FARMER MAC

# DAVE'S GPS

08/28/14

**Q & A with Dr. Dave**

By Dr. David M. Kohl

In early July, Farmer Mac hosted a webcast to build upon the bimonthly Dave's GPS articles and provide timely information on the wild world of global agricultural economics. Over 400 individuals signed up for my live webcast. Many of you who I have seen in this summer's banking schools and conferences since then indicated that you utilized the webcast in conjunction with your board and producer advisory meetings to stimulate thought and discussion. This webcast was a classic example of how time and dollars can be leveraged in the quest to stay abreast of the rapidly changing economic environment.

I was not able to answer all of the questions asked during the webcast, thus the focus of this article is to address some of those questions and build upon some of the top intriguing questions asked at this summer's banking and lending schools.

- **Is speculative money influencing commodity markets and impacting agricultural land values?**

The answer is yes. From an international and domestic perspective, investors are flush with cash and looking for a quick rate of return on investment in the markets, whereas in land, they are looking for sustainable return over time. Speculative managers quickly move in and out of the markets for commodities such as corn, wheat, soybeans and oil. This has resulted in wide swings and volatility of prices both on the output and input sides. The world of high technology accentuates this volatility on a daily basis as little bits of information, i.e. weather, mini wars, or Federal Reserve and central bank action, can quickly move markets spurred by big block money.

Concerning long-term speculative money or patient capital used by hedge funds and institutional investors, the goal has been a 4 percent return. Big block investors target large real estate acreage that can be easily managed by local or national agricultural management organizations. This money recently has taken a hiatus with the decline in corn, bean, and wheat prices.

Other speculative money comes from the local level. In energy rich regions, small block investors flush with cash are investing in farm and rural real estate seeking a return.

- **What will be the effect and future of GMO commodities?**

Consumers in rich countries in Europe and North America, as well as Japan and some regions of emerging nations have gone “food crazy.” Consumers want to know what they are eating, which unfortunately does not often result in better eating habits, i.e. junk food, etc. Society as a whole is becoming more aware of GMOs (genetically modified organisms). However, there are groups that desire GMO-free products. GMOs have a place in the agricultural industry and will be more accepted as time goes on. Statistics show the growth of local, natural and organic agricultural products, which suggests that these markets are alive and well in some of the states that have banned GMOs. The bottom line is the future of the food and fiber market is not “one size fits all.” In the future, GMOs and other technologies will be used in trade negotiations, which have been observed recently. Increased leverage will be used by negotiators to integrate food issues into military and political aspects between countries, building another case that markets can be given and can be taken away in a heartbeat, which increases volatility.

- **Could you define shadow banking?**

Shadow banks are often organizations and institutions that look and feel like a bank to the public, but are not. Often relaxed regulatory processes and practices result in major financial crises, i.e. Lehman Brothers a few years ago in the great recession. As a side note, over $1 trillion of shadow banking loans reside on this side of the ledger in China which concerns experts. Large financial reserves in China may actually buffer a collapse of their shadow banking system.

- **If the cycle makes an abrupt change downward like many are predicting, the more leveraged and higher overhead operations may experience failure and distress. Will agricultural producers and lenders be bailed out again, similar to the 1980s?**

This is a tough question. It depends on the on the abruptness and duration of the downturn whether it impacts the stability of food, fiber, or fuel production. A general response is a resounding “no” because the government has a large amount of debt. Second, the general public and politicians, who are further disconnected from agriculture than they were in the 1980’s, will have less resolve to come to the rescue.

- **How important is it to monitor the components of working capital, including the value of livestock and crop inventory?**

Many ag economists, including myself, have been stressing working capital when meeting with lenders and producers. The traditional standard for liquidity is a 2 to 1 current ratio, or working capital of 33 percent of revenue or expenses. An emerging trend in liquidity analysis is to equate crop and livestock inventories to operating lines of credit, accounts payable, and other current liabilities. This analysis will be critical in the coming years because a decline in prices of grain commodities that were not price

protected could reveal issues. On the livestock side, it will be imperative to monitor the ratio of inventory to borrowing base in the red-hot markets.

- **What is an acceptable burn rate for working capital?**

Burn rate for working capital is the number years of negative margins on the income statement that it takes to eliminate working capital, the back up to cash flow. A one or two year burn rate will certainly provide some flexibility for both lenders and producers. If the burn rate goes to zero, then the refinancing alternative utilizing net worth will be a possible next solution. However, analyzing the level of working capital and its burn rate provide flexibility to change production costs and management practices to circumvent refinancing using equity.

- **Are producers' financial records getting better?**

Yes and no. There is a certain segment of producers who "get it," and the other group seems to be in a time warp in the 1970s just before the financial crisis. More lenders are providing workshops and educational opportunities on financial records and are offering reduced rates and attractive terms to get producers to provide better records. Another key to get better records will be an economic downturn creating a teachable moment. Use these records as a tool to show how better management of the business can come about through a crisis.

