<u>Commandments of Character</u>

By Dr. David M. Kohl

Many in the agriculture industry want to know the extent and duration of this economic downturn. Lenders are spending more time in crucial conversations and monitoring strategies as they help their customers adjust to the realities of today's economics. As one seasoned agricultural lender stated, "This is the character building part of the economic cycle." Actually, an increasing amount of lenders have expressed concern that numbers and risk rating systems are being too heavily emphasized, marginalizing the element of a customer's character in the lending equation. What an interesting observation. Let's examine some of the variables that have little to do with the financial ratios or credit scores, but can indicate whether an account is performing. While not an exhaustive list, one could call these the Commandments of Character.

First and foremost, on this list is honesty, which also includes ethics. For example, the assets and liabilities reported on the balance sheet should be verifiable and within the zone of accuracy. This year, a lender shared that one customer falsified the bushels of stored grain on the balance sheet. In actuality, the bins were filled with chopped straw and sand. In another example, a mother and father settled numerous open accounts on behalf of their son. Basically, the business financials deteriorated rapidly, and as a new manager, the son was unable to correct and minimize the losses. As the co-signer for all the loans, this young man's parents worked extra jobs to pay back the bank over the next three years. In both examples, from a lending perspective, the exhibited character is extraordinary; just on opposite ends of the spectrum.

Clearly, honesty and ethics also carry into business dealings. While difficult economic times call for creativity, practices like selling a secured asset under another's name to avoid income taxes or repayment of debt obligations does not qualify, nor is it the type of cost adjustment an individual with solid character would make. Commonly, lenders note that those with questionable judgment and character make capital purchases from operating loans without notification to the lender. In one case, the same set of livestock showed up on multiple sites as an attempt to verify numbers on the balance sheet. Of course, a practice like cutting family living costs to improve business cash flow shows character strength and a resilient business. Thus, whether negative or positive, the manner in which one conducts business is an extension of one's character.

Another sign of character is one's willingness to accept responsibility. When a financial issue arises, the responsible producer uncovers the problem and makes a plan for correction. This individual would meet with the lender and solicit support from a spouse, partner, and other advisors. In stark contrast, some individuals fight the problem, refuse responsibility, and blame anyone and everything for the shortcomings on their balance sheet; instead of themselves. Playing the victim is a telling character trait, and frankly not a desirable one in the lending equation.

A few additional character traits to watch are fear, greed and pride. In fact, these have been called the three major motivators for all actions in life. And for some, these factors trigger the undisciplined pursuit of more, which can range from growth in the business, to excesses in lifestyle, to the purchase of nonproductive assets, and materialistic pursuits.

Even though downcycles may tempt practices that compromise character, an individual with poor character will exhibit marginal judgment in any cycle. On the West Coast, false tax documents appeared during the recent commodity supercycle with producers attempting to hide income and avoid taxes. While the capabilities of technology can produce perfect fake documents, it is one’s character that determines the perimeters of use and application.

Recently, one telling place to observe character is in the quick and easy debt; otherwise called credit cards. Monitoring in this area can help to determine lifestyle, budgeting discipline, and purchasing restraint. Similarly, saving practices can also be a sign of character. Of course, this can be easily spotted on the balance sheet for the business, or personally. I sometimes call this a “98% rule.” That is, if a person has a disciplined habit of savings, there is a 98 percent probability that customer will meet debt obligations. However, like any rule, there is a common exception. Those with high incomes allow their strong earning power to lure them into more extravagant lifestyles, but without the stellar financial management required to maintain such a living.

Undoubtedly, there are numerous other telling Commandments of Character, but this list provides some of the practices that strongly indicate whether an account will perform, as assessed outside of the numbers. Of course, ratios and numbers will always be part of the lending equation, but experienced lenders know to look for more. If nothing else, it certainly would be interesting to develop a list of preferred character traits or adjustments that should be part of a business’ improvement plan.

Management Tip:
Don’t forget to sign up for the ABA American Banker Agricultural Conference in Milwaukee, Wisconsin in mid-November. The Sunday session cosponsored by Farmer Mac and FINPACK will be a must-attend event.

Domestic Economy

The U.S. economy is now approaching 100 consecutive months of economic expansion, moving towards the second longest expansion period in history. Despite the duration, economic growth has not been stellar as in previous expansions, and has averaged only 1 to 2 percent GDP, which is half of the normal expansion growth rate. Some call this economy "the plow horse economy" because it is just plodding along.

