



Don't Buy In to Cotton's Head Fake

By Jacob Roche - July 18, 2011

The USDA's recent cotton report was mixed at best. On one hand, the United States is the world's top cotton exporter, and about 25% of that cotton is produced in Texas, where a record drought is threatening to ruin a third of the crop. On the other hand, Australia, the fourth-biggest exporter, is expected to have a record harvest, and global demand seems to be softening somewhat. Clothing retailers live and die by their profit margins, so the uncertainty of cotton supplies deserves some attention.

Don't Get Your Hopes Too High

Just a few days after the USDA report, Rabobank, which specializes in food and agriculture financing, warned that investors shouldn't get too excited about a drop in cotton prices, because even if the USDA forecasts are right, supplies will still be close to their lowest in more than 15 years. And the forecasts might be too optimistic, as they assume large production growth in India and China, where the weather and seed planting have been worse than expected, and underestimate the impact of the Texas drought.

This means that although cotton may not hit its March high again, when it had risen 273% since last July, it's likely to remain expensive. This is bad news for clothing retailers, especially the likes of Aeropostale and Gap, which compete mainly on price, as opposed to higher-margin companies such as Abercrombie & Fitch, which can more freely pass costs on to customers.

The possibility of sustained high prices for cotton has led to certain changes in the industry. More companies are turning to alternatives, whether synthetic or natural, that might offer a cheaper price. For instance, lululemon athletica has seen its margins explode in the past year, as the cost of its synthetic fabrics has remained comparatively stable and the popularity of its products has outweighed any moderate increase in cost.

Other more cotton-dependent companies have turned to natural alternatives. Naturally Advanced Technologies has developed a method of making a cotton-like fabric from flax, which is cheaper and easier to grow. The company is still in the process of commercializing but has already signed deals with the likes of Hanesbrands and Levi Strauss.

The Foolish Bottom Line

If you own shares of any clothing retailers, you may be focused on fashion, but you shouldn't ignore the raw costs your companies incur.

[Click here to see Naturally Advanced Technologies in the Motley Fool.](#)