- **Land values, land values, land values! How will they change?**

This is the triple digit question on the webcast. Marginal land with reduced efficiencies and potentially poor soil classification is taking a discount. Older landowners are realizing the red-hot market in some areas is softening and desire to sell. Values of good quality land, though, are still quite solid.

- **What concerns do you have with net operating loss?**

This year could be ugly for some producers on the grain side of the agriculture industry. Issues will occur if there are multiple years of operating losses, losses accelerating out-of-control, or big numbers on large producers who aggressively built businesses through renting, leasing or buying land. The key will be to closely monitor projected profits and cash flow statements and make strategic and tactical adjustments, particularly on the cost side with fixed cost.

These were some great questions. I will be looking for some more questions during the next webcast hosted by Farmer Mac in January 2015.

**Lender Tip: Omaha!**
Get ready to pack your bags and head to Omaha, NE for the American Bankers Association National Agricultural Bankers Conference in November. Insight into the sessions and speakers suggest a stellar conference, and an exciting preconference

session hosted by Farmer Mac and FINPACK. It is not quite like going to the College World Series or an "Omaha" audible by Peyton Manning, but previous conferences at this location have not disappointed!  See you in Omaha!

Let's examine the global and domestic economies using a stoplight approach where green light represents little risk; yellow light indicates moderate risk; and red light means high risk. The assessment will be based on words and numbers influencing economic growth and equity markets.

## Global Economics

One of the largest risks in the red light area is geopolitical risk. One has to look no further than Ukraine to ascertain the impact on economics, the agriculture industry, and equity markets. Recent sanctions imposed on Russia by the Western nations have impacted agricultural sectors in the U.S. and Europe such as soybeans, dairy, and vegetables. News of any escalation of conflict quickly is observed in the equity markets as well. Europe and particularly Germany, which is teetering on the brink of recession, will be very vulnerable to further change in political and military situations in close proximity to their borders.

The Middle East tension beckons watching for further escalation and involvement. Both the Middle East and Russia are major energy producers and with fall and winter fast approaching, future prices could change rapidly impacting economic growth and financial markets. So, European economic growth is moving into the red index.

China on the other hand is in late green or early yellow light status. Stimulus is now being delivered to the sluggish housing industry, which bears watching over the next few months. Recent economic growth is reported to be approximately 7.5 percent, lower than in recent years. Recent purchasing manager index (PMI) numbers reflected growth of the economy, a positive green light. In the long run, however, natural resource and environmental issues will inhibit growth and will be the story of the remainder of the decade.

Watch Argentina, Brazil, and Portugal for both economic and possibly political uncertainty. Each of these nations grade yellow concerning risk, and could quickly be a red light if defaults and political dissension occur.

## Domestic Economics

The lead economic index (LEI) and its diffusion index, along with the PMI suggest growth in the next six months, as they are lead economic indicators and would be considered in the green light status. The LEI has been up significantly since January, by nearly 3 points and its diffusion index has averaged in the high 50 percent range. The PMI has been strong since the first of the year, coming in at 57.1 for July, indicative of economic strength moving forward.

The number of annual housing starts, a critical component of the U.S. economy, is in the yellow zone, although they are picking up, at 1.093 million for July. The ideal rate of housing starts is between 1.1 million and 1.5 million. This will be promising going forward if the upward trend continues.

Factory utilization is quite strong in the yellow range. Will be interesting to see how exports, auto sales, and the domestic economy influence this metric into the future.

The reported unemployment rate (U-3) is 6.2 percent and it is 12.2 percent including U-6 workers, placing this metric in the yellow light region. Yes, jobs have been created; however, average hourly earnings have remained flat and workforce participation rate is just under 63 percent, the lowest rate in 35 years, which would place this metric in the yellow light region.

There is a balancing act between inflation and economic growth. The U.S. GDP growth rate moved up to 4.2 percent for the second quarter and recently was revised up to -2.1 percent for the first quarter. Watch these metrics in the green light area for possible signals concerning interest rates.

An unemployment rate of 5 percent, a 3 percent to 4 percent GDP growth rate, and an inflation rate of 2.5 percent would be a 1-2-3 punch for a possible interest rate increase. Only time will tell.

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

| Indicator | Current | Green | Yellow | Red |
|---|---|---|---|---|
| Leading Economic Index - LEI | 103.3 | ✓ | | |
| LEI Diffusion Index | 70% | ✓ | | |
| Purchasing Manager Index - PMI | 57.1 | ✓ | | |
| Housing Starts (millions) | 1.093 | | ✓ | |
| Factory Capacity Utilization | 79.2 | | ✓ | |
| Unemployment Rate | 6.2% | | ✓ | |
| Core Inflation | 1.9% | ✓ | | |
| Headline Inflation | 2.0% | ✓ | | |
| Oil Price ($/barrel) | $105.21 | | | ✓ |
| Yield Curve | 2.53 | ✓ | | |

### 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