FARMER MAC

DAVE'S GPS

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Higher Risk on the Horizon

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Whether it is Farm Credit, commercial banks, Farm Service Agency (FSA), or nontraditional lenders, my interaction and dialogue with agricultural lenders indicates that agricultural loan portfolios are as strong as they have ever been. This strength has been propelled by the recent run-up in commodity prices, strong government payments as a result of the pandemic, and a buildup of unearned net worth, otherwise known as paper wealth, in land, machinery, and other asset values. Balance sheets are robust. One might say, “What is the problem?” Any vintage lender with decades of economic cycles under their belt knows that good times are latent with perils that can create fissures in a solid portfolio. Let's develop a watchlist of some of the possible perils that need to be discussed in board strategic planning meetings, loan committees, and during the general credit review process.

Concentration of debt

While many operations exhibit small amounts of debt, agriculture credit is much more concentrated with fewer operations and lenders when compared to the 1980s. A high priority for agricultural lenders is to conduct an analysis of debt structure of individual loans and the portfolio. Determine the portion of fixed interest rate versus variable interest rate mortgages and when variable interest rates reset. Highly leveraged operations with variable interest rate loans are experiencing one of the first interest rate shocks in decades. For example, a 3.5% variable rate increasing to 5% represents a 42% increase in interest expense. In the 1980s, interest expense was often the second or third highest expense on the income statement. The ranking of interest expense amongst other expenses may be an analytical analysis that needs to be completed during next year's renewal season. A good set of spreadsheets can illustrate financial scenarios given a one to three percent, and possibly four percent, interest rate shock and its impact on the coverage ratio.

Risky customer

This year, lending school participants have provided input and intelligence on at-risk customers. Conduct this exercise to test your customers and portfolio against the list.

The higher cost producer has above average fixed costs in land rents, machinery, and equipment and will be at risk for income margin compression or negative margins. In

2020 and 2021, these producers did not experience financial stress as a result of government payments. Determine whether these payments are recurring or nonrecurring and how this will impact the coverage ratio.

Producers with below average production, marketing, and financial management skills are at risk also. Often these producers will not know their cost of production, breakeven points, or have very poor financial and business records. They will often ask their lender to develop their cash flow and balance sheet. This group of customers will often exhibit high equity through unearned net worth or inflated land values. This customer will experience liquidity crunches that require refinancing and restructuring to replenish working capital. This is where an analysis of the burn rate on liquidity and core equity needs to be conducted to ascertain financial resiliency.

Lifestyles

A fact of life is that inflation is impacting household budgets. A high-risk customer is one whose operation and income generation can no longer support their lifestyle habits. This can also happen when too many people are withdrawing from the operation, particularly in an economic downturn. Find out if personal expenses are co-mingled with business expenses. Examine the amount of family living withdrawals used in the coverage ratio calculation and determine if it is sustainable.

Margin flips

The peril on the horizon is when strong commodity prices take a sharp reduction due to weather, global demand, trade, or geopolitics while the expense or cost side remains elevated or is slow to adjust downward. The agriculture industry is very vulnerable to a margin flip. In this situation, $14 per bushel wheat goes to $6 per bushel, $8 per bushel corn drops to $4 per bushel, soybeans prices in the teens revert to single digits, and livestock prices retreat to pre-pandemic levels. This may sound like a cup half empty scenario, but it needs to be tested to determine the customer’s and portfolio’s resiliency, particularly with reduced government assistance.

The transition

The transition of human resources has accelerated in the past 12 months in the agriculture industry. Whether it is producers, agribusinesses, or lenders, institutional memory is out the door. At one of the recent agricultural banking schools, 77 percent of the participants had less than one year of experience. At many of the lender conferences, a small percentage of the attendees have made loans in the 1970s and 1980s. The number of experienced producers attending the meetings I conduct is declining as well. This reduction in experience is a possible underlying risk, especially in a down economic cycle. In these cases, one has to assess whether the next generation can step up to the plate or not. The following are some of the key attributes for success observed over the decades.

The lender will need to develop a culture that rewards not only how to calculate the numbers, but to critically think about the numbers and ratios while also incorporating nonfinancial factors and considering the unintended consequences of the situation. A balance of the art and science of agricultural lending along with verbal, nonverbal, and written communication skills will be critical.

