Market Economics

21 May 2012

Macro Monday

Global – Time To Cotton On!

- Every cloud supposedly has a silver lining and the collapse in global commodity prices prompted by the market's latest risk off bout is recasting global inflation risks. Oil's c.13% decline in the last few weeks is the most visible and important change in the inflationary climate. Forecasts for USD150 per barrel, from just a month or two ago, feel an eon ago. Less well documented is the quiet collapse of global cotton prices. Down almost 16% year-to-date, cotton has now moved to the bottom of the pile of the global asset returns we typically track.

- Cotton's collapse is particularly important as an unprecedented bubble in global cotton prices between July 2010 and March 2011, which saw prices treble on a mix of supply and speculative pressures, has been instrumental in pushing up clothing inflation across the globe over the last year. We estimate that clothing inflation is running at, or close to, record highs in China, the US and the euro zone. Cotton's collapse, which has seen prices drop around 2/3rds from their March 2011 peak, should therefore ensure that clothing inflation falls back rapidly over the next 6-12 months. And demand factors, proxied by Chinese narrow money growth, suggest little scope for any near-term recovery in cotton prices.

- Clothing inflation appears particularly important in China given its estimated weight of around 8% in headline CPI which is roughly double the regional average according to our estimates. Econometric estimates suggest that CPI clothing inflation could fall by 2-3% points over the next 6-9 months, crimping overall CPI inflation by c.¼% other things equal. Downside risks to inflation from cotton, not to mention oil, mean that policy 'space' in China may therefore be greater than typically assumed. Clothing inflation also looks set to retreat in both the US and the euro-zone, also increasing policy 'space' for both the Federal Reserve and the European Central Bank.

India – The Fall of the Rupee

- At first blush, the fall of the INR looks sensational. But its slide to record nominal lows has thus far been relatively orderly although this can obviously change. Given India's rapid inflation of recent years, its drop is better interpreted as correcting previous 'real' overvaluation. The recent sluggish performance of India's industrial sector and the widening in the underlying trade deficit certainly attest to a lack of competitiveness.

- The real melodrama, and the root cause of the INR's current travails, is India's too loose fiscal policy which has crowded out private sector investment, pushed up both inflation and widened the current account deficit, increasing the INR's volatility and vulnerability. India's recently updated Flow of Funds data on gross savings and investment flows underscore the role of lower public sector savings has played in pushing down national saving rates by a record amount in the last three years and, in turn, widening the current account deficit.

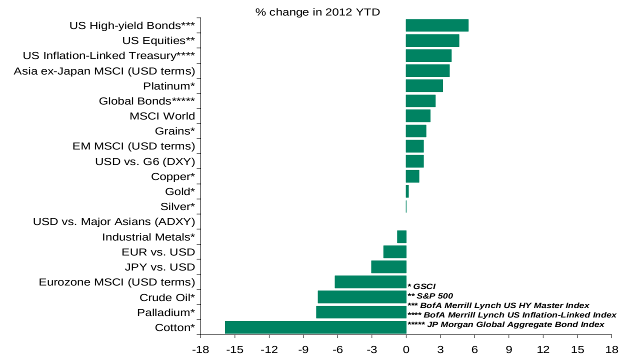
- With India's deteriorating macro-performance and rising policy uncertainty also crimping FDI inflows, reliance on hot money inflows to finance the balance of payments has increased leaving the INR more vulnerable to swings in global risk aversion, and its corollary, the demand for USD liquidity. An improvement in the situation in Europe and firmer global risk appetite therefore looks a necessary, although not sufficient, condition for the INR to stabilise. Fiscal laxity is the root of the problem; a restoration of fiscal discipline must be the solution.

- The RBI's ability to stem the selling pressure on the INR in the short term is relatively limited. FX reserves of USD282bn (down from a peak of USD319bn as recently as October) may appear adequate but are low historically relative to short-term external debt. And, with liquidity in the inter-bank market remaining unusually tight, forcing the RBI to inject liquidity on what appears to be a serial basis via open market operations (OMOs), intervention which would simply pull further liquidity out of the banking system, would simply exacerbate these pressures. The RBI has been forced to unveil an increasingly desperate series of ad hoc measures designed to stimulate short-term inflows, including the recent announcement that Indian exporters convert 50% of their foreign earnings into INR.

- Decisive action on subsidies, especially fuel subsides, in the coming weeks and months therefore is the key hinge on which prospects for the INR will turn in the short term. This would not only signal a genuine desire to restore fiscal discipline despite the inevitable political fall-out but, by bringing domestic fuel prices more into line with international prices, will tend to restrain the oil import bill and so reduce dependence on hot money inflows. If, combined with a fresh and successful attempt to allow FDI in multi-brand retail that signals that India is 'open for business', foreign perceptions over the medium-term prospects for the Indian economy and, in turn, the INR could begin to improve.

Global: Time to Cotton On! – I

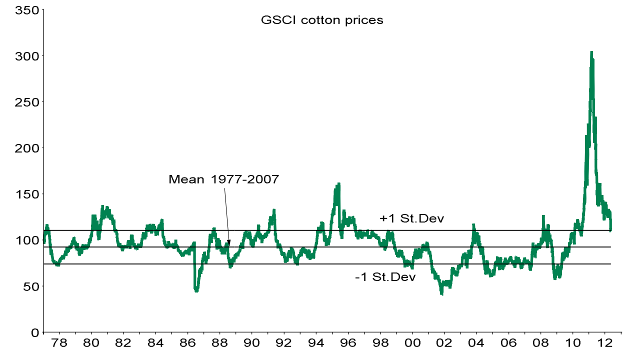
Chart 1: Bottom of The Pile



Source: BNP Paribas, Reuters EcoWin Pro

As global risk appetite once again retreats, dragging commodities down, most commodities have fallen sharply, but the drop in cotton is particularly noteworthy. Its c.16% YTD drop has moved it to the bottom of our global asset return pile.

