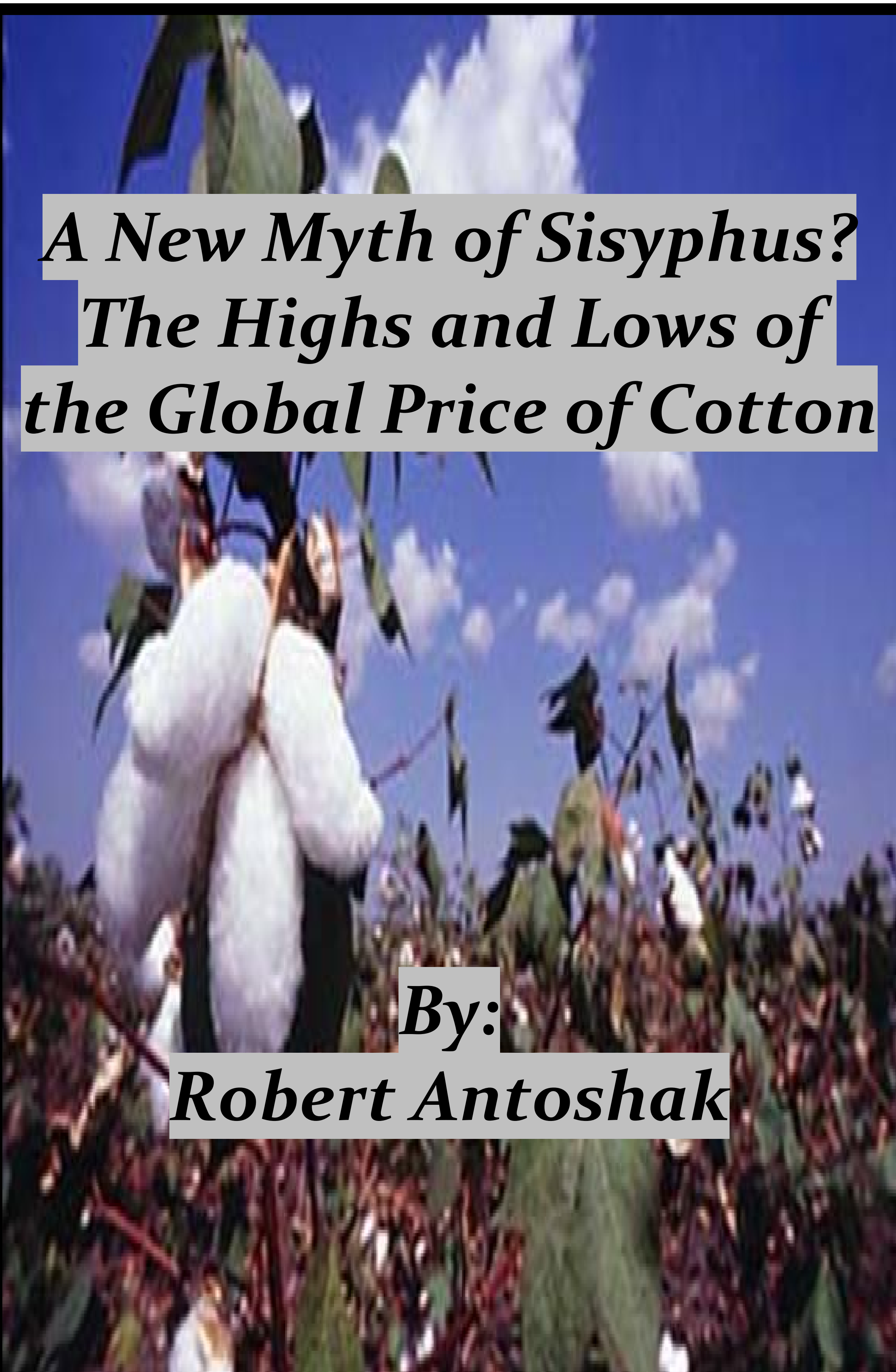

A New Myth of Sisyphus? The Highs and Lows of the Global Price of Cotton

By:
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Sisyphus. The French Algerian writer Albert Camus popularized the fate of Sisyphus in his famous essay, "The Myth of Sisyphus." According to Greek mythology, Sisyphus was condemned to forever push a rock up a hill only to have it roll back down time and again. The poor guy was locked in this perpetual struggle-a metaphor for the absurdity of life, said Camus.

