FARMER MAC

DAVE'S GPS

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<u>Lender Radar Screen 2021</u>
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To kick off the 2021 Farmer Mac Dave's GPS column, a view of the radar screen is appropriate with the many changes occurring in the agriculture industry in the U.S. and around the world. Let's examine the playing field and determine how it will impact both short and long run risk.

<u>Minimum wage</u>

The proposed increase to the federal minimum wage could be a major factor impacting margins and long-run viability for agriculture and small businesses. This change could provide a distinct advantage to large businesses which are in a better position to absorb costs and implement automation. A higher minimum wage could also be detrimental to young people who are attempting to build life skills through employment. Fifteen dollars per hour does not include any Social Security or fringe benefits. The bottom line is that we could see the acceleration of business consolidation, automation, and the closure of small businesses which are the lifeblood of entrepreneurship in America.

<u>Oil and energy complex</u>

After decades of building self-sufficiency in the energy complex, the unraveling is starting to occur. The government’s stance on fracking, ethanol, wind, and solar power will be integral in the supply and demand balance. The record economic expansion of 128 months was partly due to stability in energy prices, which is critical to U.S. agriculture. A new era of volatility could be around the corner. The U.S. is currently the largest energy producer in the world, but this standing could be hindered with potential cutbacks, resulting in more dependence on OPEC and Russia. This would impact costs and, in some cases, revenues for farm businesses. The accelerating trend toward electric vehicles must be closely observed for reduced fossil fuel demand. Supply chains will need to be scrutinized as nearly 75 percent of the components for electrical vehicles and other electric infrastructure reside in China. This concentration could result in unintended consequences.

<u>Taxes</u>

Agriculture and other small businesses are in the crosshairs of higher taxes. Higher local, state, and federal taxes could be the outcome of generous stimulus payments.

Changes in estate tax laws could influence the balance sheets and decision making of many farmers and ranchers.

De-urbanization and the Rural Renaissance

A demographic shift of the population from urban areas to satellite cities and rural areas could be a trend of the 2020s. Some individuals will relocate based on access to broadband internet. Others will seek rural, recreational properties. Both groups represent business development opportunities for agricultural and rural lenders. The rural renaissance could result in more discord as well as opportunities as new neighbors bring their beliefs and desires to rural areas.

Regulation

Expect more swagger from regulators. Increased regulation in the labor, food, banking, and financial services sectors could be a positioning statement. Any adversity in the aforementioned areas could result in accelerated oversight, leading to higher business costs and increased risk.

Non-recurring income

During the renewal season, agricultural lenders will need to pay close attention to the grain sector's latest economic boom as a result of non-recurring income from stimulus checks. Many producers, particularly on the grain side, are observing the strongest economy since the great commodity super cycle one decade ago. The root of many financial issues can often be linked to decisions made by producers during stellar economic times. Lenders must scrutinize how non-recurring income was prioritized and used in the credit assessment. Did the customer build working capital, increase cash reserves, pay down debt, increase efficiency, utilize profits for upgrading capital infrastructure, or embark on a major expansion? One danger in the last strategy is that long-term decisions made based on non-recurring income could create future cash flow and working capital shortfalls. Some producers may have also used the windfall income for family living costs or, an old favorite, “killer toys.”

Many farm and ranch businesses will need to have a positioning strategy for going from direct farm program payments to more carbon and green payments. This trend will accelerate around the middle of the decade. One positive result of this trend is that the agriculture industry may be highlighted as a solution to environmental and climate issues.

With this being said, the decade of the 2020s will be one of economic and financial divide. Price and cost volatility will be extreme, requiring strong marketing and risk management programs and plentiful working capital reserves. The ability of producers to innovate and adapt, but at the same time follow a process and focus will be a high priority.

Producers who can zero in on managing the controllable variables, such as cost of production efficiencies, and managing around the uncontrollable variables, including geopolitics and trade agreements, will be the successful ones. A decade of management transition in farms, ranches, agribusinesses, and agricultural lenders will place a premium on the alignment of people skills. The agri-entrepreneur will flourish as one size of business will not fit all and the methods to secure net income may come from many different sources.

At times, the radar screen will appear cluttered with the possibility of unintended consequences. Those that practice incrementalism, attempting each day to be a little bit better in their business and personal lives, are destined to flourish in the long run.

