

Cotton and “The Big Four”

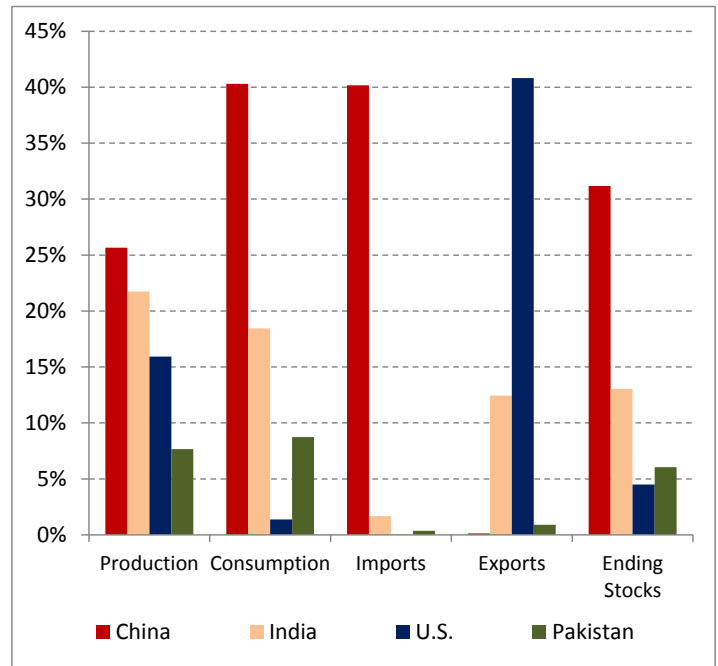
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Cotton market highlights

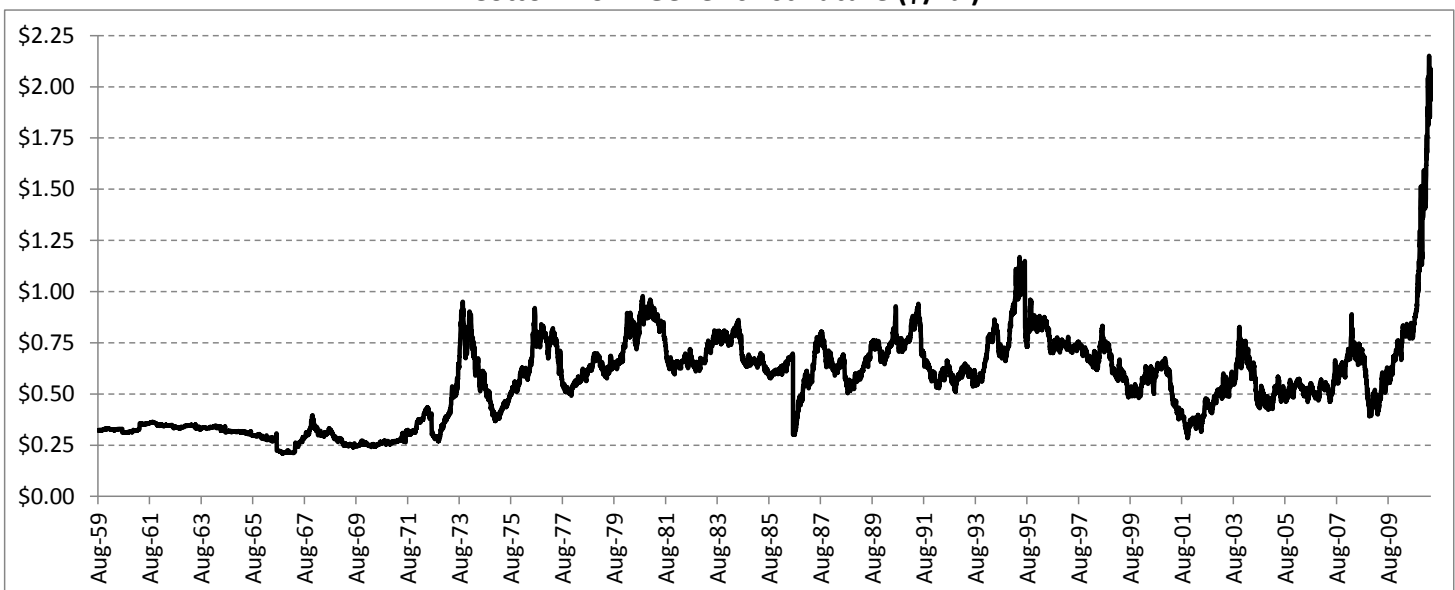
- *Prices up dramatically in the past year*
- *China dominates production, consumption, imports, and global stocks*
- *The U.S. is the largest exporter*
- *Weather plays a major role*
- *Demand destruction is a concern*

“The Big Four” Percentage of World Cotton Market



Source: USDA March 11, 2011

Cotton No. 2 Generic 1st Future (\$/lb.)



