Not All Fibers Carry Light

Last week's acquisition by Koch Industries of DuPont's INVISTA fibers unit served as a reminder that whatever the state of the economy or of the markets, industries such as textiles and carpets will remain. Clothing may not be an actual necessity - the precise need is to keep our internal body temperature over 92° Fahrenheit - but it seems to be such a widely accepted social courtesy globally as to constitute a necessity.

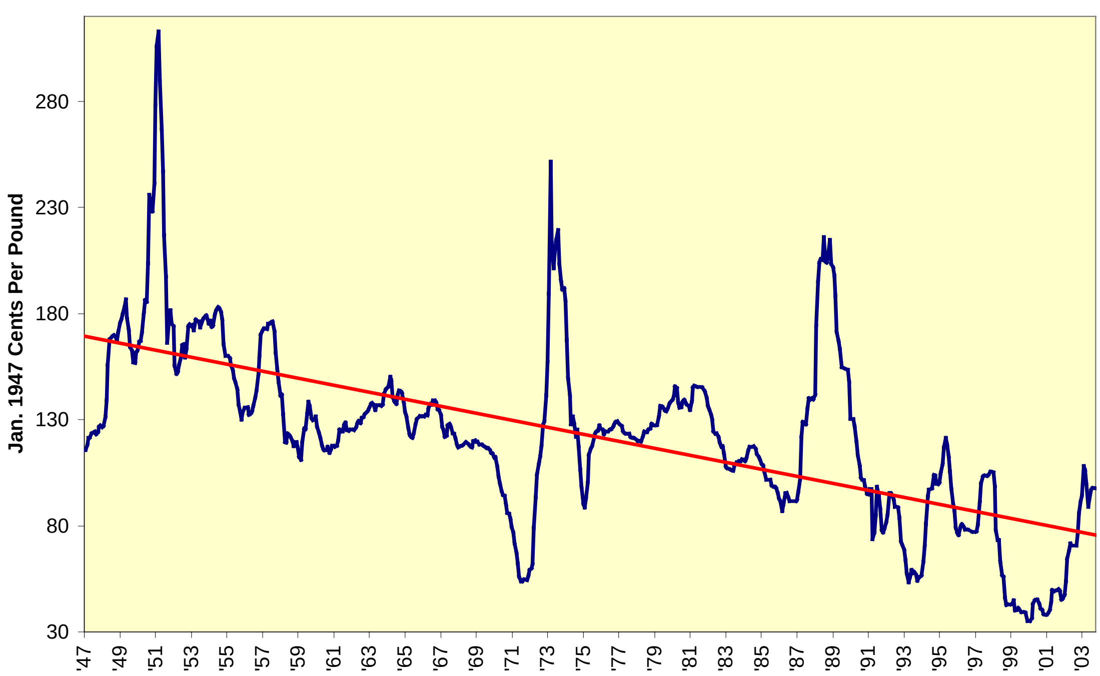
And let us not forget the key role that textiles played, for better and worse, both in European colonial expansion and in the development of the industrial revolution. Cotton played a critical role not only in American history, but also in the histories of Egypt, India (remember Gandhi's spinning wheel) and Australia. In the former Soviet Union, it was known as white gold and prompted the diversion of two rivers for irrigation purposes and the subsequent desiccation of the inland Aral Sea. Eli Whitney's cotton gin created the economic incentive for the westward expansion of both cotton planting and slavery. The English textile industries with their new steam-driven looms made Great Britain the leading commercial power of the nineteenth century. Even today, textiles remain among the most contentious of global trade and development aid issues.

Both An Industrial And An Agricultural Market

For all of the benefits created by synthetic fibers - one of INVISTA's leading products is spandex, which I mercifully do not wear to the gym - the ancient standbys of cotton and wool still play a critical role. Chances are a good portion of your wardrobe contains these fibers. Both markets share a somewhat unique status, along with commodities such as rubber and jute, of being industrial commodities subject to the cycles and vagaries of agricultural production.

