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Potential Storm Clouds on the Horizon

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On a rainy day in June with a break in harvesting hay and other timely chores on the farm, it is time to sit back and examine potential economic and financial storm clouds on the agricultural horizon. Let's draw upon survey results from the 31st annual Southeastern Agricultural Lenders School and a recent Farm Credit University Commercial Ag Lender class face-to-face session. While this list is not exhaustive, it does provide some points to ponder.

Loss of Government Supports

Loss of government supports was a risk high on the list of these lenders, since many of them reside in the Southeast, Southern Plains and the Mid-Atlantic states. While many sectors of agriculture have made the adjustment to reduced support, others will face the full brunt of this in their cash flows and income statements in 2014 and beyond. Lenders will need to sensitivity test for these adjustments and ask tough questions regarding how producers will strategize to alter management and operational tactics to accommodate these changes.

Input Prices

Ag lenders indicated that inflation creep of 3 percent to 8 percent as a result of high input cost, real estate taxes, and cash rents is resulting in margin compression. While core and headline inflation are still close to 2 percent in the U.S. general economy, the agriculture sector, which has had some stellar economic times, has experienced much higher levels of inflation. With commodity price reductions, negative margins are now being observed in some industries and inflation only compounds the matter.

The Livestock Sector is Crazy

No, this is does not refer to the old Patsy Cline song, but the theme fits. With the recent run-up in prices of beef, swine, and dairy, emotional behavior has kicked in resulting in irrational exuberance, as former Federal Reserve chairman Dr. Alan Greenspan used to remark about the red-hot stock and housing markets. Grassland rent at $500 per acre, $2,500 to $3,000 per cow-calf pair, and high dairy cow prices as a result of strong milk prices concern many of the ag lenders lending to those sectors. Yes, one or two years of strong prices can be expected; however, it will be critical to ensure high prices do not cause consumer demand destruction or disruption of trade relations with importers of U.S. agricultural products. Are producers making long-term decisions based on a short-term windfall of profits? Also be aware of the new kids on the block, i.e. novice producers desiring to make quick money in these sectors. Remember, often it is the good times, not the tough times, which get your customers into financial difficulty.

Relaxed Underwriting Standards

Strong profits in the agriculture sector along with reduced demand for debt and new entrants in the ag lending market are creating the perfect convergence of events for difficulty. Collateral lending with high land values is alive and well in some regions of the country as lenders attempt to either gain back or increase market share in agricultural portfolios. Super equity loans for operating money on 5-year up to 20-year payback terms with fixed rates are new products on the block, reminiscent of home equity loans a decade ago. Sound underwriting with an emphasis on profits, cash flow, and liquidity need to be adhered to in this volatile, cyclical marketplace where there is an economic or financial surprise around every corner.

Alpha Dogs and Alpha Pups

Large, aggressive agricultural producers with a “pedal to the metal” mentality, referred to as alpha dogs and alpha pups, are now experiencing some adversity with the softening of commodity prices in some sectors. These producers are often a large part of the ag lender’s portfolio and major influencers in the community, sometimes serving on boards as well. Their strategies work very well in the uptick of the economic cycle. Now a strategy of focusing on efficiency or eliminating some of the unprofitable entities will be top priority with this group. The savvy ones will work with their lenders to make adjustments, while others will resist. This will probably necessitate revisiting the 96-4-50 rule. That is, 96 percent of your portfolio will perform very well during good and bad times, but you will spend 50 percent of your time, money, and effort with the 4 percent of your customers who have difficulties, which is often some of these wounded alpha dogs and alpha pups.

Interest Rates and Land Values

When will the shoe drop in interest rates and land values? Interest rates appear to be remaining low and steady, which is good news for operating money. The wild card is land. Anecdotal evidence suggests land values and cash rents are off 1 percent to 5 percent in some regions, but remain steady to slightly up in others. There is a small probability of a crash when you contrast it to the 1980s because this is not a credit bubble, but an asset bubble. That is, more equity and cash are in the game, resulting in more flexibility and resilience, particularly if producers have liquid assets and they do not have to sell land at discounted prices. Crop insurance has placed a floor on the values also. If commodity markets exhibit negative margins for multiple years, interest rates rise, biofuel mandates soften, and regulators cause the tightening of credit, particularly on the operating side, a major adjustment may occur.