Domestic Economy

The United States economy can best be described as one with a disjointed recovery. Sectors such as airlines, hotels, and restaurants are still operating at 40 to 60 percent of capacity. Other businesses such as Amazon, FedEx, Walmart, and other high-tech entities are operating at 125 to 200 percent above the trendline. Stimulus checks and unemployment benefits are attempting to fill the gaps for individuals and households. A second round of Paycheck Protection Program (PPP) checks have provided a boost for some small businesses.

The stock market boom in the U.S. and abroad is being fueled by institutional investors and day traders. Some are in a gambling mode betting on companies with high price to earnings valuations, knowing that the central bank and fiscal policies are there to back them. The personal savings rate continues to be high at over 15 percent with more than $4 trillion in savings accumulated since the beginning of last year's lockdown. How and when these savings will be unleashed is a key variable for stellar growth or possible inflation in the U.S. economy over the short and long run.

Analysis of the economic indicator dashboard finds some interesting trends. The Leading Economic Index (LEI) is on a nine-month upward trend. The LEI diffusion index, which measures whether the factors comprising the LEI are trending positive or negative, is averaging 70 percent. Both of these measures bode well for the future of the economy.

The Purchasing Manager Index (PMI) is down slightly, but remains above 50, which indicates a growing economy. Oil prices have observed some bounce as a result of the new administration’s stance on the energy industry and oil producing nations reducing supplies. Travel has resumed in some areas of the world and is positively influencing the demand side of the equation.

Factory utilization is still below its potential as industries are working out the impacts of shortages because of supply and marketing chain disruptions and the impact of trade with global competitors.

A strong variable of the economy has been housing starts above the green light target of 1.5 million units annually. Low and stable interest rates, employment growth, and continued relocation by individuals and households will be necessary in the next six months to continue support for this sector. On a negative note, lumber prices have risen above $1,000 per 1,000 board feet; this could curtail new housing starts.

The recent unemployment rates of 6.3 percent and 11 percent for U-3 and U-6, respectively, are positives for the job market. However, be careful of interpreting these numbers as positives because of lower workforce participation rates. Many individuals are withdrawing from the workforce as a result of generous stimulus benefits. The question becomes, will they continue to be employable and productive as a result of the rapidly changing skill sets needed by employers?

Examining the Index of Consumer Sentiment, published by the University of Michigan, finds the latest numbers in the high 70s to low 80s. This index will need to be above 90 for several months to certify the economy is truly back to pre-COVID levels.

Global Economy

A disjointed recovery can also describe the world economy. Starting with the U.S., the growth rate in 2020 was approximately negative 3.5%. The U.S. economy represents over 20% of the world economy.

Moving to China, the second largest economy comprising 16.8% of the world's GDP had an economic growth rate of 2.2%. While China has bragging rights for being one of the few economies with positive growth, by historical standards this feels recession-like. In the 1990s, the Chinese economy was barely 2% of the world economy. They have averaged 7% growth and peaked above 12%. This strong growth, fueled by the commodity super cycle from 2007 to 2012, really accelerated the Chinese economy. As China continues to embark on its Belt and Road Initiatives through medical and vaccine innovation in developing nations, strong economic growth may be the outcome. The question is where will they purchase their goods from the U.S., emerging Eastern Europe, or South America? The Chinese economy and their purchasing decisions will be a foreteller of commodity prices in the early years of this decade.

The European Union and Great Britain are in the midst of negative economic growth. As a matter of fact, Great Britain's economic growth is the slowest it has been for three centuries. The pandemic and geopolitical uncertainties do not bode well for this area of the world, which represents about 20 percent of the global economy.

On the global watch list will be political change in Germany and possible new variants of the coronavirus. Global actions on climate change and globalization will need to be closely monitored.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	110.3	✓		
LEI Diffusion Index	70%	✓		
Purchasing Manager Index - PMI	58.7	✓		
Housing Starts (millions)	1.580	✓		
Factory Capacity Utilization	75.6		✓	
Unemployment Rate	6.3%		✓	
Core Inflation	1.4%	✓		
Headline Inflation	1.4%	✓		
Oil Price ($/barrel)	$54.36		✓	
Yield Curve	1.03		✓	

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