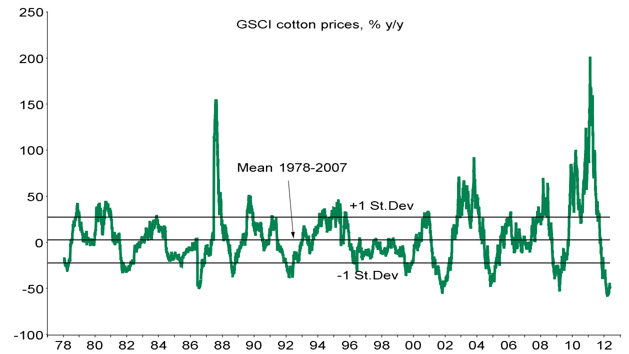
Chart 2: Cotton Bubble Bursts



Source: BNP Paribas, Reuters EcoWin Pro

Cotton's more pronounced weakness in part reflects the continued unwinding of its 2010/2011 bubble which saw prices more roughly treble between July 2010 and March 2011. Prices are now down more than 2/3rds from their March 2011 peak.

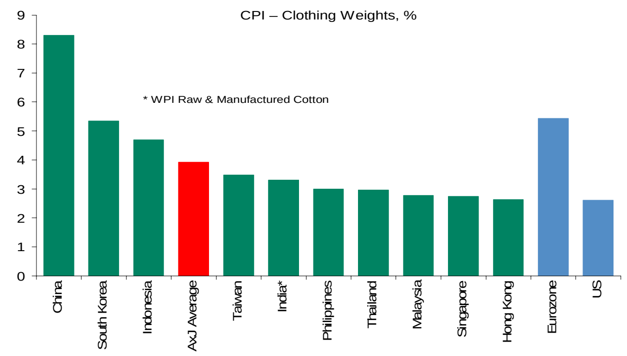
Chart 3: Record Disinflation



Source: BNP Paribas, Reuters EcoWin Pro

In terms of growth rates, cotton price inflation peaked at over 200% y/y in February and has subsequently collapsed. Current inflation rates of around -45% to -55% are at record lows.

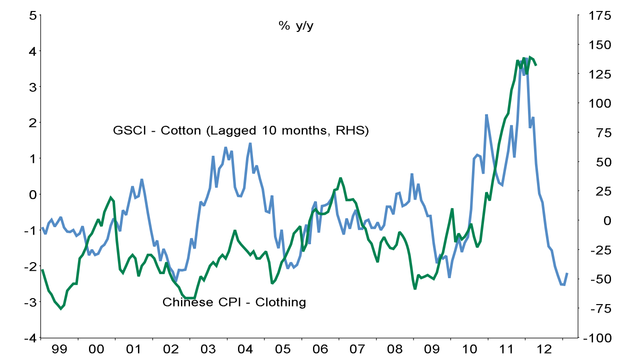
Chart 4: Inflationary Impact



Source: BNP Paribas, Reuters EcoWin Pro

Cotton's bubble played an often under=appreciated in adding to global inflationary pressures. In Asia ex-Japan (AXJ), China stands out as having the highest clothing CPI weight. The AXJ average is 3.9%, the Eurozone 5.4%, the US 2.6%.

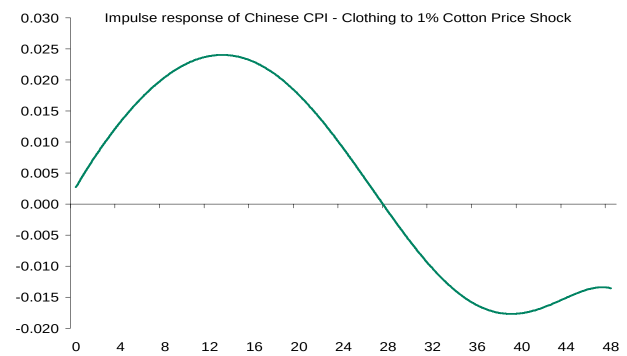
Chart 5: Chinese Clothing Inflation - I



Source: BNP Paribas, Reuters EcoWin Pro

Global cotton global price inflation appears to influence Chinese CPI clothing inflation with a lag of about 6 months. Clothing inflation has been running at close to record highs of c.3¾% in the six months since last October.

Chart 6: Chinese Clothing Inflation - II

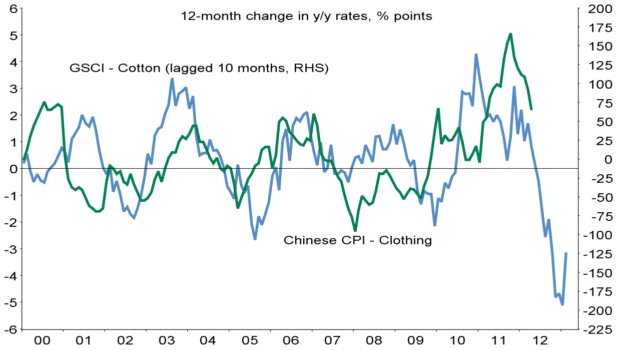


Source: BNP Paribas, Reuters EcoWin Pro

Based on a VAR on the y/y rates of GSCI cotton prices and Chinese CPI - Clothing, there is around 2.5% pass-through of an global cotton price shock to Chinese CPI - Clothing after around 12 months. 2011's 200% inflation therefore added c.5% points.

