12/20/13

The Winds of Change

By: Dr. David M. Kohl

The winds of change on the agricultural economic horizon are analogous to an Alberta clipper combining with moisture from the South to bring warning of winter weather. This year's 63rd annual American Bankers Association National Agricultural Bankers Conference in Minneapolis, MN, had an overall feel of change on the horizon in the economics driving bottom line profits, cash flows, and balance sheets in the agricultural landscape.

John Blanchfield, of the ABA's Center for Ag and Rural Banking, and his team organized a stellar educational venue for bankers and others attending from approximately 30 states and seven foreign countries. This represents my 36th year of presenting, moderating programs, and attending as many sessions as possible to seek insight and information. This year I could sense a change coming in the economics of agriculture given the session topics, networking in the hallways, and discussion at exhibit booths at the convention. Here is a quick summary of some of the highlights.

Sunday's kickoff was a well-attended preconference session sponsored by FINPACK. Sessions were presented by Bob Craven and his team at the Center for Farm Financial Management at the University of Minnesota. The first fast fact that caught the attention all of the bankers is that FINBIN data, representing eight states and thousands of above-average producers, shows that the cost of production for corn for over half of the producers is above $5.00 per bushel. Yes, that is $5.00 per bushel for producers in this database who maintain good records and are considered above average in the general farm population! A farmer with no risk or marketing management program could likely face negative margins, which is a considerable change from previous years, since corn prices could realistically range from $2.70 to $5.00 per bushel.

Where are producers most vulnerable? Bob Craven presented another session during the conference on hard charging go-go farmers of recent years. No, it was not the debt levels, as one would suspect. The debt-to-asset ratio is 38 percent for the top 20 percent of producers ranked by ROA, and just above 50 percent for the bottom 20 percent of producers. The biggest area of concern given ominous economic storm clouds was working capital. The top 20 percent exhibited a median net working capital to revenue ratio of 52 percent, while the bottom 20 percent of producers had 17 percent net working capital to revenue. If multiple negative margin years are ahead, growing go-

go producers who are renting and leasing large amounts of farm ground versus owning land will be customers that must be closely monitored for negative consequences.

Discussion concerning land values and cash rents was the talk of the town at the Twin Cities convention. Dr. Jason Henderson and Dr. Brent Gloy of Purdue University, and Dr. Alan Featherstone of Kansas State University discussed some interesting perspectives concerning land values and farm debt concentration. Years of double-digit land value appreciation and exploding cash rents, particularly in the upper Midwest, appear to be waning. While some may be fooled that farm debt levels are not an issue; the concern of the speakers, particularly Dr. Featherstone, was that debt concentration, interconnectedness, and third-party counterparty risk are brewing variables.

As farmland market values are leveling off with possible re-entrenchment, the credit cycle is heating up with more requests to finance farmland and operating needs. A point that caught my attention was the stages of investment by producers. Early in the great commodity super cycle many producers invested in farmland, paying in cash and profits. The second stage included equipment and machinery purchases, and the third stage involves lifestyle investments. Sometimes I call these non-farm capital investments “killer toys.” Will the canary in the farm economy’s coal mine be reduction of farm equipment purchases by producers and fewer purchases being allocated for non-farm capital expenditures? Only time will tell.

After a 4:00 a.m. workout and shooting basketball at the great workout facilities, attendance at the early morning commodity sessions found discussion on economic change. To quickly sum it up, the grain industry is analogous to a baseball game in the late innings. On the other hand, livestock and poultry, particularly beef cow-calf operations, are on the rise or in the early innings of the game. Yes, economic cycles do still exist and prudent customers and lender management teams need to focus on riding out these cycles.

Transition management was another theme of the conference. I moderated an interesting session concerning growing the next generation of farm customers. Bankers and others discussed how their banks invest in educational programs designed for beginning and growing young producers. The panelists found this investment paid off with customers who gain higher levels of management skills and, from the bank’s standpoint, the bank enjoys a deeper understanding of customer needs and overall loyalty. Dr. Ron Hanson, of the University of Nebraska, did his usual good job in a session on the importance of succession planning with a focus on the human aspects and the role bankers can play.

The conference sessions also focused on internal banking issues. Stress testing portfolios based on land value decline shocks, industry concentration, programs to mitigate the effects of rising interest rates, and loan programs offered by FSA and Farmer Mac were well presented and attended. For the larger institutions, an outstanding session was presented on educating senior management about agricultural lending programs and how to take a stand and position agriculture as an important industry to non-farm executives.