Source: Bloomberg

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RUNAWAY COTTON

Cotton was the best performing commodity in the S&P GSCI Commodity Index in 2010 and continued to be a standout in the first quarter of 2011. The primary mover of the surge in cotton prices has been a bullish fundamental backdrop. The physical market has been extremely “tight” as weather conditions siphoned production and global stocks have drawn in order to fulfill export commitments and domestic use. Speculation and the U.S. dollar have played roles, however their roles have been secondary. Marginal demand for cotton has been fueled by emerging market growth and the expanding global middle class. Where cotton prices go from here is largely dependent upon production, the weather, economic growth, and the policies of China, India, the U.S., and Pakistan.

FUNDAMENTALS MATTER

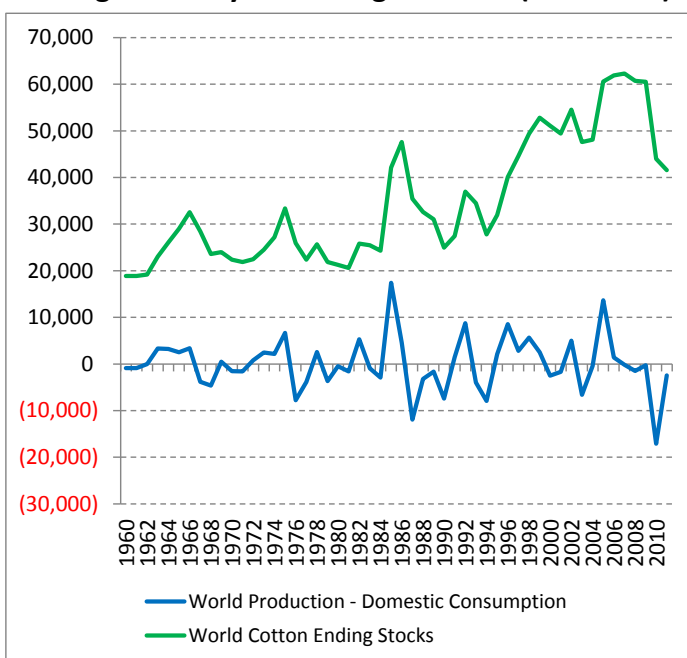
The 2009-2010 cotton marketing year (beginning August 1) brought a sharp divergence of supply and demand in the global cotton market that was absorbed by price levels. The shortfall of world cotton production, relative to consumption, was at its highest level in fifty years as the weather ravaged

the cotton crop with floods, fires, and droughts. World cotton stocks have drawn, year-over-year, as ending stocks declined by the largest percentage and absolute level in fifty years. A recovery in production is anticipated, although it will take time for stocks to grow, as high grain prices spur competition for acreage. It is important to remember that, although a standout in magnitude, the surge in cotton prices did not happen in isolation. Corn, soybean, and wheat prices have experienced strong price moves as well, as the battle for acreage is set to intensify. Volatility may be fueled by crop progression, unanticipated weather events (or lack thereof), revised global growth assumptions, and changes in export policies. The concentration of emerging market cotton production, consumption, imports, and stocks may amplify volatility.

THE BIG FOUR

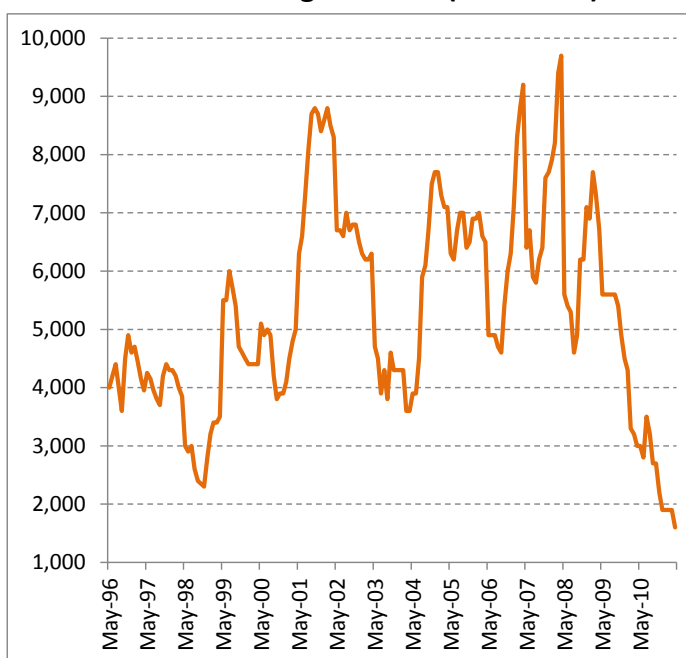
The world cotton market is dominated by “The Big Four” of China, India, the U.S., and Pakistan. These four countries account for approximately 71% of production and 69% of domestic consumption. “The Big Four” are northern hemisphere countries but cotton is not exclusive to the northern hemisphere. Southern hemisphere cotton exports play an

Cotton Production-Domestic Consumption and Ending Stocks by Marketing Year End ('000 bales)



Source: Bloomberg, USDA

U.S. Cotton Ending Stocks as of Marketing Year End ('000 bales)



Source: Bloomberg, USDA

important part in the global cotton market in between northern crops, especially those of Australia and Brazil. However, China is of critical importance to the cotton market as it is the largest single producer, consumer, importer, and holder of stocks. The possibility of intensified cotton stockpiling by China is not to be overlooked. India is the second largest producer, consumer, and exporter of cotton. Of particular note is India's export protectionism policies on cotton which have consequences for the composition of Chinese imports. The U.S. is the largest exporter of cotton, exporting a majority of its crop. A bulk of U.S. cotton grows in Texas and weather conditions are to be closely monitored. Pakistan is the third largest producer and consumer of cotton and may be on the path to self-sufficiency. The interplay of Pakistan and India over supply agreements provides intricacies to the global cotton trade.

