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<u>Fault Lines in the Agricultural Economy</u>

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After 17 months of a global pandemic, the agriculture economy is telling two stories. On the grain and row crop side, some producers are experiencing their best years economically since the great commodity super cycle. Others who may be in drought stressed areas or who operate certain livestock enterprises are struggling to maintain profits on the positive side of the ledger. While government and accommodative central bank policy came to the rescue in the short run, what are some of the fault lines or potential risks in the agriculture economic landscape moving forward?

Inflation

For some, this year's profit margins were the result of 2019 and 2020 input costs combined with a recent rise in commodity prices. As one producer at a recent banking school stated, “It is about to change!” Fuel, fertilizer, cash rents, and many other input costs are up 30 percent or more and will certainly dampen profitability expectations for the latter half of 2021 and into 2022. This, coupled with uncertainty as a result of commodity prices, will make monitoring cash flow projections for the next year a high priority. A financial sensitivity analysis of profits and cash flow will need to have wider parameters with a backup of working capital.

Those who have not been on the receiving end of high commodity prices and producers who are experiencing elevated operating costs will be required to draw on liquidity reserves and adjust business models for operational efficiency.

Greed versus discipline

A deep fracture in the agriculture economy as a result of high commodity prices has caused many producers to disregard their marketing and risk management plans. The thought of leaving money on the table has seen greed set in and caused the abandonment of sound marketing principles. This has set the marketing component of the business and financial IQ back five to ten years. In an environment of financial and economic volatility, following a sound marketing and risk management plan will garner steady profit potential eight out of every ten years.

Speaking of greed, “cryptomania” is gaining momentum. At the Graduate School of Banking at Colorado, a banker shared a story of two customers who both mortgaged land to increase their operating lines of credit to invest in cryptocurrencies. Another banker indicated that some of their customers' stimulus money was directly invested into the newest craze. Their logic was that the stimulus checks were “house money.” It appears that Las Vegas and Reno have come to Main Street! On a side note, an online survey of the bankers at the school found that nearly 25 percent had themselves invested in cryptocurrency with 82 percent reporting positive returns and 18 percent with negative outcomes. Investing in cryptocurrencies and the stock market could have far-reaching effects for agriculture and general society.

Family living cost creep

An analysis of farm record databases finds that family living costs are at levels similar to the stellar economic times during the agriculture super cycle. Careful monitoring of the number of people and the amount of living costs will be necessary as often these withdrawals come out of the operating lines of credit. One red flag, particularly in an economic environment with higher rates of inflation, is when reported family living costs remain the same in the credit analysis year after year.

Post stimulus withdrawals

A high priority in the financial analysis for 2021 and 2022 is to examine cash flow and profits of individual customers and portfolios post-government checks. In 2020, over 60 percent of net farm income was the result of government stimulus. From 2016 to 2019, this amount has been in the 30 percent range. While it is highly unlikely the government will completely abandon the agriculture industry concerning financial support, a financial sensitivity analysis with 25, 50, and 75 percent reductions in government support should be in store. The major question post-harvest and renewal season is what is the plan for profit post government stimulus?

Supply and marketing chains

As discussed in previous articles, this is an additional area of the five C's of credit analysis. Supply and marketing chain disruptions are a major fault line that can result in considerable market uncertainty and affect a producer's ability to purchase inputs on a timely basis. Power in the hands of too few processors, input suppliers, technology companies, and other agribusiness firms will be challenged by government, industry, and experts both here in the U.S. and abroad. This, coupled with port and distribution issues, requires one to examine the third-party counterparty risks more closely in a rapidly consolidating agriculture industry and general economy.

Oil and energy

The movement from fossil fuels to green energy and geopolitical shifts concerning fossil fuel production and distribution are tremors that are increasing in intensity. With much of agriculture expenses directly or indirectly dependent on oil prices, expect extreme volatility which will directly influence profits and cash flow.

Income and wealth taxes

The generous stimulus checks will come with a price. Expect higher local, state, and federal taxes on income and general operations. As lenders closely monitor the changes in tax exemptions and the stepped-up basis on estate taxes, the often-overlooked area of deferred taxes on the balance sheet will have a new meaning, particularly in the case of partial and total liquidation.

Cash rents and land

Cash rent increases and appreciation of farmland values are a given, which is going to impact global competitiveness. Higher commodity prices will send signals to global competitors in the Southern Hemisphere and in Eastern Europe. These areas have considerable land reserves that can be placed into production at a very competitive rate. It will be necessary to keep a close watch on land values, which comprise over 80 percent of the farm balance sheet and are often a major part of equity and collateral for loans.