It was my pleasure to present a session with Dr. Michael Swanson of Wells Fargo on global and domestic economics. Our conclusion was that macroeconomics suggests a slowdown, but not like the 1980s crash in agriculture. Both of us indicated that it is important to watch for a sequence of events to determine the degree and severity of change in the coming years.

A real highlight was listening to Dr. Barry Flinchbaugh of Kansas State University indicate the Farm Bill could possibly be passed by early next year, and the importance of combining the SNAP program with other agricultural policy to maintain the importance of agriculture to the nonfarm public.

Orion Samuelson, the famous farm broadcaster, was on top of his game presenting points from his new book, *You Can't Dream Big Enough*. Orion put a positive light on the future of agriculture drawing upon his deep historical perspective from working with world leaders. As a side note, his book contains a great historical perspective of agriculture in the past century in a narrative format.

Finally, the conference closed with Dr. Lance Fox, a large animal veterinarian from Wisconsin, who really dreamed big by scaling Mt. Everest. His theme was that you can only dream big by having a vision, teamwork, dedicated people, focus and goals. This is only a short rendition of the power packed conference. Please join me for next year's conference in early November in Omaha, NE. They get better every year!

Lender Tip: Sharing Knowledge

Leading lending institutions and businesses are requiring employees who attend conferences to compile a one page executive summary of bulleted key points they learned from the conference. These reports can facilitate important information and knowledge flow from outside the lending institution back to the organization. Some will actually debrief conference attendees either through webcasts, videoconferences, or conference calls as a way to spread information throughout the organization.

Global Economics

Economic moderation is well in place particularly in emerging nations including the BRICS (Brazil, Russia, India, China, and South Africa) and the KIMT nations (South Korea, Indonesia, Mexico, and Turkey). Many large multinational firms are cutting staff in China as the economy moderates and others are doing the same throughout the emerging regions. Average GDP growth rates are below 5 percent in countries in the emerging regions. China's GDP growth rate is 7.5 percent, which is strong by developed countries' standards, but it illustrates moderation when compared to the 10 percent plus growth rate China maintained during recent decades. The European region is struggling at slightly above recession levels with northern Europe doing quite well, while southern Europe is challenged by high unemployment and negative economic growth.

Domestic Economics

Turning stateside, the lead economic indicators are back after the government shutdown. The Leading Economic Index (LEI) and its diffusion index, which includes the ten factors making up this metric, are positive, indicating growth. The purchasing manager index (PMI) has been increasing in recent months well above 50, indicating a growing economy also. The caveat is whether Federal Reserve stimulus is the reason for these indicators' positive results. Now that the Fed has decided to start tapering its stimulus, it will be interesting to see if these metrics will stay strong.

The economic metric that was a real surprise is unemployment. A decline of 0.3 percent to 7.0 percent (U-3) and 13.2 percent (U-6) for November need to be closely watched in the coming months. The Federal Reserve indicated this level or slightly below would foretell a decrease in the amount of economic stimulus and possible increase in interest rates. Factory capacity utilization is strong at 79 percent, while core and headline inflation are tame at 1.7 percent and 1.2 percent respectively, which are well below the 2 percent guidelines of the Federal Reserve.

Another surprise was the last report of third quarter GDP at 4.1 percent. However, digging deeper finds much of this improvement was a buildup in inventories that must be sold to maintain sustainable growth. Housing starts just broke above 1 million annually in November, which is a positive sign. Watch the direction of the 10-year treasury rate, which is critical for improvement in the housing sector, since it is linked to mortgage rates. Should this rate rise above 3 percent due to central bank stimulus cutbacks, the result might be unsettling to this important sector of the economy.

In summary, the economy is not stellar, but muddling along with economic analysts focused on the Federal Reserve's action, and, of course, direction from Washington, D.C. on many legislative, regulatory, economic, and political fronts.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	98.3	✓		
LEI Diffusion Index	80%	✓		
Purchasing Manager Index - PMI	57.3	✓		
Housing Starts (millions)	1.091		✓	
Factory Capacity Utilization	79.0		✓	
Unemployment Rate	7.0%		✓	
Core Inflation	1.7%	✓		
Headline Inflation	1.2%	✓		
Oil Price ($/barrel)	$107.34			✓
Yield Curve	2.69	✓		

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