FARMER MAC

DAVE'S GPS

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<u>GPS Unplugged</u>
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Welcome to another Dave's GPS! This column will be similar to a webcast as we will discuss the answers to common questions posed by lenders for crucial conversations impacting your credit risk and business development priorities.

What are some of the issues you are seeing in the agricultural lending world today and what are bankers saying to you via webcast interaction and dialogue?

First, the COVID-19 pandemic has accelerated change throughout the agriculture industry. One of the top issues emerging in the last six months is how dependent certain segments of agriculture producers are becoming on government support payments. Decades of globalization and increased net income generated from agricultural exports had paused many payments. However, the pandemic has accelerated government checks in 2020 through programs such as the Paycheck Protection Program (PPP) and Coronavirus Food Assistance Program (CFAP). With the reduction in exports, disruption in marketing chains, and overall market uncertainty, these support payments have become critical to the financial health of the agriculture industry.

A recent crop insurance conference, attended by 465 insurance professionals and sponsored by FINPACK, provided evidence of the growing influence of government support payments to the bottom line for many agricultural producers. Compelling results were enumerated when the group was polled on how government support payments in 2020 have impacted the net income and cash flow of their customers. Fifty nine percent of respondents indicated that government payments had a large impact while 29 percent reported a modest impact. Only 12 percent of those surveyed described a neutral or slight impact on net income and cash flow.

Data from the 2019 FINBIN database is even more revealing. For crop and grain producers, 95 percent of net farm income was from government coffers. Moving to the protein sector, 93 percent of net farm income was generated by the government for the hog industry and 115 percent for the beef segment. Government support payments for dairy farms in the FINBIN database was considerably lower at 35 percent.

Moving forward, what level of government payments will be supported in 2021 and beyond? When compared to other segments of the economy, what will be the government priorities when stimulus packages are crafted in the U.S. and abroad? How will 25, 50, and 75 percent reductions of government payments influence cash flows, working capital, and eventually land values? This sensitivity analysis needs to be conducted on producers and the overall portfolio.

Are there any specific commodities or segments of the industry on your watchlist?

All of them! The COVID-19 pandemic has created extreme volatility with uncertainty. For cotton, corn, and soybeans, China's economic recovery and rebuilding of their protein sector, specifically hog and poultry, bears watching. The economic health of the ethanol industry is critical for corn and parts of the livestock industry in various regions of the country.

The value of the dollar in relation to major agriculture competitors' currencies could influence the bottom-line profits of exporting agricultural enterprises. The U.S. and global weather patterns and the uneven economic recovery throughout the world will need to be carefully examined by agricultural lenders.

Labor and immigration in the vegetable, fruit, and protein segments, which are human resource dependent, will influence commodity and business entities across the agriculture industry. Major hiccups at processing plants and suppliers where considerable concentration exists will be high on political, producer, consumer, and general society's agendas.

What are the pressure points of farmers and ranchers now?

The keyword is *uncertainty* regarding the political landscape, global markets, and the aforementioned access to markets and suppliers. From an outside perspective, the economic pain will not be prevalent across the board in the agriculture industry and specific sectors in 2020. Pressure will mount in 2021 and beyond as the decade of the 2020s for the agriculture industry will be one of economic divide. For example, some farm consultants have found that certain groups of producers are experiencing their best financial year since the great commodity super cycle. The government checks coupled with the weather and markets aligning in a positive manner have resulted in strong profits and cash flow. Tax management and growth strategies along with replenishing working capital are high on this segment of producers' priorities. Others are utilizing the government checks to meet cash flow needs or positioning for restructuring debt. Still others have fallen through the cracks of government supports and have experienced market and weather adversity, leading to the perfect financial storm. This dichotomy will tax the agricultural lending teams in the art of agricultural lending. There will not be a one-size-fits-all approach that fits all commodities or producer segments.

What advice do you have for agricultural lenders before the renewal season?

On your financial analysis checklist there should be a metric measuring government payments as a percent of net income in 2020 and for the last three to five years. If financial windfalls from government payments occurred, are the benefits being used for growth, liquidity reserves, equity, or nonfarm capital purchases?

If possible, conduct an accrual analysis on high profile accounts such as financially stressed customers and ones in growth and transition mode. As the agriculture industry consolidates and becomes larger, accrual adjustments are going to be a requirement.

Maintain a balance between distressed credits and business development. Remember, it requires four times the amount of time, money, and effort to service distressed credits versus performing accounts.

Finally, the financial depth chart and a balanced approach to risk management will be critical. Profits and cash flow are analogous to a defensive line in football that blocks adversity and creates opportunity for the offense. If properly used, financial liquidity is your backup if the defensive line breaks down. Equity and capital are your safeties and your cornerbacks if adversity occurs and can also be leveraged when opportunity comes knocking.