Global: Time to Cotton On! – II

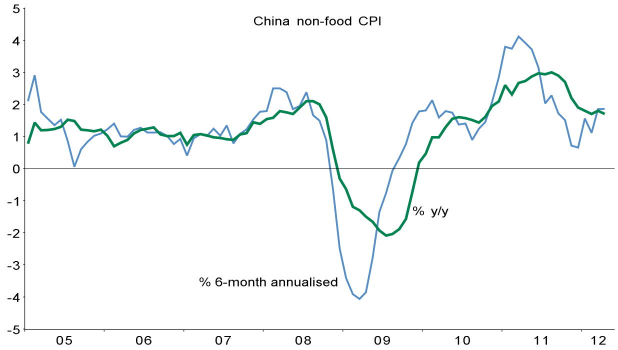
Chart 7: Chinese Clothing Inflation - III



Source: BNP Paribas, Reuters EcoWin Pro

Inevitably, the change in y/y rates between clothing and cotton inflation are closely correlated. Cotton's record momentum swing signals a likely 2-3% off clothing inflation in the next 6-9 months. Given its weight of c.8%, this could trim c.¼% off CPI inflation.

Chart 8: Downward Surprises?



Source: BNP Paribas, Reuters EcoWin Pro

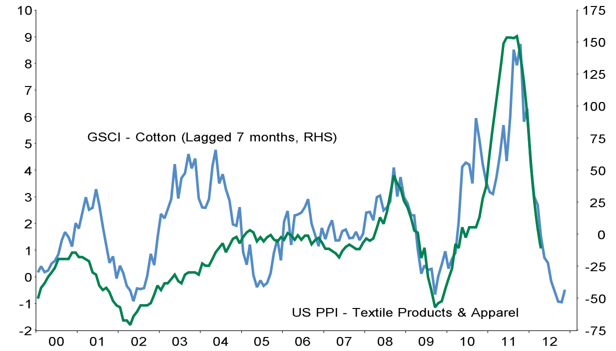
The continued pass-through of lower cotton prices in CPI should work to ensure that non-food CPI inflation, whose downward momentum has flattened out in recent months, remains restrained, maximising policy 'space' in the balance of the year.

Chart 9: Down & Out

Source: BNP Paribas, Reuters EcoWin Pro

The current risk-off environment combined with the unwinding of its previous bubble account for cotton's return to earth. Chinese domestic demand, proxied by y/y M1 growth, also seems to exert an important influence, suggesting little scope for a rebound.

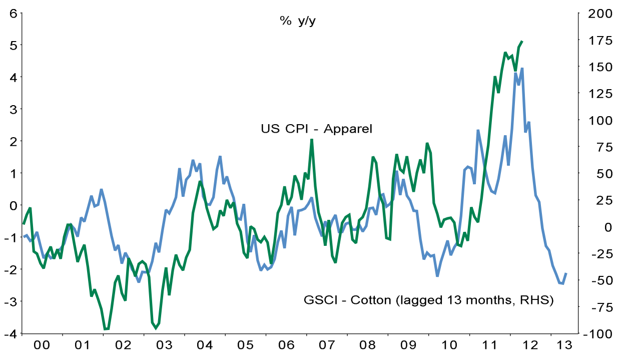
Chart 10: US – Feeding In



Source: BNP Paribas, Reuters EcoWin Pro

Cotton's bubble has also played an important role in driving the upward surprises to US core inflation over the last year. The disinflationary impact of cotton's collapse can already be seen at the PPI level where inflation has fallen from 9% to 1%.

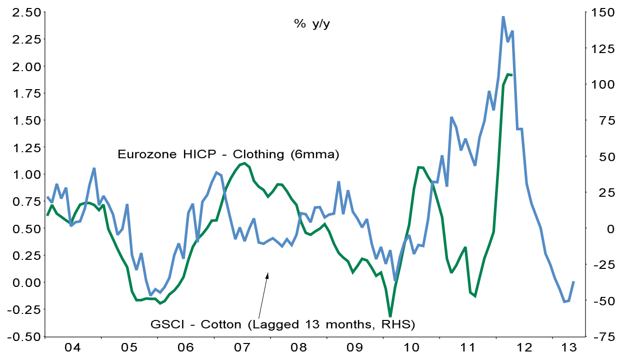
Chart 11: US - Yet To Be Felt



Source: BNP Paribas, Reuters EcoWin Pro

The downdraft is yet to be felt at CPI level where apparel inflation hit a 20-year high of 5.1% y/y however. Although cotton is obviously not the only price driver, apparel inflation looks set to tumble over the next year, possibly crimping a ¼% off core CPI.

Chart 12: Euro-zone – Downside Risks

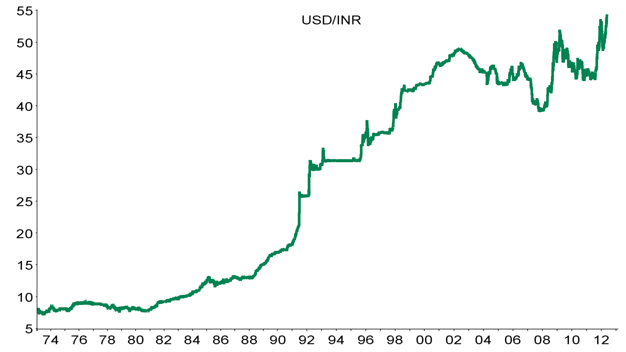


Source: BNP Paribas, Reuters EcoWin Pro

The situation looks similar in the eurozone with clothing inflation running at record highs over the last six months and the impact of cotton's collapse yet to be felt given the involved. As elsewhere, rapid clothing disinflation will increase policy 'space'.

India: The Fall of the Rupee – I

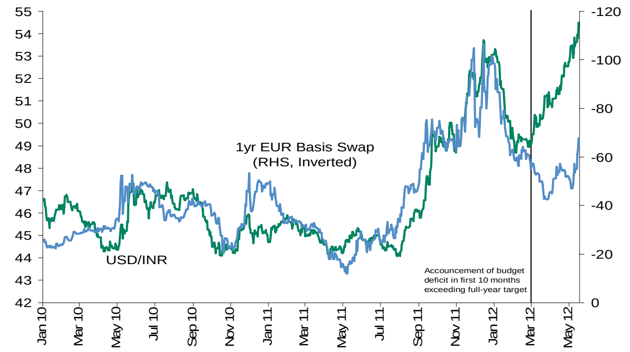
Chart 1: The Fall of the Rupee



Source: BNP Paribas, Reuters EcoWin Pro

The RBI earlier this month raised interest rates on local bank's foreign-currency deposits and required exporters to convert at least half their overseas earnings to rupees. The USD/INR, yet, has continued sliding, hitting a record intra-day high of 54.9%.

