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<u>Where's the Risk in Agricultural Credit?</u>

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This title sounds like the catchy old television commercial from a couple of decades ago, "Where's the beef?" That being said, this is a very serious issue to management and loan staff of any institution serving the agricultural landscape. Let's examine the current state of the agricultural economy, specifically as it relates to credit risk.

Top of mind is the decline in land values, which comprise a large share of the U.S. farm balance sheet. There are four elements that could bear watching concerning land and structural asset values.

First is a possible decline in commodity prices, an increase in input prices, or a combination of both that would result in negative margins, cash flow, and profits. This would be devastating to areas of the upper Midwest in crop production. However, it would take multiple years of negative margins before declines in land values occur because producers are eternal optimists.

Regulatory and taxation policies at the federal, state and local levels of government should be monitored. Capital gains tax changes, along with estate and income tax revisions could result not only in negative cash flows, but higher taxation for the sale and transfer of assets. Many producers will see an increase in income taxes, especially those who have over $250,000 in net income. These "HENRY's" or "High Earners, Not Rich Yet," are those who have not had time to accumulate wealth or equity on the balance sheet.

Of course, with every major economy in the world devaluing their currency to expand export markets, this element truly needs to be followed closely. The possibility of currency wars, trade sanctions, or input and export tariffs could devastate an industry or a total portfolio if global markets lock up. The agricultural economy may be a victim of strategies used to protect other industries in the economy. For example, a tire sanction on China may result in a counter strategy not to accept U.S. corn, soybeans, or poultry.

Another risk that is much more prevalent now compared to the 1980s is the specialization and consolidation of the agricultural industry. Some producers have become too big to finance because of industry or individual producer concentration risk as a percentage of a lender's portfolio. Others that are financially and economically stressed and are forced to liquidate find the assets of specialized facilities sell at $0.30 to $0.40 on a dollar with few buyers capable of the acquisition, even at discounted prices.

Finally, the interconnectivity of agriculture and agribusiness is an element much more prevalent in the agricultural landscape today than in the past. An economic problem with a certain producer, agribusiness, or processor can spread like wildfire through a portfolio to affect other entities with which it conducts business or has alliances.

Agricultural lenders are in the risk business. Risk is around every corner, reaching locally to globally. The ability to proactively identify and mitigate this risk will be a key element of any successful ag lending portfolio.

Devaluation of the US dollar is creating strong commodity markets, but placing the livestock industry into a cash flow squeeze because increase in corn, soybean, wheat, cotton and oil prices. The Federal Reserve is likely to resort to using a second round of quantitative easing in the amount of $500 billion to $1 trillion in incremental steps to stimulate the economy and circumvent deflation. The Conference Board Leading Economic Index® is positive, increasing 0.3 percent in September. The PMI and factory capacity utilization have remained fairly constant over the past two months. Housing starts are up, but still well below the 1.1 million level. The reported unemployment rate remains constant, but real unemployment increased to 17.1 percent, because of an increase in part time workers due to economic reasons, or those who want and are available for full-time work but have had to settle for a part-time schedule. The yield curve continues to flatten. The U.S. economy is fragile at best.

Indicator	Green	Yellow	Red
The Conference Board Leading Economic Index® - LEI	✓		
LEI Diffusion		✓	
Purchasing Manager Index - PMI	✓		
Housing Starts (millions)			✓
Factory Capacity Utilization		✓	
Unemployment Rate			✓
Core Inflation	✓		
Headline Inflation	✓		
Oil Price ($/barrel)		✓	
Yield Curve		✓	

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%	3%-4%	>4% or <0%
Headline Inflation[2]	0%-3%	3%-4.9%	>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