

# Will US slowdown deny the cotton bull?

By Ed Jernigan, CEO, Globecot, Inc.

**R**ecession and stagflation are economic terms that strike fear in the heart of every global retail company. Stagflation is the term used to describe economic conditions in which inflation escalates at the same time the economy experiences slow-to-no economic growth. Unfortunately, both words are being used to describe the economic conditions that lie ahead for the world's largest economy, the United States.

Let's briefly take a look at the odds of such a situation happening.

### Housing crisis

The worst crisis for the US housing sector in modern times has ignited a call by the US financial markets for new cuts in interest rates. By last week, the US Treasury had priced in a three-quarter of a per cent cut in US rates.

If the Federal Reserve (Fed) cuts rates by this amount, it would be the largest cut since 2001.

The Fed dramatically cut rates following the September 11 terrorist attacks and continued to cut rates for several years. The problem for the Federal Reserve is that the US dollar is collapsing, with the dollar reaching another round of record lows against many currencies last week — for the first time, the US government has begun to express concern over its free fall.

For the Federal Reserve, further cuts in interest rates will likely further accelerate losses in the US dollar. The US dollar weakness, itself, is adding to the progression of inflation. Oil prices are moving in direct opposite correlation to the US dollar.

For example, on Tuesday, November 20, the dollar value as measured by the US dollar Index fell 40 points as crude oil prices rose by over \$US1.50 per barrel. In October, US consumer prices increased at an annual rate of 3.5 per cent, the fastest growth in 14 months, and import prices grew 1.8 per cent, the largest increase in 17 months.

So if the Federal Reserve provides the credit markets with the cuts they need, it would likely accelerate the US dollar's decline and increase domestic price inflation.

This situation puts the Federal Reserve in a very difficult position and clearly raises the spectrum of stagflation, which develops when such conditions exist. Each move by the Fed has negative outcomes. If the path is to hold rates firm, it truly means greater woes for the embattled housing sector. US homebuilding declined 20 per cent in the third quarter, marking the seventh straight loss — each 20 per cent decline is estimated to shave a full per cent point off US GDP growth. The Index of Homebuilder Sentiment is at a record low.

The US last experienced stagflation during Presidents Nixon, Ford and Carter Administrations. The most extensive stagflation occurred during former President Carter's Administration. It was eventually defeated by US Federal Reserve Chairman



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Paul Volcker, who first raised interest rates from 1979–1983 to eliminate inflation and then followed it with a fiscal stimulus beginning in 1983.

**Recession fears**

The fear is that these conditions will give way to a US recession. The US National Bureau of Economic Research defines a US recession as a significant decline in activity across the country that lasts more than a few months and is visible in industrial production, employment, real income and trade.

The US came close to a recession in 2001 when third quarter GDP only grew 0.2 per cent in current dollars and fell 1.4 per cent in 2000 in current dollars.

The Fed's action quickly allowed growth to move back to 3.6 per cent in the fourth quarter of 2001 and 4.3 per cent in first quarter of 2002. The last official recession in the US occurred in the 1990–92 period. Real GDP growth dropped to negative three per cent in the fourth quarter of 1990 and fell two per cent in the first quarter of 1991.

For cotton, the fear is that the US economic slowdown will reduce global cotton consumption. Of course, the ultimate impact on consumption will be determined by whether or not the US economic downturn spreads to Europe and Asia.

At this stage, the negative impact on the rest of the world has been constrained. Europe appears to be the first affected, led by a decline in the housing markets of the United Kingdom. Now, it looks as if the woes of the US financial service sector are spreading to Europe.

Growth in the European financial services industry moved to the negative in October, the first period of lost growth since September 11, 2001. In addition, the record euro/US dollar exchange rate has impacted European exports.

The counter economic argument is that growth in Russia, East Europe, Middle East and Asia will offset the slump in the US and Europe. In essence, the “new” economies will move to overshadow the “old” economies, leaving total global growth unchanged. This new relationship has yet to be proven. The economic impact has already started affecting US consumer spending, and US textile and apparel imports are declining, with September imports basically flat.

It is difficult to build a direct correlation of NYBOT cotton futures to US economic growth. The price movement during the

1980 to 1990 period was heavily influenced by US domestic farm program policies.

There was the inventory protection scheme of the 1985 Farm Bill that drove futures to below 30 cents.

Then came the rally that followed, which peaked in May of 1991 just as economic growth accelerated. The US economy grew strong in the second quarter of 1991 — but cotton futures fell from a high of 94.45 in May to a low of 50.68 in October 1992, driven by other forces altogether. So there appears to be little real correlation between the behaviour of NYBOT cotton prices and US recessions. In addition, the end of major US domestic cotton consumption also reduces any pre-

vious connection as well.

For cotton, the largest damage would be any real impact on global cotton use, which has grown 53 per cent since 1989–90. The maintenance of global cotton consumption and its expansion will prove more of a direct influence on cotton prices. Therefore, any US and European economic adversity migrating to the rest of the world would prove crucial in this regard.



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