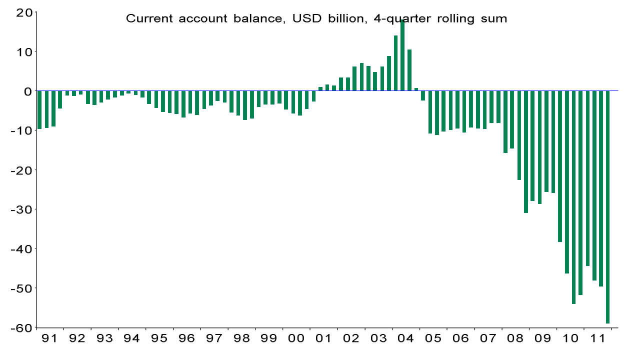
Chart 2: Risk Off



Source: BNP Paribas, Reuters EcoWin Pro

USD global liquidity had been a key driver of swings in the INR until recently. The beginning of the divergence coincided with the Indian government's announcement in late February that its fiscal deficit in the first 10 months exceeded the full-year target.

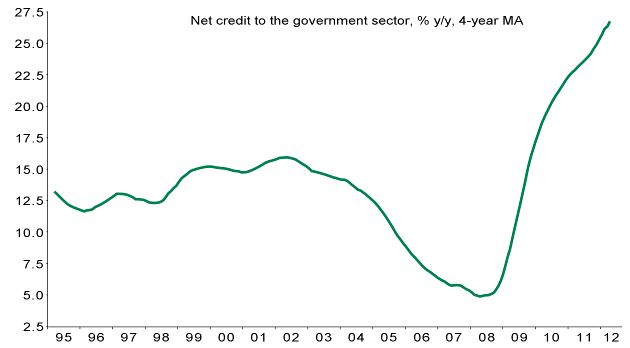
Chart 3: Current Account Deficit Widening



Source: BNP Paribas, Reuters EcoWin Pro

At USD 59bn in 2011, India's current account deficit reached an all-time high, which, with the basic balance in deficit, by definition has had to be funded by short-term, more volatile portfolio investment inflows.

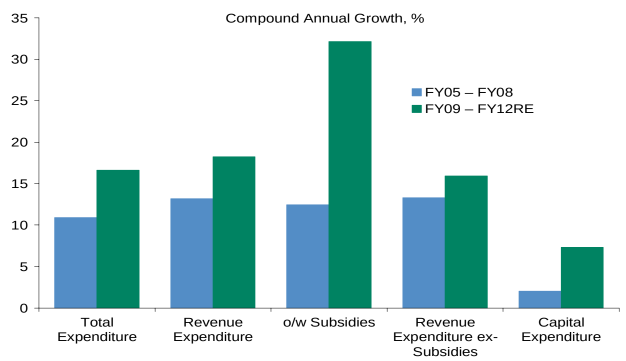
Chart 4: Loss of Control – I



Source: BNP Paribas, Reuters EcoWin Pro

Fiscal backsliding is a key driver of India's macro-deterioration. Over the last four years, net credit to the government sector has grown by c.27% per annum. This compares to average growth of just 5% between FY05-FY08.

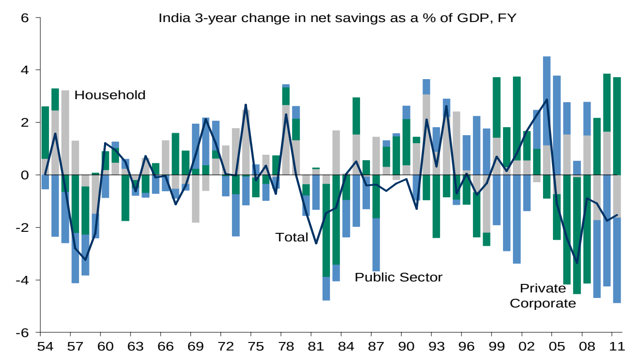
Chart 5: Loss of Control – II



Source: BNP Paribas, Reuters EcoWin Pro

Total central government spending has grown by an average 17% per annum over the last four years. Spending on subsidies, however, has soared by a much faster 32% compound rate over the same period, against c.12.5% per annum over FY05-FY08.

Chart 6: Untangling The Deficit – I

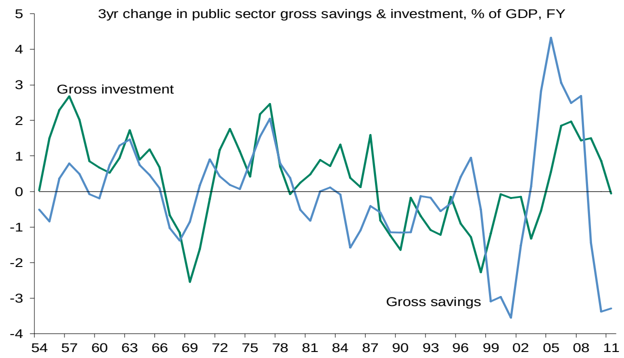


Source: BNP Paribas, Reuters EcoWin Pro

CSO's 'quick' estimates of Flow of Funds data for FY2011 reveals that from a sectoral perspective the bulk of the widening in the current account deficit since the global financial crisis came from the public sector.

