FARMER MAC

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Countdown to 2019 Renewal Season Kickoff

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To say the least, 2018 has been an interesting year in farm economics and the agriculture lending world. Weather issues like too much or not enough rainfall, the uncertainty surrounding a series of tariffs and trade riffs, and the "Sonny money," or the $12 billion of funds mainly going to soybean producers, have left clouds over the agricultural lending horizon for most of the industry. Let's provide perspective to some of the most often asked questions or remarks heard from the road when engaging with agricultural lenders, producers, and public policy officials.

Where are we in the international trade negotiations?

The short answer is the first and second innings in a nine-inning economic baseball game with a curveball every time at bat. The United States-Mexico-Canada Agreement (USMCA) still must be approved later this fall and then again by our legislative branch in 2019. Midterm election results and continual political posturing north and south of the border will create an environment of volatility based on news headlines. Expect more agreements to come as European and Japanese negotiators attempt to piecemeal a global agreement.

On a side note, public perception of these agreements can be interesting. I spoke with some urban consumers at our creamery's 10th annual farm day in October, which had over 8,000 visitors. While milking a Jersey cow, one individual from an urban area stated, "It seems like you dairymen are going to be okay with the new agreement with Canada and possibly Mexico." I first stated that the agreement with Canada only amounts to an estimated $70 million dollars in net additional benefit over the Trans-Pacific Partnership agreement for the dairy industry. U.S. dairy farmers produce more milk in 33 days than Canada produces in one year. One can quickly see how news headlines and mainstream media can distort the public's perspective.

China is one country that has everyone's attention in international trade. Soybeans and pork are greatly impacted by trade with China. However, the impacts can ripple through many segments of the industry and in many areas of the country. The Chinese and the other Asian communities are very resilient, as history has proven many times. While adjustments have been heated in trade with China, the timing and methods may have hindered the U.S. long-term image concerning trust and reliability. Whether it is trade with China or other countries, it has given them an opportunity to seek other trading partners, which may impact our competitiveness in the long run.

One element the agriculture industry and lenders must observe is China's Belt and Road or Silk Road Initiative. Launched in 2013, it is a massive infrastructure investment of up to $1 trillion in the Southern Hemisphere. The project spans over 68 countries and is designed to enhance regional interconnectivity. This initiative is taking a page out of the Marshall Plan, which directed reconstruction in Europe and Asia post-World War II and provided decades of economic reward to the U.S. economy. The Belt and Road Initiative will be a methodical process to enhance China's economic standing and will need to be monitored by the agricultural industry because it may affect our competitiveness for decades to come.

With rising interest rates, increases in input costs, and flat to lower commodity prices, what should a lender focus on in better positioning a borrower for success?

In most cases, you should be monitoring your customers' financials more than once per year. Next, you should not depend on tax records to give you a true estimate of where the customer is from a cash flow standpoint.

The good old-fashioned monthly or quarterly cash flow is a planning tool for the times. Variance analysis, which involves comparing projections with actual results, can be a tool to monitor the business' ability to execute a plan. If the borrower and lender, and in some cases the advisory team, meet on a regular basis and review the results, adaptive strategies can be developed before the economics get out of hand. Today, contrasted to the 1980's, there are many more commas and zeros on the balance sheet and income statement. These larger operations increase concentration risk. Conducting due diligence and being candid can not only aid in preserving wealth for a customer but help position them for the next cycle.

In this prolonged agriculture economic downturn, customers are seeking any form of financial assistance. Many lenders have reported observing more vendor credit, credit card debt, and loans from friends and relatives to bridge the gap caused by operating deficits. Remember, with this type of credit what is reported on the balance sheet is typically only the tip of the iceberg. Due diligence and open communications with suppliers and others are a necessary evil during these economic times. Usually, these extra lines of credit are a symptom of bigger issues such as management inadequacy, business and industry competitiveness, and lifestyle spending. In good economic times, deficiencies in these areas are often masked.

Why have land values not crashed, similar to what was experienced in the 1980s?

The financial strength of landowners is very important in credit analysis. In the 1970s and 1980s, land was owned by youthful, baby boomer farmers that were in a growth mode and were financially leveraged with little resiliency. Fast-forward four decades, the baby boomer farmers who survived the 1980s had the benefit of an economic super cycle where profits and land appreciation occurred over an extended period. This has allowed multiple refinances of carryover debt in the past six years of the economic downturn. A change in philosophy by the producer or the lender regarding refinances could create land supply and demand imbalances in certain regions of the country. When this occurs, a correction in land values will take place which will reduce the collateral holdings of the lender.