The real question is what will tip the U.S. economy into a recession. There is an old saying that economic expansions do not die, but are killed off by unexpected changes. Historically, the U.S. Federal Reserve's policy changes such as raising interest rates to soften both inflation and economic growth have halted the expansions. Currently, inflation is tame and economic growth has been very modest, which makes such Federal Reserve action unlikely.

Since World War II, oil shocks have been a major factor in stalling economic expansions. Today, America is less dependent on oil from OPEC, making oil shocks less of a factor. Yet, a major correction in the stock market could be a significant influence. And the impact of the wealth effect on consumer spending remains a significant force. Specifically, with equity and real estate markets continuing to appreciate at a good pace, this could be a clear and present danger if a correction should occur.

Of course, issues in the White House, along with military tension in Asia, and poor trade negotiations could be other factors that make negative growth a possibility for the U.S. economy.

While the aforementioned issues are factors to watch carefully, the dashboard of economic indicators point towards a solid economy. The LEI (Leading Economic Index) has been extremely positive since January, increasing nearly 3 points. The LEI diffusion index, comprised of the 10 factors making up the LEI, is strong at 85 percent. The weaker dollar against the euro and the yen has been a positive attribute to industries dependent on exports. Of course, those importing goods and services are finding increased costs on the other side.

Oil prices are steady in the high $40 per barrel range. This is good for the consumer, as well as for industries with major dependence on oil.

The Purchasing Managers Index (PMI), a leading economic factor, remains strong at 56.3. In fact, 90 percent of the major economies around the world have a PMI above 50, indicative of a growing economy.

The unemployment numbers illustrate a tight labor market at 4.3 (U-3) and 8.6 (U-6). Wage inflation has been buffeted by the movement toward mechanization and the use of robotics.

The housing industry is still mired in a very modest growth mode just under 1.2 million housing starts annually. A shortage of starter homes, as well as those that are modestly priced has curtailed growth in this important segment of the U.S. economy.

Factory capacity utilization still remains quite strong in the high 70s range. Those exporting factory goods are seeing a rebound as a result of the weaker dollar and stronger global economic growth.

The Index of Consumer Sentiment by the University of Michigan is still above 90, which is extremely positive as consumption drives over two-thirds of the U.S. economy. With core and headline inflation both at 1.7 percent along with GDP growth around 2 percent, it is doubtful that the Federal Reserve will aggressively raise interest rates. However, we might see one more interest rate increase this year.

Global Economy

The news on the global economy is the rebound of economic growth in the Euro region which represents 25 percent of the world economy. Additionally, Japan, which is the third largest economy in the world, is experiencing stronger rates of growth as well.

China's growth rate is in the mid-six percent range. The Chinese government is watching real estate closely and curbing the use of debt, which, if left unchecked, could create a real estate bubble. In the coming months, watch the outcomes of German elections. Chancellor Merkel is now one of the most tenured world leaders and a champion of globalism. In summary, geopolitical and military tensions could loom large for the economy going into 2018.

Lender and Business Dashboard Economic Indicators (for the month of July)

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	128.3	✓		
LEI Diffusion Index	85%	✓		
Purchasing Manager Index - PMI	56.3	✓		
Housing Starts (millions)	1.155		✓	
Factory Capacity Utilization	76.7		✓	
Unemployment Rate	4.3%	✓		
Core Inflation	1.7%	✓		
Headline Inflation	1.7%	✓		
Oil Price ($/barrel)	$49.97	✓		
Yield Curve	1.22	✓		

Lender and Business Dashboard Economic Indicator Benchmarks

Indicator	Green	Yellow	Red
The Conference Board Leading Economic Index® - LEI	Increasing	Flat to Decline	Decline 0.3% for 3 consecutive months AND >1% over the period
LEI Diffusion[1]	>60%	40%-60%	<40%
Purchasing Manager Index - PMI	>50	41.7-50	<41.7
Housing Starts (millions)	>1.5	1.0-1.5	<1.0
Factory Capacity Utilization	>80%	70%-80%	<70%
Unemployment Rate	5%-6%	6%-8%	>8% or <5%
Core Inflation	0%-2%	2%-4%	>4% or <0%
Headline Inflation[2]	0%-4%	4%-5%	>5% or <0%
Oil Price[3] ($/barrel)	<$50	$50-$100	>$100
Yield Curve[4]	Steep	Flattening	Inverted

[1]Ten indicators make up the LEI - measures % that are increasing; [2]Includes food & energy;
[3]Consumer's perspective; [4]3-Month Treasury Bill rate to 10-Year Bond rate