India: The Fall of the Rupee – II

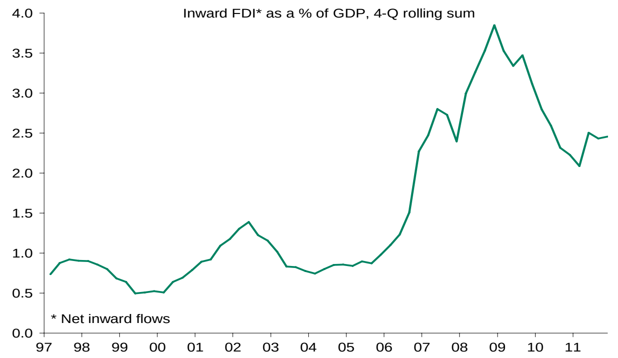
Chart 7: Untangling The Deficit – II



Source: BNP Paribas, Reuters EcoWin Pro

The deterioration in the public sector's external balance over the past three years in turn was a result of a sharp drop in its gross savings with gross investment broadly flat. Fiscal consolidation, thus, is key to curing India's exploding current account deficit.

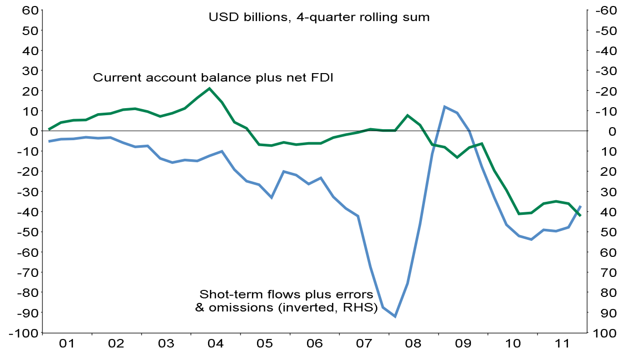
Chart 8: Inward FDI Short of 'Potential'



Source: BNP Paribas, Reuters EcoWin Pro

Inward FDI flows into India saw a modest recovery in 2011 but remain well below their pre-crisis highs and short of 'potential' as per the RBI's estimates. RBI research attributes this, at least in part, to increased policy uncertainty.

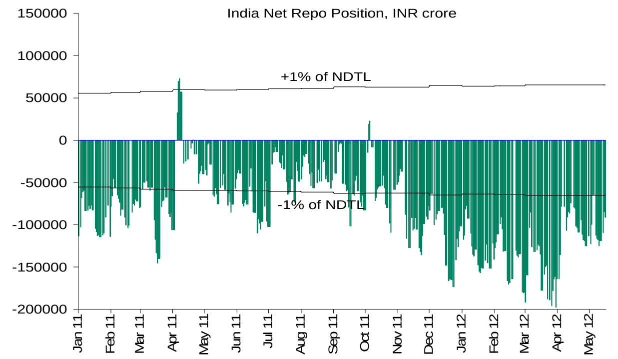
Chart 9: Balance of Payments 'Deficit'



Source: BNP Paribas, Reuters EcoWin Pro

Lower FDI plus stalling 'hot money' flows left capital inflows far short of financing requirements. India's balance of payments swung into 'deficit' (at USD 5.1bn), for the first time since 1995, meaning it was drawing down its reserve assets.

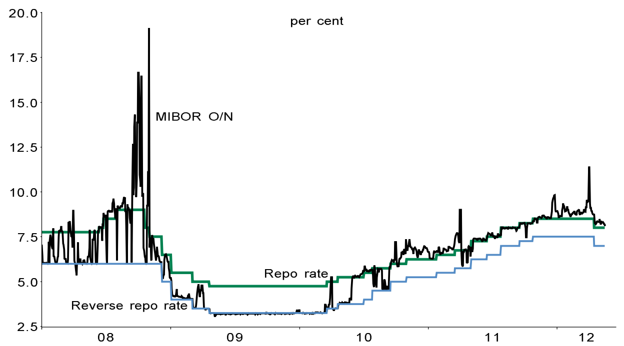
Chart 10: Liquidity Strains



Source: BNP Paribas, Reuters EcoWin Pro

Continued heavy government borrowing has worked to sustain if not intensify India's liquidity problems. The net liquidity deficit in the banking system has consistently been running over INR 1trn, far above the RBI's comfort level.

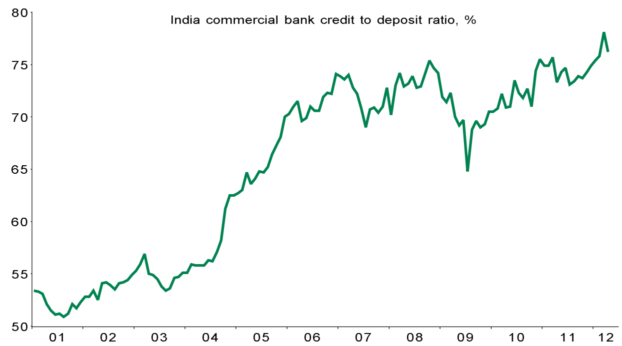
Chart 11: LAF Corridor



Source: BNP Paribas, Reuters EcoWin Pro

Consistent with persistently tight domestic liquidity conditions, the inter-bank overnight rate has failed to fall back within the RBI's liquidity adjustment facility corridor after a seasonal tightening during March.

Chart 12: Bank Credit-Deposit Ratio

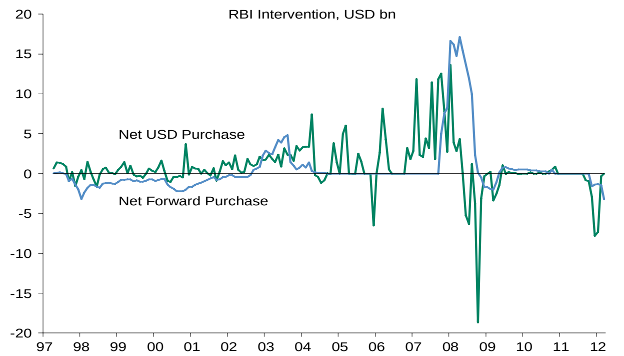


Source: BNP Paribas, Reuters EcoWin Pro

The commercial banking sector's credit-deposit ratio hit a record 78.1% in March before edging down in April. This suggests any genuine interest rate cuts risk intensifying the loan/deposit imbalance and hence banks' reliance on inter-bank funding.