Customer culture is critical as well. How do your customers manage success? When benchmarked to their peers, are production yields and operational efficiencies within the ballpark? If it is a family operation, is the next generation allowed to make financial and marketing decisions? Who in the senior generation is serving as a mentor and are they teaching the right practices and actions to the younger generation?

The following winter renewal season may be full of surprises as a result of complacency and the lack of attention paid to finances. Examining the aforementioned variables can position your customers and portfolios to weather the storm clouds on the horizon.

The global economy is in a definite slowdown, with China and Europe leading the way. China's economic growth last quarter was the lowest recorded in decades. The combination of COVID-19 restrictions and a real estate slowdown, which drives between 25 and 30 percent of the Chinese economy, are major contributors. Homeowners are missing mortgage payments to large developers, such as Evergrande, as a protest against incomplete projects that many individuals invested their life savings in. The Chinese unemployment rate, while modest at 5.9%, is between 15% to 20% with youth between 16 and 25 years of age. This is very concerning for President Xi, who is seeking confirmation for an unprecedented third term this fall. China's discontent with Washington leadership visiting Taiwan has moved China to decouple five of its largest firms from the New York Stock Exchange. China, the United States' largest agricultural export destination, is a wildcard with the combination of a slowing economy, decoupling, and possible geopolitical military opposition. The old saying, "Don't bet the farm on China" rings loud and clear now!

Moving to Europe, the economic slowdown is in progress. A key country to the solidification of NATO will be Germany, the fourth largest economy in the world. There are rumblings of Germany breaking away from Western support of Ukraine and particularly NATO. Germany is very dependent upon natural gas and technology from Russia and Ukraine. Supply chain issues, their ability to export, and aging demographics to support labor needs could create economic peril for Germany. Will authoritarian economies such as Russia, China, Iran, and North Korea and emerging nations such as Brazil and Argentina wear down Western geopolitics? If you examine the wars in Vietnam, Iraq, and Afghanistan, the historical view does not bode well for continued long-term support of Ukraine.

Dashboard of indicators

The dashboard of economic indicators supports that the U.S. economy is in or near a recession. The Leading Economic Index (LEI) is down three-tenths of one percent for the traditional three months and it is down more than 2.2 total points, which are together indicative of a recession.

Copper prices are under $3.75 per pound, which is another measure that supports a recession. China utilizes nearly 50 percent of the globe's copper and these prices may be indicative of a global recession, particularly for the second largest economy in the world.

The Index of Consumer Sentiment is still in very bearish territory registering in the mid-50s. This metric has been less than 75 since last August. High inflation and uncertainty about the direction of the economy, especially for middle- and low-income people, is creating negative sentiment.

The yield curve is another dashboard metric that is in recession territory. The yield curve inversion has increased since the last article and shows no signs of improving.

Inflation, along with the national debt, continues to provide headwinds. Core inflation, without food and energy prices, is maintaining at 5.9%. Headline inflation, including food and energy, has declined to 8.5% due to lower fuel prices. The Producer Price Index (PPI) is 9.8%, which is down from double digits earlier this year.

Watchlist

Housing starts are a key metric to examine in the next few months. Housing sentiment, measured by the National Association of Home Builders/Wells Fargo Housing Market Index has moved below 50 for the first time since 2014 due to higher costs and affordability issues. Housing starts have dropped below 1.5 million in July; if housing starts fall to 1 million units annually, this could be a factor pushing the U.S. economy into an official recession because one in seven people are employed in the housing industry.

The Purchasing Manager Index (PMI) is still above 50, which is positive for the economy. This metric, along with factory utilization being above 80 percent, is solid as companies fill inventories and back orders.

Unemployment, while low, will possibly increase this fall and winter. Layoffs are occurring in the technology sector, mortgage banking, and real estate. This could spill over into housing and service-based industries as people burn through their stimulus savings.

Recession?

Are we in a recession? As a common heuristic, two quarters of negative gross domestic product (GDP) indicates a recession. However, the National Bureau of Economic Research (NBER), a nonpartisan group of academics, makes the official recession determination. This determination is not likely to come out until next year, and that may be optimistic.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	116.6			✓
LEI Diffusion Index	60%		✓	
Purchasing Manager Index - PMI	52.8	✓		
Housing Starts (millions)	1.446		✓	
Factory Capacity Utilization	80.3	✓		
Unemployment Rate	3.5%	✓		
Core Inflation	5.9%			✓
Headline Inflation	8.5%			✓
Oil Price ($/barrel)	$110.84			✓
Yield Curve	0.34			✓

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