So what can we learn from the plight of Sisyphus? In its simplest meaning, whatever goes up must come down. In today's terms, that can easily apply to markets. Talk about absurdity-take a look at cotton prices. Going up and down like Sisyphus's rock.

After months of soaring prices, it appears that cotton prices may be easing. But the big question is for how long?

An Invisible Hand

As I am waxing philosophical, there's an essential theory in economics that I'd like to mention as I feel it's particularly relevant as a tie in for cotton's Sisyphean behavior over the last year or so- namely, Adam Smith's "invisible hand" of the market.

The "invisible hand" is an analogy for market forces. As we know so well in the cotton and textile business, we all welcome lower raw material costs, but it's hard to ignore higher costs no matter what we do. When cotton prices rise, sooner or later those higher costs will translate into higher prices for textiles and eventually higher prices for made-up products such as clothing and home furnishings.

Then again, I think the textile supply chain often fights the invisible hand of the market-with a futility of Sisyphus-by trying to absorb as much of the higher cotton costs as possible before passing increases on to customers. This is especially true during recessionary times. Yet despite the best efforts to do otherwise, eventually price increases, due to higher raw material costs, have to be passed on to customers. Maybe it's futile to fight higher prices, but that's the point; confronted by such adversity-and uncertainty-companies persevere. And it's that perseverance which keeps some companies in business and forces others out.

Perception and Reality in the Market

How this perseverance manifests itself in the marketplace gives new meaning to the invisible, but undeniable, nature of the hand of the market. Perception, as much as reality, drives markets, as does fear or greed. As cotton prices soared over the past year or so, the tension between reality and perception has come to dominate the textile business. Some people fear there's no cotton to be had anywhere, which is silly; there's plenty of cotton out there. It all just comes down to the price one is prepared to pay.

The perception of a shortage has not only helped to feed panic in the market, but it has also helped suppliers to prime their customers for higher prices. Let me explain. A little hype about how bad business is goes a long way for preparing customers for bad news -- in this case higher textile prices. I don't mean to pick on mills. Retailers do it too. Have you ever noticed all the business reporting on retail conditions just before there's a significant change in products sold to consumers? Most recently, there's been a barrage of stories in the media about higher apparel prices, even though those prices have yet to hit consumers in any meaningful way (in fact, excluding food and energy, U.S. Consumer prices were only up 0.1% in March). It's just the hype to prepare consumers-the retailers' customers-for higher prices down the road, to literally test the market. Textile mills and apparel companies have already conditioned retailers to accept higher prices and now retailers are in the process of conditioning consumers. I think I see a rock rolling down a hill.

Nonetheless, panic in the market has resulted in changes in how companies make and market their products. For example, as the price of cotton went up, many textile companies switched their fiber blends by incorporating more synthetic fibers to help offset higher cotton costs. Lots of manufacturers are using more polyester than they did before the run up in cotton prices-and it hasn't stopped there. Alternative natural fibers have also made their way into the market. Wool is back, so is flax and I'm sure before too long, hemp and ramie will make greater inroads into the market. As evidence, I cite a recent public announcement by a major U.S. knitwear company that it would be using more flax in its clothing as a hedge against higher cotton prices.

But guess what's happened? The price of polyester has gone up along with demand. I suppose the price of flax will go up too. As with cotton, these fibers may in time get hit with their own supply and demand problems. It's hard to ignore the invisible hand of the market!