India: The Fall of the Rupee – III

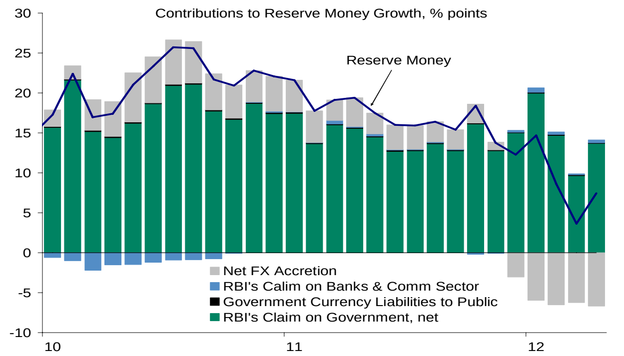
Chart 13: FX Intervention



Source: BNP Paribas, Reuters EcoWin Pro

Structural liquidity deficit in the banking system has prompted the RBI to intervene in the forward market in addition to the spot market. The RBI was said to have intervened again last week after it announced it would conduct another round of OMOs.

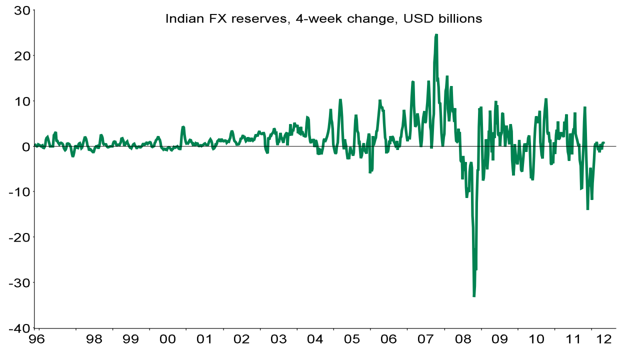
Chart 14: Reserve Money Growth



Source: BNP Paribas, Reuters EcoWin Pro

FX outflows over the past year coupled with a cumulative 125bp cut in the CRR since January have seen reserve money growth fall to the lows since the global financial crisis and broad money slide below the RBI's indicative trajectory.

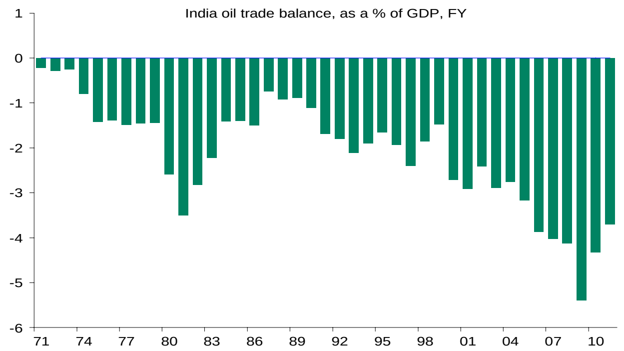
Chart 15: FX Reserves



Source: BNP Paribas, Reuters EcoWin Pro

Weekly data suggest the pace of reserve depletion has stabilised of late, indicative of India's borrowing requirements broadly met. Whether this reflects reviving capital inflows or a narrower current account deficit or both is far from certain, however.

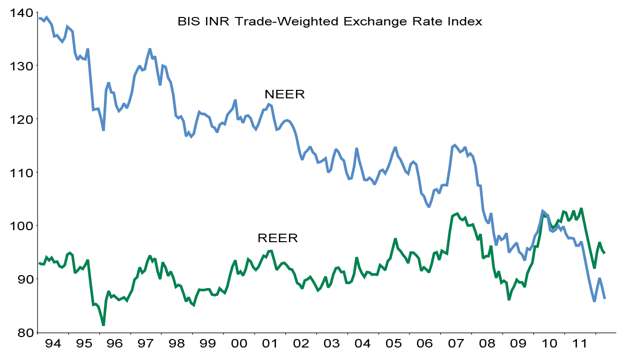
Chart 16: Oil Trade Balance



Source: BNP Paribas, Reuters EcoWin Pro

However, with the Indian economy a substantial net oil importer with oil trade deficit worth around 4% of GDP, the recent retreat of global oil prices could be a key escape valve, at least in the near term.