By no means is this all the dark clouds on the economic horizon, but a few that can be discussed in board and management planning meetings this summer, or also in informal and formal conferences in your shop. I challenge you to post this list and then develop your own list and add your variables as well as you do strategic planning.

<u>Lender Tip</u>: Alpha Dog and Alpha Pup

A question came from a young lender about dealing with an alpha dog and pup:

How do you effectively manage a large lending relationship with a borrower who is a major influencer in the community who has begun to struggle with the farm and financial management?

Very carefully! Historically, I have seen this type of customer attempt to bully and intimidate young lenders. The best strategy is to tag team with another lender. Focus on the facts, numbers, and the trends. Have a meeting agenda and document major points, actions, and deadlines from the meetings. Sometimes a team of advisors can be also an important step in communicating with this type of customer.

Global Economics

Now the world hotspots have moved from Ukraine to the Middle East, particularly Iraq. It appears that Iraq is losing control politically again, which is impacting oil prices. A close eye on oil prices must be maintained as many of the expenses in farm and rural areas are linked to this important variable. Consumers, both domestic and abroad, are sensitive to changes in oil prices. If oil prices were to sustain above $120 a barrel, then lower economic growth in the U.S. and abroad could be expected. A point to keep in mind is that every recession since 1969 has had a relationship with increased oil prices, so only time will tell.

The European Central Bank just lowered rates and is now charging interest on deposits as a method to move short-term investments in these deposits into the economy to encourage growth and consumer activity. Slow economic growth with the possibility of deflation threatens Europe, which represents about a quarter of the world economy.

In the Asian region, Japan's quarterly economic growth was 6 percent plus. It remains to be seen whether stimulus policies in that country will sustain this strong growth. China's growth is still in the 7 percent range, significantly lower than the go-go years a decade ago. China continues to import milk, pork, and some other commodities from the U.S. which bodes well for those sectors. Other emerging region's economies are still exhibiting moderating growth. The World Bank recently reduced its growth expectations for the global economy.

Domestic Economics

The leading economic index (LEI) and its diffusion index as well as the purchasing manager index (PMI) indicate growth for the U.S. economy, which should be modest to strengthening in the second and third quarter. The PMI is in the mid-50s, suggesting strong growth signals.

Oil prices and increased militant activities in Iraq need to be closely observed. Consumers, who drive much of the U.S. economy, are very sensitive to higher oil prices. Consumer sentiment is marginal at best right now.

Housing starts, bedrock to the U.S. economy, are now above 1 million starts again, but they still have a long way to go before this sector is stellar. Young people's university debt, higher interest rates, and regulation are a drag on the sector.

Factory capacity utilization still remains quite strong in the high 70s. Both core and headline inflation are benign, generally around the 2 percent metric established by the Federal Reserve.

Unemployment reports indicate a 6.3 percent headline unemployment rate, but the U-6 rate is 12.3 percent. The Federal Reserve is keeping a much closer eye on U-6 rates before making any adjustments in interest rates.

Finally, first quarter GDP growth was -2.9 percent. Two quarters of negative growth generally indicate a recession. Many economists blame the weather, but could it be the foreteller of something more than Mother Nature? The lead indices say no, but there are many who say positive growth for the second and third quarters may be subdued as a result of regulation, slowing growth, and external shocks, like oil.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	101.7	✓		
LEI Diffusion Index	85%	✓		
Purchasing Manager Index - PMI	55.4	✓		
Housing Starts (millions)	1.001		✓	
Factory Capacity Utilization	79.1		✓	
Unemployment Rate	6.3%		✓	
Core Inflation	2.0%	✓		
Headline Inflation	2.1%	✓		
Oil Price ($/barrel)	$106.45			✓
Yield Curve	2.44	✓		

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