THE PHYSICAL AND FORWARD MARKET

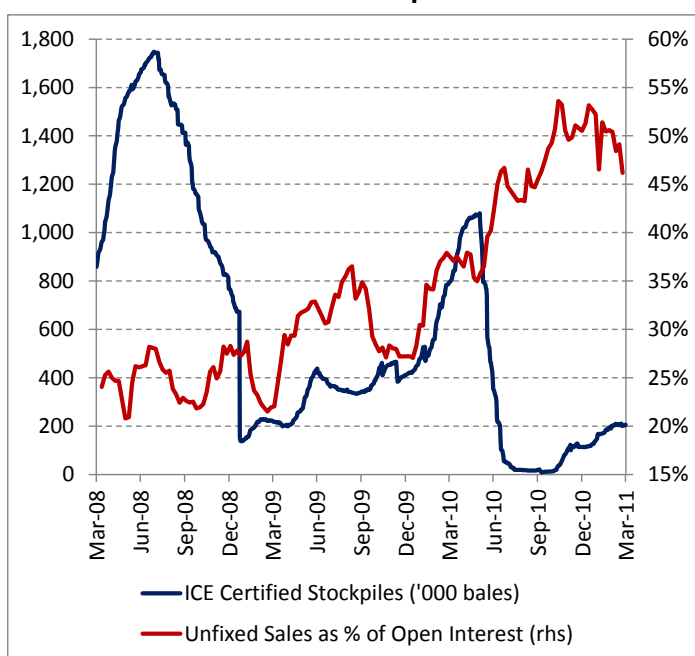
Efficiency ebbs and flows for any given market, however the high-end of market efficiency for cotton is not very high by modern standards. The velocity and robustness of cotton information is not as high as many global investors and traders have

become accustomed to. Significant data points include forecasts (production, consumption, etc.) and market participants must anticipate revisions. Moreover, the importance of China in the cotton market brings a fresh set of opacity and behavioral considerations. Nevertheless, there are nuances between the physical and forward cotton market and their interplay is important as physical market constraints and considerations affect the forward cotton price structure. Agreements to trade physical cotton can be on a fixed price basis or an on-call basis, providing the potential for chaos in the event of widespread defaults or disorderly price fixing.

OLD CROP AND NEW CROP

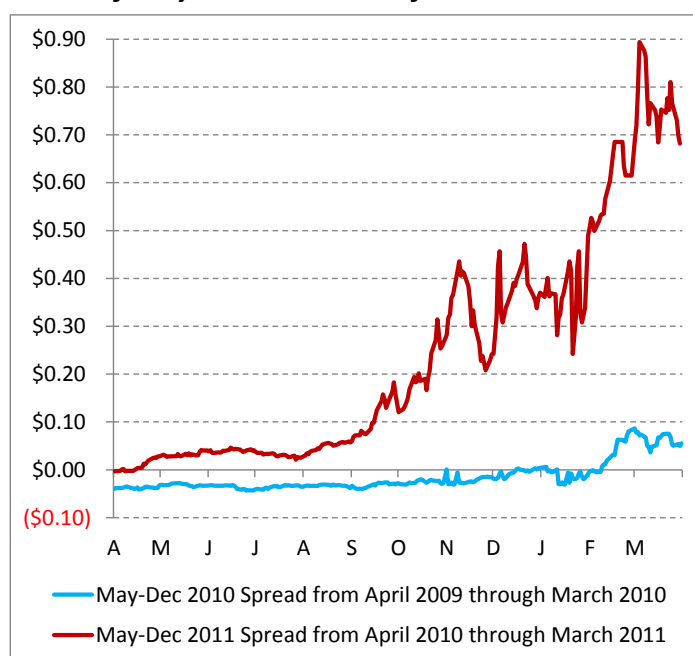
There is generally an old crop and a new crop priced in the ICE forward market at any point in time. Although there are factors that may affect both crops, prices may diverge due to, in part, shifts in fundamentals and their anticipated timing. Matching cotton exposure to an investment thesis should take many types of variables into consideration and should be implemented with risk-controls and a high tolerance for volatility as the chaos may prove both mesmerizing and distracting to the unprepared.

ICE Cotton No.2 Certified Stockpiles and Unfixed Sales as % Open Interest



Source: Bloomberg

ICE Cotton No. 2 May-December Spreads (\$/lb.) Price of May Contract-Price of December Contract



Source: Bloomberg

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