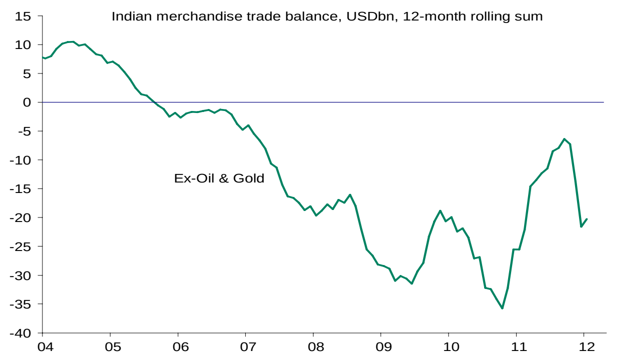
Chart 17: REER vs. NEER



Source: BNP Paribas, Reuters EcoWin Pro

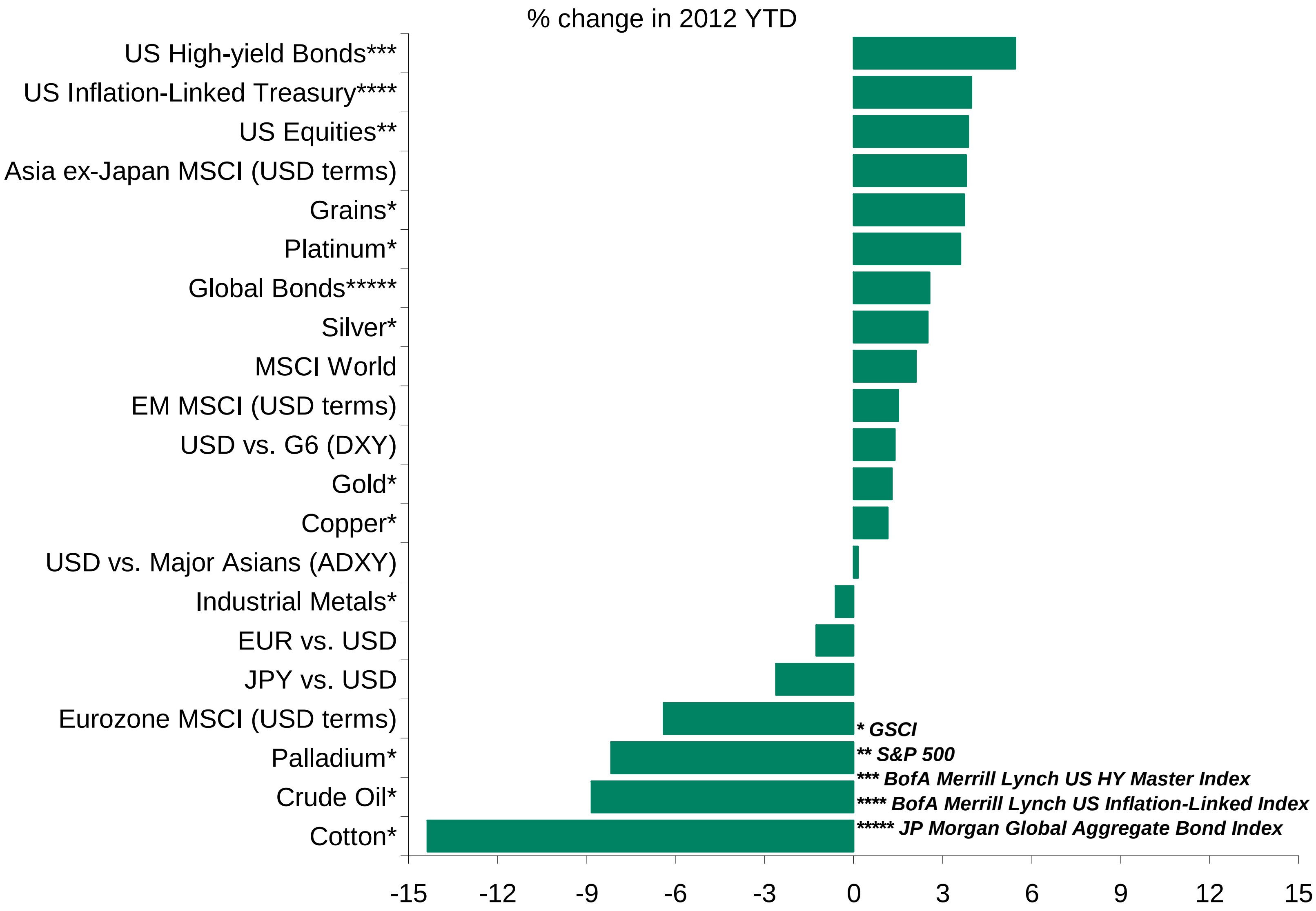
The slide in the NEER indicates autonomous weakness of the INR. But, on an inflation-adjusted basis, there is no apparent evidence that the INR is 'undervalued'. Rather, it appears just correcting its previous overvaluation.

