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Ag Lender Inflation and Interest Rate Watchlist

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The Federal Reserve has telegraphed its intention that the economic public enemy number one is inflation. The duration of inflation and the extent and timing of interest rate increases will be debated over the next 12 months. Globally, 23 of 34 central banks are raising interest rates, which is creating a ripple in the strength of currencies, economic health, and geopolitical strategies that can influence trade strategies critical to the agriculture industry.

It appears that the duration of inflation will be pesky, particularly headline inflation which includes both food and energy, and the Producer Price Index (PPI) which is a critical indicator for inputs and capital expenditures. Worldwide food inflation is a clear and present danger. For example, Russia and Ukraine export over 25 percent of the world's wheat. Fifty countries are dependent on Russia and Ukraine for more than 30 percent of their wheat imports. For Egypt and Turkey, the amount exceeds 60 percent! A disruption in the food supply can lead to social unrest, which is a breeding ground for terrorism.

Oil and energy shocks will be persistent, even with the rise in interest rates. Imbalances of supply and demand for oil, natural gas, and fertilizer can result in unintended consequences for businesses and consumers later this year and in 2023, particularly with an uncertain outcome in the European conflict.

Will the Federal Reserve and other central banks globally overshoot interest rates? Of course, higher interest rates can create paper wealth declines in assets such as stocks and real estate which impacts consumer confidence. The 1970s and 1980s inflation and interest rate battle created two back-to-back sharp recessions and caused major reductions in paper wealth as a result of stock market declines. After this decline, the general economy was bolstered by the growth of the computer and, eventually, Internet technology, global markets, and a bull stock market until about 1987. On the other hand, the farm economy and manufacturing industry struggled for a number of years before returning to prosperity in the 1990s, but significantly so after the turn-of-the-century.

As we approach the possibility of turbulent times in terms of inflation and interest rate adjustments, what should be on the agricultural lender's watchlist? How can lenders work with customers to navigate the economic volatility that creates risk and financial traps, but also opportunity and growth for others? As a veteran of the 1970s and 1980s economic transition cycle, there are many strategies in the old playbook that were learned working with producers and lenders that can be utilized today.

Watchlist

Inflation and rising interest rates will first erode financial liquidity. Why, one may ask? Producers often get so locked in on prices and revenue that they fail to realize how quickly inflated costs can deplete margins. This leads to an *economic flip*, which is when prices and revenues decline, but costs, particularly fixed costs, remain elevated before adjusting downward over about a 24-month period. When margins become negative, the next fallback position is working capital and financial liquidity.

Lenders need to carefully monitor accounts payable, both the number and size of accounts. Realize that reported accounts payable are often understated by 20 to 40 percent. It is important to elevate your level of involvement and networking in the community where you lend to stay on top of these potential red flags and anticipate unreported accounts payable.

In the 1970s and 1980s, credit card debt was in its infancy. Fast-forward to today, and credit card use *and abuse* is on high alert. At recent schools and conferences, lenders have indicated high credit card usage by producers for both business and personal expenditures. Credit cards can be instant liquidity, but how will these balances be paid off?

Line of credit usage has gone through the roof as a result of inflated costs. If cash reserves were built up over the past two years during the pandemic, these funds can quickly disappear. Closely monitoring the use of funds from lines of credit will be essential. Inflated family living expenses often find their way to the balance sheet in the form of draws on lines of credit or the aforementioned increase in credit card debt.

Recent surveys at lending school and conferences are finding lenders somewhat overwhelmed by the time required to accomplish all of their responsibilities. Perhaps senior management could consider freeing up 20 to 30 percent more time for financial statement analysis, customer evaluation, and account monitoring. Annual financial statements will not be enough in this volatile period, particularly for leveraged and higher risk customers. Inflation and higher interest rates can quickly turn a performing, profitable customer with positive cash flow into a negative wealth destroying situation. Complacency, whether it is the customer or the lender, often leads to deeper issues later on with fewer financial options for recovery.

As the agriculture industry consolidates, third-party counterparty risk becomes a greater concern. Concentration and consolidation of supply chains, producers, and processors and the subsequent timing issues of when producers are paid can all wreak havoc on margins. During the pandemic, government stimulus came to the rescue. What will be the plan in this era? Supply and marketing chains, for both inputs and outputs, must be evaluated during individual and portfolio discussions.

Spreadsheet financial sensitivity tests will be critical during inflation and interest rate cycles. Interest rate increases from one to four percent on variable rate loan structures will need to be in your vocabulary. If loan structures have a three to five-year maturity reset, how will this impact bottom-line results? If negative margins occur, concepts such as the burn rate on working capital and core equity will need to be discussed as options are examined.

While this article may appear to be negative, when one examines a similar economic cycle in the 1970s and 1980s, positives were found.

Compared to the 1970s and 1980s, relationship lending, where customers and lenders are working side-by-side, has accelerated. This resulted in both parties becoming better managers of the business and lending institutions.

