will be issues. As we indicated last week, from the current level of 81-82 and lower for Dec futures cotton will enjoy good offtake as long as the macro forces calm down. Unlike the past the US is the center of the drama and not providing the stability.

This means the path for these forces are more unknown. Cotton is taking market share from man-made fibers but still under attack from some areas. It is encouraging that many of the new fashion campaigns have a higher percentage of cotton than two years ago. The famous Guess Girl is even being featured in denim. At the moment it's not so much what the total demand level will be but when will it be purchased. A close in Dec below the lowest level of the earlier mentioned outside range days would raise the possibility of another leg down. But on the other hand, any further resolution of one of the crisis in the cotton buying regions would spark a brisk adjustment. At the moment the US appears set to announce this week additional import tariffs on 200 billion USD of Chinese imports which have been going through public comment. Domestic groups are on both sides of the issue but duties on the remaining Chinese imports, including apparel are under discussion. A group of US Senators also asked the US State Department to sanction 7 leading Communist Party officials from Xinjiang and two security companies providing equipment because of the detentions of an estimated million Uighurs in Xinjiang. This can be done by State Department action under the Global Magnitsky Act. The issue was on the front page of US and Australian newspapers last week. From the Chinese side the Global Times launched a verbal counterweight to say China would never follow the lead of Mexico, it was in English and went viral on social media. All this will leave the cotton market with plenty of anxiety and probably add to the longevity of the US/China trade dispute.

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