Chart 18: Loss of Competitiveness

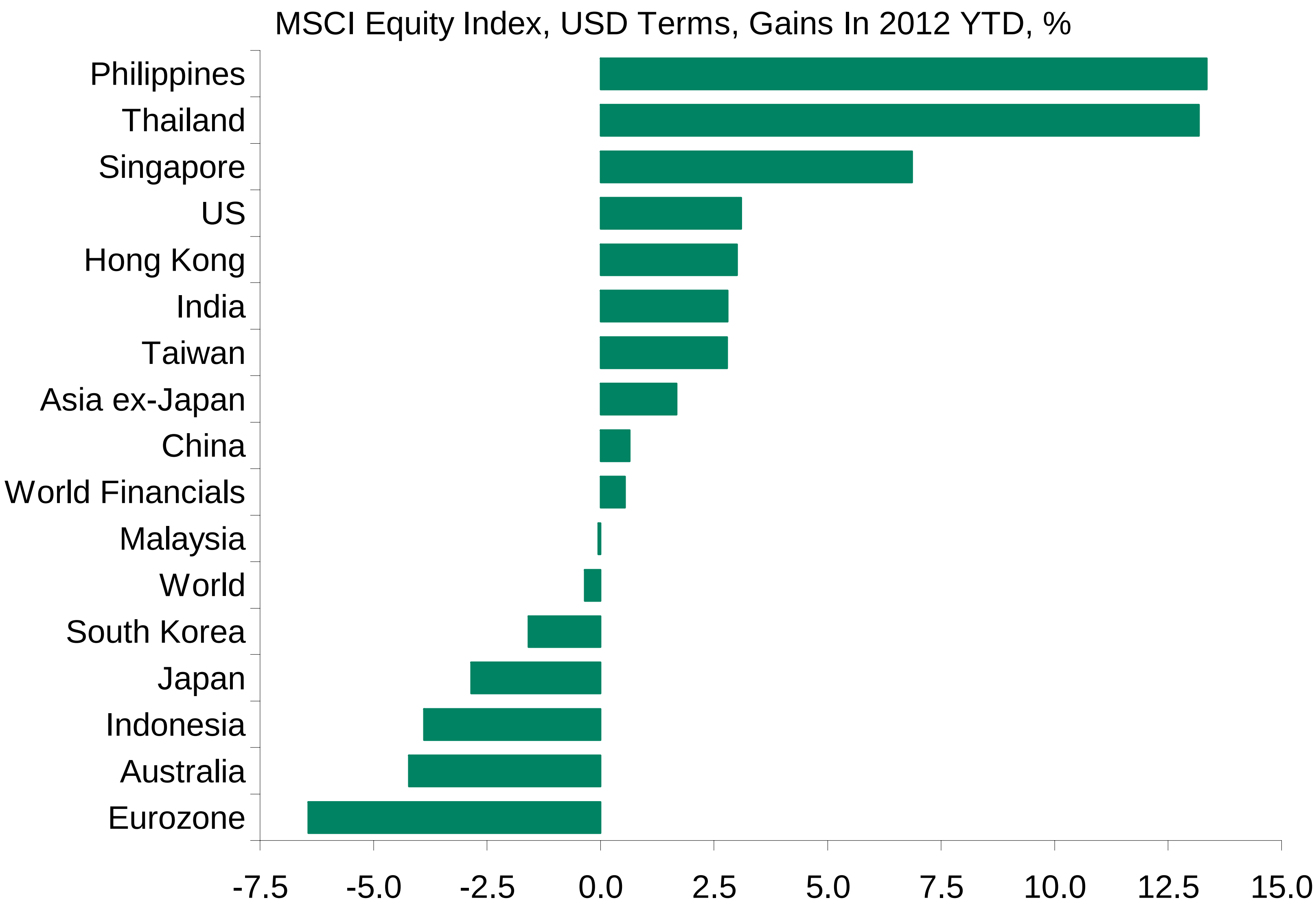


Source: BNP Paribas, Reuters EcoWin Pro

The deterioration in the ex-oil, ex-gold goods trade balance taking hold is consistent with the previous sharp real appreciation in the INR. The nominal depreciation thus should help restore some competitiveness back to India's external sector.

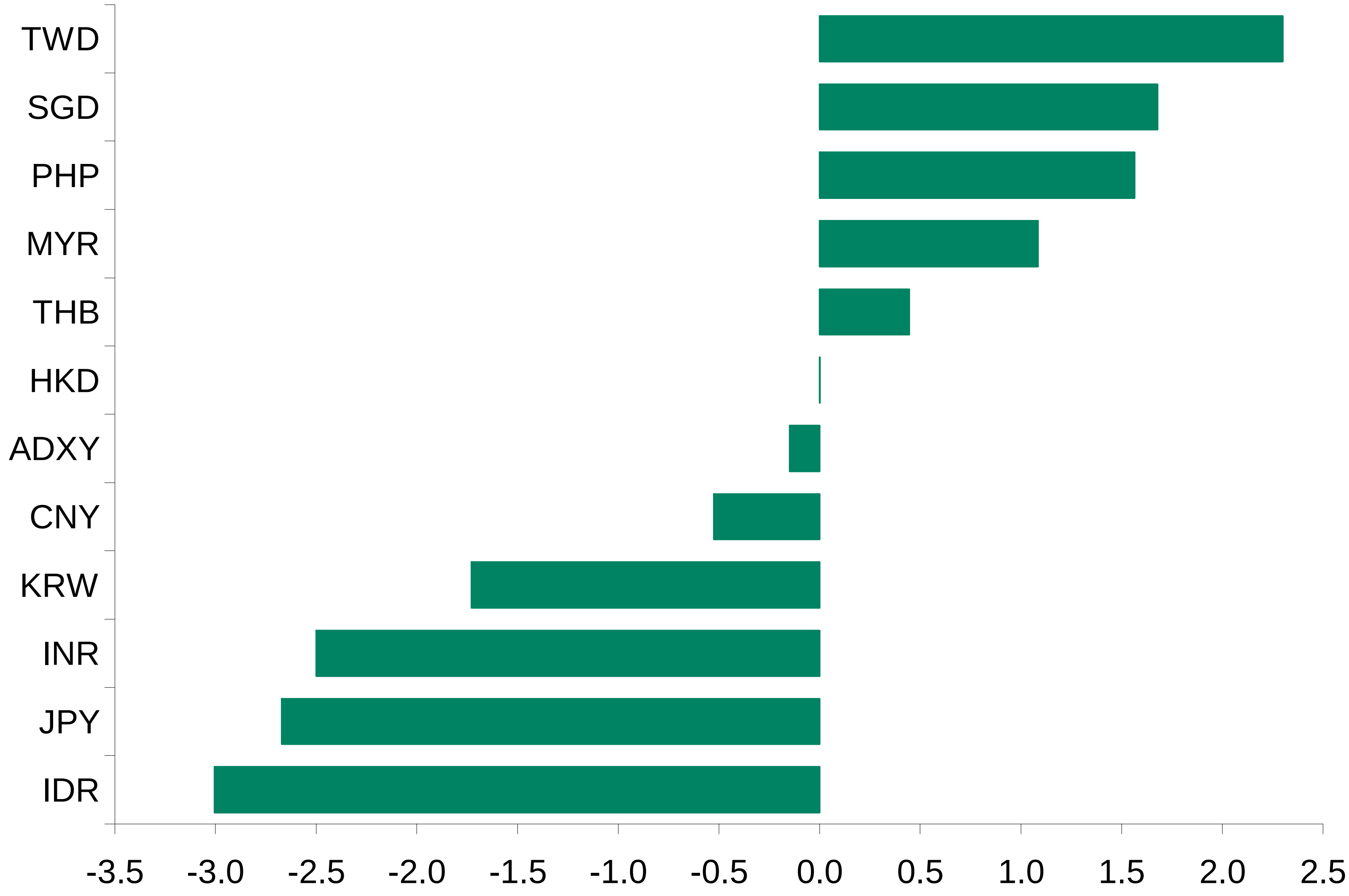


Source: BNP Paribas, Reuters EcoWin Pro



Source: BNP Paribas, Reuters EcoWin Pro

FX changes against the USD, %, 2012 YTD



Source: BNP Paribas, Reuters EcoWin Pro

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