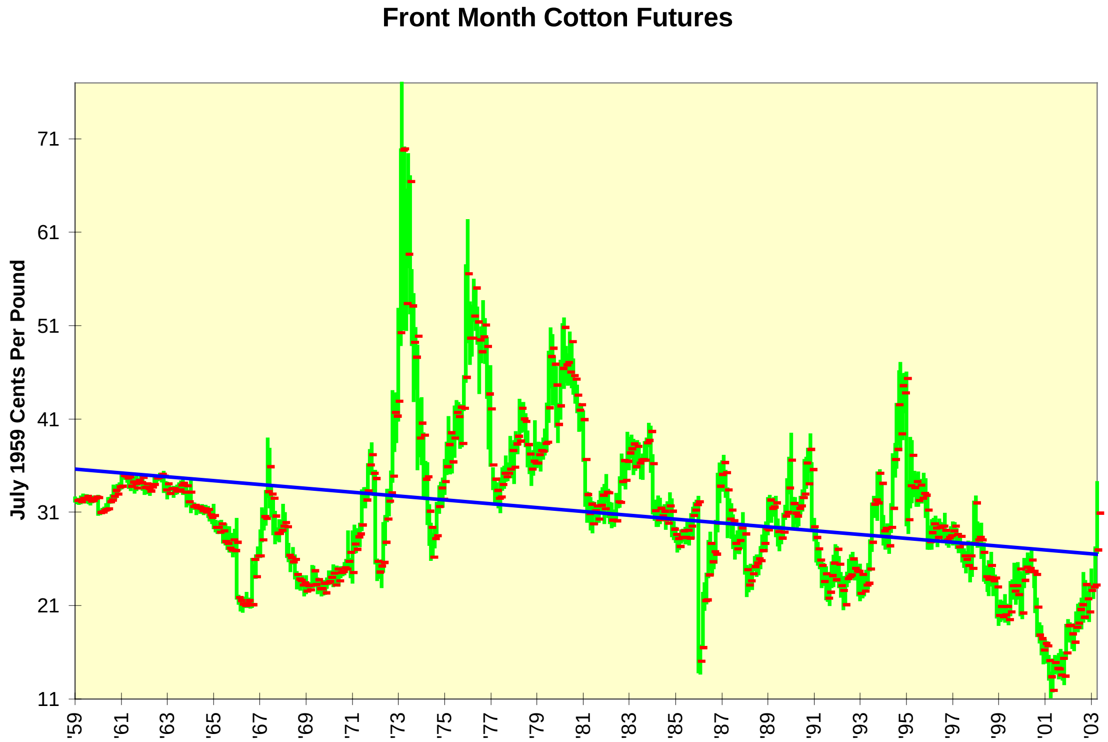
Even with agricultural production constraints, the long-term price trends of both fibers exhibit the classic commodity pattern of a decline punctuated by a short-lived price spike. By the turn of the century, wool prices deflated by the apparel and textile producer price index were at their lowest level on record.

No. 64 Wool Tops Prices In Boston



Wool is a difficult futures market for American traders; the Sydney Futures Exchange offers contracts on "greasy wool," and on two grades of merino wool, fine and broad. Commodities are not pretty: Almost half the weight of greasy wool, which is the unwashed shearing, is lanolin, dirt and trapped vegetable matter. All three contracts are thinly traded and denominated in Australian dollars.

The chart for similarly deflated cotton futures shows a similar pattern, including an all-time low for real prices in late 2001. The production economics for cotton are more complex than are those for wool; much of the world's cotton is grown on irrigated land and therefor is subject to the price of the fuels used to power the pumps. In addition, the Department of Agriculture allocates cotton acreage in the U.S., export prices are subsidized, and many farmers can switch between cotton and soybeans. The big price jumps in cotton in the 1970s were partly the result of planting decisions in favor of soybeans.



The Chinese Connection

As is the case for so many industrial commodities, the marginal demand for cotton is centered in China. The Department of Agriculture is forecasting 2004 exports of 7 million 500-pound bales of cotton to China. To put that in perspective of the futures market for cotton, each contract is for 50,000 pounds, or 100 bales. The entire open interest on the New York Board of Trade's Cotton Exchange is 88,701 contracts, so the exports to China will account for 78.9% of present open interest.

The higher prices seen for soybeans in the U.S. this year, also an artifact of Chinese demand, should lead to higher soybean acreage at the expense of cotton in 2004, barring an exceptional South American soybean crop. If Chinese cotton demand grows along with the economy - and given economic development experience elsewhere, this is almost a given - will a combination of supply and demand factors propel cotton futures back toward the current dollar highs seen in early 1995?

Threading A Needle

Not necessarily: Cotton, like so many commodities, exhibits what is called a mean-reverting price pattern. Prices jump higher out of a range, or drop lower out of a range, but they somehow manage to find themselves returning toward the midpoint of that range, in this case about $0.68 per pound for cotton. And unlike equity prices, whose mean exhibits a strong upward trend over time reflective of the economy's growth, the mean for most commodity prices stays flat. The DuPonts and now the Kochs of the world can develop new synthetic fibers and improve their efficiencies of production, but how are you going to get a merino sheep to increase its wool output?

The key to trading cotton is to sell (buy) too soon. Just when this market appears to be a one-way affair on both a technical and a fundamental basis, it stops and reverses and has done so for years. The recent behavior of the front-month March 2004 contract, with its outside reversal and gap lower following a contract high, is typical of what you should expect from trading this market.

March 2004 Cotton