The last 25 years were driven by bioengineering and information technology. The next decade will be driven by the consumer's link to information or big data. This change will be a disruptor to the agriculture industry. In some segments, it will lead to consumers who purchase customized experiences, rather than products. Personalization will become very important throughout the supply chain, regardless of the agricultural product.

Management Tips

Lender sponsored educational programs for producers can be a great way to provide a value-added service to your borrowers. If you cannot do it yourself, consider co-sponsoring an event. It is not all about the numbers anymore. It is more about who shows up and attendance can be good way to test the character of your customers.

Global Economy

The global economy is experiencing an economic slowdown after seven years of stellar growth, specifically in the emerging nations known as the BRICS (Brazil, Russia, India, China, and South Africa) and KIMT (South Korea, Indonesia, Mexico, and Turkey). Speaking of Brazil, the next 120 days will have to be closely watched from both a political and agricultural standpoint. It appears that the conservative candidate will be elected in a runoff election later in October. He is a former military leader and has a strong stance on corruption and economic reform.

Argentina's leader has reduced tariffs on agricultural products that are exported. This is resulting in rapid expansion of agriculture. For example, the beef industry could expand up to four times over the next two years.

Planting acreage changes and continued forging of relationships with China and Europe on agriculture trade will be a high priority on the radar screen for both the short and long-term economics of the agricultural industry.

New leadership is coming in Mexico in the next few months. Mexico is the third-largest trading partner for U.S. agriculture. It will be interesting to see if concessions are made on steel and aluminum tariffs. If so, this could be very beneficial to dairy and poultry producers and, to some extent, corn growers.

China is posturing trade positions with the U.S. and the Europeans. The Chinese central bank has reduced reserve requirements to stabilize a slowing economy. It is interesting to note that the trade issues with the U.S. can result in up to a three-quarter percent decline in the Chinese economic growth. In the long run, will China be willing to sacrifice this growth for long-term gain? History indicates that the Chinese often maintain focus on the long-term outlook.

Domestic Economy

In the words of Johnny Cash and June Carter, the U.S. economy is hotter than a pepper sprout. The LEI, or Leading Economic Index, is still going strong and showing very little signs of recession in the next three to six months. The diffusion index measures the indicators that are positive or negative and is in the 70 to 80 percent range since the last column. Oil prices have increased due to supply and demand imbalances. The key is that they have not spiked, which is good for both the agriculture and U.S. economies that are heavily dependent on oil and energy.

The PMI, or Purchasing Manager Index, is still very strong. It will be interesting to see how supply chain management issues with other countries and how changes in tariffs will influence these numbers over the next few months. Based on my interactions, frontline people are indicating that there are issues developing. For example, it is becoming more difficult to get parts from Canada and Mexico to put into the new trucks and cars.

Unemployment is at 3.7 percent; who could have imagined 10 to 20 years ago that this number would be at this low rate? This is the lowest unemployment rate reported since 1969 during the troop buildup and after the Tet Offensive in Vietnam. U-6 unemployment, including discouraged and not fully employed people, is in the mid-7 percent range.

Inflation rates are picking up as a result of a robust economy and trade issues. The Index of Consumer Sentiment is currently in the high 90s and actually hit 100. If consumer confidence continues to be strong, along with increased pressure on imported goods, 3 percent inflation is possible.

Keep a close eye on the 10-year treasury rate, now in the 3 percent range. Changes could foretell higher interest rates and possible issues for the U.S. economy.

The factories are continuing to operate at nearly full capacity. Housing starts are sluggish at best with around 1.2 million units annually.

In conclusion, what are the bets that the U.S. economic expansion will set a record of 120 consecutive months? The U.S. equity markets and the 10-year treasury rates could be a key to zero in on whether this metric reaches the record level.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	111.8	✓		
LEI Diffusion Index	80%	✓		
Purchasing Manager Index - PMI	59.8	✓		
Housing Starts (millions)	1.201		✓	
Factory Capacity Utilization	78.1		✓	
Unemployment Rate	3.7%	✓		
Core Inflation	2.2%		✓	
Headline Inflation	2.3%	✓		
Oil Price ($/barrel)	$80.88		✓	
Yield Curve	0.86	✓		

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