What is the Pass-Through Cost of More Expensive Cotton?

I heard the other day that a large U.S. t-shirt wholesaler had to raise its prices by 75% due to the higher cost of cotton. This was, for sure, a hefty increase. But in reality, it’s less than the price rise in cotton since last year (at about 180%). This got me thinking even if cotton rose by 180% would it really translate into a 75% increase in the cost to a clothing manufacturer?

A couple of really smart guys, Jon Devine of Cotton Incorporated and Alejandro Plastina of the International Cotton Advisory Committee (ICAC), recently developed an analysis to help measure the impact of higher cotton prices on the end cost of a garment.

In their analysis, entitled "Pass-Through Analysis of Cotton Prices," which was presented at this year's Beltwide Cotton Conference, Devine and Plastina estimated the cost of cotton fiber in different commonly purchased garments. The purpose of this theoretical work was to approximate the effect higher cotton costs would have on the ultimate retail price of a garment if the increase in retail garment prices were due solely to the increase in cotton fiber prices.

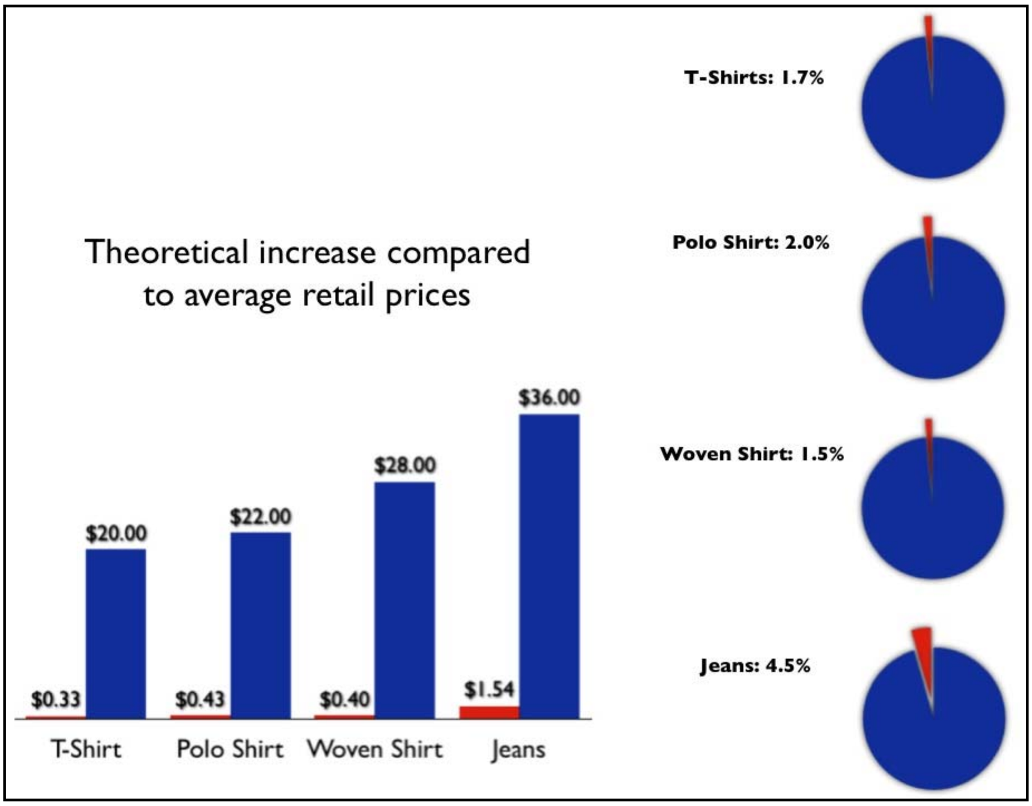
In their analysis, they considered that the average increase in cotton prices this crop year has been 80 cents/lb relative to the same time period last crop year (Cotlook’s A Index, August through March). This average increase was multiplied by estimates for the total amount of cotton represented by retail apparel products (t-shirts, polo shirts, woven shirts and jeans). Estimates for the total amount of cotton contained in apparel came from Cotton Incorporated’s Retail Monitor™ and estimates regarding the amount of waste lost in manufacturing from the USDA Economic Research Service.

