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**The Wild, Wild World of Global Economics**

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This article conjures up memories of the old TV show *The Wild, Wild West* with James West and Artemus Gordon. However, the wild, wild world focused on here is currently front and center with many producers and ag lenders, leaving them in a conundrum wondering what is coming next on the world economic front. The health of the euro sector and overall global economic climate are definitely top-of-mind. Many have asked me questions concerning how it could impact both short run and long run decision-making, as well as risk in ag lending portfolios. Let us examine this subject further.

First out of the gate, the global economies are in major transition. Developed countries such as Japan and those in North America and Europe have been or are now moving into the second decade of economic moderation. This is the result of elevated levels of public debt to GDP, an average of 78 percent, and the high cost of entitlement programs, such as Social Security, pensions, and healthcare. These programs were built in the strong economic times in the U.S., and by the Marshall Plan during the reconstruction of Europe and Japan after World War II. The aging population accentuates these obligations, particularly in Europe and Japan. All of these factors have been major drags on the developed countries' economies, placing these economies one "black swan" or unusual event away from a prolonged recession.

Contrast this to emerging nations, i.e. the BRICS nations of Brazil, Russia, India, China, and South Africa. These countries have experienced increases in standards of living by providing services and consumer items to the aforementioned developed nations. While the BRICS nations represent only approximately 20 percent of the world economy combined, they have contributed nearly 50 percent of the world economic growth since the year 2000. Of course, agriculture has benefitted in the U.S. because of their increased demand for food, fiber, and fuel.

Around every corner, bad economic news has been coming out of the European region. The European Union is made up of 17 nations that represent approximately 7 percent of the world population, but 25 percent of the world economy. The sector has benefited economically since its union, particularly Germany, which is the fourth largest economy in the world. These countries engaged well during strong economic times; however, the political divisions as a result of social unrest amongst these nations are raising tensions between them in distressed economic times. For example, Portugal, Italy, Ireland, Greece and Spain, commonly referred to as the PIIGS, have economic challenges. This has resulted in many of the European, and to some extent American, banking systems questioning the strength of loan portfolios in this region. The interconnections throughout the global banking system have resulted in wide swings in the equity markets worldwide.

Germany has led action in the euro sector to provide financial and economic assistance to these countries. However, it has resulted in reduced political popularity of the German government and its leaders, particularly Chancellor Angela Merkel. European countries have developed austerity programs and increased taxes to curb some of the economic woes, which has created social discontent in some regions, particularly Greece. Discussion has also led to the possibility of the breakup of the EU. The result has been a strengthening U.S. dollar, causing short-run declining commodity prices. Also, China has forwarded the possibility of a new world currency under the International Monetary Fund (IMF). If this occurs, it would create tremendous uncertainty and possible trade disputes, possibly resulting in a global economic slowdown, or more extreme volatility.

These events are situations that will require careful monitoring over the next few months, along with the slowing of the BRICS economies, specifically China where growth rate declined by nearly one percent in the last quarter. China's real estate market is overbuilt, and social unrest is arising throughout the country. Next year new leadership will take the reins. All of these variables place uncertainty in the global marketplace, but particularly agriculture in the commodity-driven “islands of prosperity” in the Upper Midwest and other regions of the U.S.

The year 2012 is a presidential election year in the U.S., during which political theatre will be played out concerning trade negotiations, funding of deficits, and our own handling of budget austerity, taxation, and regulatory reform. All of these elements provide a combustible mix of economic scenarios for any business or personal financial situation.

In summary, the global economies are so interconnected that an adverse economic event in one area results in a ripple effect throughout the global economic system. Some advice to lenders and producers is to strengthen your balance sheet, particularly the top half, with available working capital and cash. It will be critical to have a prudent risk management program inclusive of revenue, cost, and interest rates, which is executed and monitored in the stormy economic weather.

<u>Lender Tip</u>

In the upcoming renewal season, sensitivity analysis of cash flow, collateral, and liquidity will be critical. Shock test for extremes, i.e. a 20 percent decline in revenue and a 20 percent increase in cost. Regardless of Dr. Bernanke's pledge to keep interest rates low for the next two years, it is prudent to shock test a 3 percent increase in variable interest. With a large share of foreign-financed national debt, the level of interest rates may be out of the hands of the Federal Reserve. Margins could be tight if prices of commodities decline and built in cost structures of rented or purchased ground remain high, along with input costs, resulting in margin compression.

The major concern this fall will be whether the U.S. is headed for another recession or will continue to struggle with low growth rates. It looks like there is a low probability of the GDP growth rate returning to normal anytime soon. The lead economic indicators, the LEI, diffusion index, and PMI, would suggest a struggling economy. Housing starts at 658,000 annually still suggest a sector that is slightly over halfway back to normal. Large down payments and high unemployment are contributing to a very anemic housing sector, which is a large variable in the U.S. economy. Unemployment is reported at 9.1 percent, but when discouraged and displaced workers and those who have dropped out of the workforce (U-3 to U-6 workers) are included, the unemployment rate is 16.5 percent. Automation, regulation of business, and global political and economic uncertainty have played a critical role in high unemployment.

Factory utilization is at 77.4 and is just below full capacity for this component of the economy. Core inflation is at the Federal Reserve's target of 2.0 percent; however, headline inflation, which includes food and energy, has continued to increase and is currently at 3.9 percent, suggesting higher oil and food prices are squeezing consumers.

Oil prices have been stable to declining in the past two months as the dollar strengthened to the euro. At the $80 to $90 range per barrel is still high given slowing demand. Worldwide investors have driven short term Treasury rates down as a safe haven for the global economic storm. This will continue until other investments are more attractive.

The Federal Reserve has attempted stimulate the economy with Operation Twist. This is attempting to lower long term rates and raise short term rates. The bottom line is the economic buying power of American households is in decline. With higher inflation previously mentioned along with declining income, stagflation is a more prominent possibility.

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

| Indicator | Current | Green | Yellow | Red |
|---|---|---|---|---|
| Leading Economic Index - LEI | 116.4 | ✓ | | |
| LEI Diffusion Index | 55% | | ✓ | |
| Purchasing Manager Index - PMI | 51.6 | ✓ | | |
| Housing Starts (millions) | 0.658 | | | ✓ |
| Factory Capacity Utilization | 77.4% | | ✓ | |
| Unemployment Rate | 9.1% | | | ✓ |
| Core Inflation | 2.0% | ✓ | | |
| Headline Inflation | 3.9% | | ✓ | |
| Oil Price ($/barrel) | $103.11 | | | ✓ |
| Yield Curve | 1.90 | | ✓ | |

## 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