Education became a top priority for both lenders and producers emphasizing financials, marketing, risk management, and business management.

Some of the best producers and lenders that made it through the “school of hard knocks of the 1980s” were a prelude to the decades of prosperity in agriculture during the 1990s and up until the pandemic occurred.

Global Economy

Wow, what a difference six months has made in domestic and global economics! Globally, 23 of 34 central banks are raising interest rates and reducing accommodative monetary policies. The impact is that the equity markets, which have ballooned paper wealth, are now in a corrective platform. Trillions of dollars of paper wealth is being destroyed, which will eventually impact consumer spending patterns. Consumer spending drives 70 percent of rich nations' economies and over 50 percent of emerging countries' economies.

Food and energy imbalances are now the number one discussion point, whether it is mainstream media, coffee shop talk, or social media conversations. Fifty countries are dependent on Ukraine and Russia for more than 30 percent of their wheat imports. Egypt and Turkey import more than 60 percent of their wheat from this region of the world. Globally, a term called *food nationalism* is becoming more widespread. Food nationalism is when countries will limit or cut off exports to ensure sufficient supply of food for their own nation. Historically, food shortages have led to societal tensions which can breed terrorism.

China continues to experience difficulties in their domestic economy. As a result of COVID-19 lockdowns, 40 percent of their manufacturing economy has been stifled. Exports are being constrained by port issues. China's real estate, which drives about 29 percent of the economy, is in a slowdown mode. The world’s second largest economy could experience economic growth in the five percent range, which would be the slowest growth recorded in a number of decades.

The European area and Great Britain are in a slow growth mode. Supply chain issues concerning technology and manufacturing components imported from Ukraine have resulted in a slowdown, particularly for the German economy. Germany is the fourth largest economy in the world and is very export driven.

On the global watch list are weather patterns in major growing areas of the world. Much of the food needs are being fulfilled from last year's crops in storage. Next year's supply, which is in the ground, is going to be a big question mark.

The end game in the Russo-Ukrainian War is very muddled. Russia's strategy of wearing down the west’s support of Ukraine will be interesting to observe over the next few months.

Oil and energy, along with food inflation, will be difficult to tame by central banks without creating a major global recession.

Currently, global politics, military, and economic strategies are in a flux. Managing with high degrees of uncertainty will be the call to order for both business and banking.

U.S. Economic Indicator Dashboard

The first crack in the armor and an indicator of a possible recession has been noticed in the Leading Economic Index (LEI) and the diffusion index. The LEI has been down over three-tenths of one percent for two consecutive months now and the diffusion index is showing weakness, at a level of 20 percent in April, and 55 percent in May.

Oil prices continue to increase above $120 per barrel. Average gasoline prices exceeded five dollars per gallon for the first time nationwide. Two recent trips on Interstate 81 have found traffic at 70 percent of normal; perhaps I was traveling during a period of time where there was less traffic. Copper prices are still in the strong range above four dollars per pound.

The Purchasing Manager Index (PMI) remains above 50, which is a sign of an expanding economy. However, this indicator can decline at a rapid rate. Thus, close examination of the PMI must remain over the next few months.

The U-3 and U-6 unemployment rates, which are lagging economic indicators, are still extremely low at 3.6 percent and 7.1 percent, respectively. In some sections of the economy, such as mortgage, banking, and technology, layoffs are starting to occur.

Housing starts remain above 1.5 million units annually. As mortgage rates increase above five percent, the number of home loan applications are declining. Nationwide, 14 percent of homes are observing a reduction in price; however, this is very location dependent.

The headline inflation rate remains ugly at 8.6 percent. Energy and food prices continue to rise as a result of supply and demand imbalances. The core inflation rate is at 6.0 percent but has observed some decline. The hotel and air travel industries remain strong due to the impact of spending stimulus savings and increases in credit card balances. Airfares are moving up 12 percent per month and hotel prices are close behind.

The big ugly factor among the economic indicators is the Index of Consumer Sentiment, published by the University of Michigan. The latest figure was near 50, the lowest level ever recorded since this indicator was started in the early 1940s. It will be interesting to examine this metric later in the summer after the stimulus savings are spent and stagflation, a period of high inflation and flat wages, gains momentum.

The second quarter gross domestic product (GDP) projections would suggest slightly positive growth. This would keep the U.S. economy out of a recession, which is defined as two consecutive quarters of negative GDP. If this metric is reported in the negative, then the U.S. could be in for a prolonged recession.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	118.3		✓	
LEI Diffusion Index	55%		✓	
Purchasing Manager Index - PMI	56.1	✓		
Housing Starts (millions)	1.549	✓		
Factory Capacity Utilization	79.0		✓	
Unemployment Rate	3.6%	✓		
Core Inflation	6.0%			✓
Headline Inflation	8.6%			✓
Oil Price ($/barrel)	$120.01			✓
Yield Curve	1.81		✓	

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	<6%	6%-8%	>8%
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