P.S. To hear more questions and answers, register for the upcoming Southeastern Ag Lenders School (SEALS) on November 10-12, sponsored by Farmer Mac. I will be teaching alongside a great group of knowledgeable instructors in a virtual format this year. It is open to lenders as well as producers! https://seals2020.eventbrite.com

Domestic Economy
The U.S. economy is moving into the fourth quarter of 2020 with no definitive direction based on general observations. Let's examine the economic indicators to establish some sort of direction.

The Leading Economic Index (LEI) has shown a positive direction in recent months after a fall off the "economic cliff." Since April, the LEI has increased nearly 10 points, which is in historical proportions for such a short period of time. The diffusion index measures whether the 10 components that make up the LEI are trending positive or negative. This metric has been above 50 in recent months, which is positive for the future direction of the economy. Both the LEI and the diffusion index will need to be closely observed for a sustained direction in the fourth quarter.

Oil prices have settled into the low to mid $40 per barrel as summer travel has abated, specifically in the Northern Hemisphere. Mid $40 per barrel of oil and above is needed to sustain fracking, ethanol, and other sources of alternative energy.

Copper prices have remained strong as a result of the Chinese economy, manufacturing, and infrastructure building. Improvements have also been occurring in the economies of the rich nations of the world.

The Purchasing Manager Index (PMI) has registered above 50 since June, which is indicative of growth in the manufacturing sector in the U.S. However, factory utilization is still lagging with the numbers in the low 70s, indicative of a sluggish sector.

Recent reports at the end of the third quarter find the U-3 unemployment rate at 7.9 percent. However, the U-6 unemployment rate is in double digits territory at 12.8 percent. Uncertainty and stimulus packages could be very influential for unemployment rates in the fourth quarter. The retail holiday period is expected to be less than stellar with reduced in-store traffic and a slowdown in the hospitality, entertainment, and restaurant sectors. These elements should be on the watch list as far as future unemployment rates.

Another metric to watch closely is the Index of Consumer Sentiment published by the University of Michigan. This metric has rebounded from a low of 71.8 to slightly above 80. However, this is substantially below the aspired number of 90 and above, which is indicative of strong consumer behavior.

Inflation on both the production side (Producer Price Index) and the consumer side (Consumer Price Index) is very tame. Core inflation remains under two percent at 1.7 percent and headline inflation, which includes food and energy, is at 1.3 percent.

The U.S. GDP growth rate will be reported later in the month of October, which has a high probability of improvement from a nearly all-time low of negative 31.4 percent.

The bottom line is that the U.S. economy is not out of the woods yet with a disjointed recovery depending on the sector and geographical area of the United States.

Global Economy

The global economic recovery is being led by China which is showing strong positive manufacturing activity and is resulting in a positive GDP. Exports to the U.S. from China have been strong for medical supplies, technology, and other critical goods. However, there is some general sluggishness in the exports of consumer goods that fuel the U.S. service-based sector, which is 70 percent of the economy.

China's dual circulation strategy, which is a movement to encourage the Chinese to consume more and focus on the Asian area, is in its infancy. It will be interesting to determine whether the Chinese consumer service sector, at approximately $5 trillion versus the U.S at $14 trillion, will be enough to sustain a healthy manufacturing sector in China. Japan, Oceania, and the U.S. have joined together to examine possible trade pacts that will be less dependent on Chinese exports. It will be interesting to see how these trade pacts play out.

On the agriculture side, soybean and corn prices have rallied as a result of China rebuilding its pork sector and increased consumption in the poultry sector. Historically, China has been known to stockpile inventory of agriculture and other critical industry products which could influence commodity prices. These elements are converging to create volatility in commodity prices for the remainder of 2020 and into 2021.

China's new five-year plan includes targeting developing countries with vaccines and medical innovation as part of their influence strategy in the Belt and Road Initiative. This could represent potential competition for U.S. businesses in the decade of the 2020s.

Moving to Europe, the economy has been rebounding quite well. However, recent outbreaks of COVID-19 in France, Spain, and other countries are impacting the overall strength. The upcoming elections in Germany will need to be closely observed to determine which direction Europe will be moving politically and economically. It will be interesting to see how discussions on trade, the environment, and social action play out after the U.S. and German elections.

In the Southern Hemisphere, a watchful eye on the weather in the growing regions of Brazil and Argentina and its impact on the agriculture sector in the Northern Hemisphere will need to be observed. Currently, dry weather in these regions as they move into planting season could result in rapid changes in commodity prices.
The cases of COVID-19 need to be observed as the summer season evolves below the equator. Will the number of cases continue, or will they decline? This will be a critical question for the $80 trillion world economy.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	107.2	✓		
LEI Diffusion Index	65%	✓		
Purchasing Manager Index - PMI	55.4	✓		
Housing Starts (millions)	1.415		✓	
Factory Capacity Utilization	71.5		✓	
Unemployment Rate	7.9%		✓	
Core Inflation	1.7%	✓		
Headline Inflation	1.4%	✓		
Oil Price ($/barrel)	$41.46	✓		
Yield Curve	0.51		✓	

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