What did the results show? Well, compared to average retail prices observed by Cotton Incorporated's Retail Monitor™, the analysis showed that on a per unit basis the impact of higher cotton prices would result in an additional cost of about 4.2% for a pair of jeans if the increases in costs were due to cotton fiber alone. The theoretical increase for woven shirts was only 1.5%. Hypothetical increases for t-shirts and polo shirts fell somewhere in between. These price increases really don't sound like a lot, so what's going on here?

Study the following table. If cotton rose by an additional 80 cents/lb then, theoretically at least, the price of q garment would increase by a minimum of 33 cents per unit (t-shirts) and maximum of $1.54 (jeans).

Common Cotton Apparel Products	**Avg. Retail Weight (Lbs.)**	**Total Cotton Required (Lbs.)**	**Theoretical Effect of 80 cent/lb Increase**
T-Shirt	0.40	0.41	$0.33
Polo Shirt	0.52	0.54	$0.43
Woven Shirt	0.42	0.50	$0.40
Jeans	1.54	1.92	$1.54
Sources: Cotton Incorporated, ICAC, USDA ERS			

However, when compared to average retail prices for the four garment types, then it seems that the increases really aren't all that significant, as shown in the graph below.



Sources: Cotton Incorporated, ICAC, USDA ERS

But here's the rub for retailers and branded apparel companies-although individual unit costs seem relatively small, those costs grow exponentially when dealing with millions of units. That can translate into tens-of-millions of dollars across a major company's entire product line. Hence, this is why so many retail companies are forewarning about higher prices. A 33-cent per unit increase in the cost of one t-shirt doesn't seem like a lot. But when a company produces 100 million shirts a year, even that modest increase would add costs to the tune of $33 million per year, a figure that's hard to ignore for any apparel brand or retailer.

The Profit Motive: Real and Imagined

Something I've learned over the years is to never underestimate the power of the profit motive. I don't agree with the Hollywood assessment that "greed is good," but I do agree that the profit motive is a force to be reckoned with-a force every bit a strong as gravity pushing Sisyphus's rock back down that hill. To put it more bluntly: companies will do whatever it takes to protect their margins. And that goes for when prices are up or down!

In the clothing business, we have ended an extended period of significant price deflation. Over the past twenty-five years, we've witnessed an explosion in global consumption of apparel-particularly in the United States and Europe-as well as a boom in producing capacity around the globe to meet that demand. In fact, so much new capacity came on-line over the past two decades that it really outstripped demand and resulted in producers lowering prices just to maintain their place in a crowded global supply chain.

With the global recession, however, I feel those days are quickly coming to an end for one very simple reason: higher cotton prices. Cotton is a market catalyst. In the case of raw materials, cotton in particular, prices have soared exactly when economists say commodity prices should typically plummet, when demand is flattened due to recession. This time is different. There is every indication; at least for the moment anyway, consumption in China and India may have helped to boost demand for cotton at a time when weak demand in the United States and Europe would have normally deflated prices. I also wonder- will this increased demand in China and India really result in higher prices for clothing around the world over time?

Which brings me back to our friend Sisyphus. He's still busy pushing that rock up a hill- but now I just noticed that it fell back to the bottom again. A lesson for textile and apparel companies? Yes. What goes up will eventually go down. It's the same with cotton prices. They are up today, but they will be lower in the future. The same goes for margins -- today's margins may be thin, but that can change tomorrow.

Originally published in TEXTILE QUARTERLY magazine.

Views presented here are of Mr. Robert Antoshak, Managing Director of Olah Inc.