These are some possible fault lines that could result in different degrees of tremors concerning financial outcomes and credit analysis. While this list is not all-encompassing, it is a start as one begins the fall and winter season in agriculture credit analysis.

Domestic Economy

Reemerging from a 17-month travel hiatus has brought about some interesting perspectives as I traverse through airports, check into hotels, and observe the general public. In June and July, the consuming public was analogous to water pouring through floodgates. Packed airports with no rental cars and crowded highways were the norm. In recent weeks, a significant slowdown has been observed as the Delta variant has emerged in many areas of the country. Predicting the direction of the U.S. and global economy will be predicated on the consumer's ability to work around the next phase of COVID and the subsequent geopolitical action.

Examining the leading economic indicators would suggest a growing economy as the Leading Economic Index (LEI) is increasing and the diffusion index is above 50. However, one will notice a slowdown in the Purchasing Manager Index (PMI). Earlier in the year, this metric recorded robust growth in the mid-60s. While still in the expansion phase, the PMI has softened to the high 50s.

Oil prices have leveled out in the high $60 to mid-$70 per barrel range as supply concerns have eased as Russia, OPEC, and other leading oil producers have increased production levels. One word of caution is that oil prices could spike up or down if bottlenecks or disruptions should occur. Oil prices are important to the agriculture industry as many expenses are directly or indirectly related to energy prices. Natural gas prices have been increasing, which influences grain drying costs and other expenses in farm and ranch businesses. Copper prices have stabilized between $4.25 and $4.50 per pound, which indicates that we still have a growing world economy.

The U-3 unemployment rate has fallen to 5.4% and the U-6 unemployment rate is at 9.2%. The difference in these metrics indicates the underemployed and the discouraged workers. The mismatch of workers to job openings and the uncertainty surrounding back-to-school plans and work re-entry are factors that will affect the unemployment rate moving forward.

Housing starts are still very strong with over 1.5 million units annually. A close watch of this metric is needed as a slowdown in the housing and real estate market is occurring in many areas of the U.S. Factory utilization is leveling out at 75 percent of capacity as a result of supply chain issues and a shortage of productive workers.

Stagflation was a common term in the late 1970s. This term indicates stagnant growth of the economy and wages coupled with rising prices, which reduces buying power. This economic situation can be interpreted by the misery index which is the sum of the unemployment and inflation rates. Inflation, whether measured by the Producer Price Index (PPI) or the Consumer Price Index (CPI), has been higher than it has been in recent decades at above five percent. When examining the agriculture economy, capital investment spending is significantly lower in recent months as producers are very concerned about margin squeeze and the overall cost of capital investments.

The latest report on the Index of Consumer Sentiment, published by the University of Michigan, was extremely disappointing. The index had fallen to 70.2 points, the lowest level since the Great Recession of 2011 and one of the largest percentage drops in history at around 13 percent month over month. This confirms my observations from the airport traffic as the Delta variant spreads throughout the country. If consumer sentiment remains in this range, this could cool inflation expectations on the consumer side. Overall, this fall and winter could be interesting!

Global Economy

As with the U.S. economy, forecasting the global economy is a rapidly developing wildcard that will center around the resurgence of COVID-19 variants.

China and Japan, the second and third largest economies in the world, have implemented new COVID restrictions in many regions of their countries. The social and economic repercussions of these restrictions are yet to be seen. The world economy cannot afford a massive shutdown or voluntary restriction on economic activity. China is moving ahead with their vaccine rollout, particularly in third world countries. This strategy is designed to spread China's influence along with their Belt and Road initiative.

Europe is showing slight growth, but at levels less than previous decades. Over the next few months, it will be interesting to see if central bank policy in Europe and in other areas of the world will continue to be very accommodative which will impact economic growth and currency values.

Whether it is the U.S. or global economy, uncertainty surrounding the pandemic, geopolitical environment, and overall trade and central bank policies will be elements strategic planners will be required to manage around.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	116.0	✓		
LEI Diffusion Index	100%	✓		
Purchasing Manager Index - PMI	59.5	✓		
Housing Starts (millions)	1.534	✓		
Factory Capacity Utilization	76.1		✓	
Unemployment Rate	5.4%	✓		
Core Inflation	4.3%			✓
Headline Inflation	5.4%			✓
Oil Price ($/barrel)	$74.42		✓	
Yield Curve	1.17		✓	

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