DAVE'S GPS

4/27/2022

Lending in Extreme Economic Shockwaves

By Dr. David M. Kohl

In this column two years ago, our discussion centered on negative oil prices, possible deflation, and the end of a 128-month economic expansion, the longest in U.S. history. Fast-forward to today and oil prices are triple digits, commodity and input prices are at record levels, and farmland values have been increasing in many areas of the country. These factors have resulted in strong agricultural loan portfolios with a cautionary feeling that the financial and economic tide could quickly take a turn toward the negative. Let's take a look at what needs to be on your economic and financial radar screen for this spring and summer.

The Federal Reserve

Dusting off your spreadsheets is a good start to conducting a "but, what if analysis" on cash flow and income statements. Credit facilities with a variable rate structure could experience a 50-basis point increase as a result of *each* Federal Reserve meeting in 2022. Can your customer maintain profitability with a three percent rise in interest rates over the next two years?

Inflation and the bottom line

As an economic educator with a number of decades of experience under my belt, there are telltale signs of pending issues. Whether it is a farm business or household finances, be aware when paper wealth gains in real estate and stock values exceed retained earnings. This often results in a strong financial standing in net worth gains, but is the increase in paper wealth an illusion? This is why examining the last five years of net worth gains is very important. If more than 50 to 75 percent of net worth gains were a result of asset or wealth appreciation versus retained earnings, an economic downturn impacting wealth could quickly change the status of equity ratios.

The economic flipper

Strong and rising commodity prices above the rate of inflation can lead to a sense of financial complacency. However, if one examines the financials, you can quickly observe that margins, while still positive, are embedded with increased revenues and higher expenses. Similar to the late 1970s, lenders, owners, and managers need to be aware of the *economic flip*. This is when prices received decline rapidly for an extended

period of time and costs remain elevated or, in some cases, actually increase. There is usually an 18-to-24-month period of margin compression or negative margins on income statements and cash flows. Producers who are most vulnerable are the ones who are locked into long-term fixed costs such as land rents, contracts, and intermediate and long-term debt commitments which reduces agility and the ability to withstand financial shockwaves. These issues are often commodity specific. For example, the livestock industry is currently very vulnerable due to increased feed costs. However, any industry or enterprise can show vulnerability if markets or cost structures quickly change due to macroeconomic events.

Financial chokepoint

Whether it is a nation, industry, business, or personal household, the financial chokepoint is often liquidity. For example, Russia recently scrambled to meet interest payments on bond debt and risked default on those bonds. China's crackdown on real estate developers through increased regulation and oversight has resulted in a real estate recession. Real estate drives nearly 30 percent of the Chinese economy.

The Great Recession of 2008 to 2009 was impacted by the lack of financial liquidity in real estate developers and households. This created issues for agricultural lenders, who held loans on farm real estate that was in development or transition.

The pandemic quickly exposed people who lacked household financial liquidity. In this case, they were lucky that generous unemployment and stimulus checks from the government bailed them out.

The question becomes, do you receive an annual or a “living” financial statement from your customers to quickly assess their financial condition? “Living” financial statements refer to those that are examined more often and used in management decision making. Unfortunately, the recent government checks paid to businesses and households have resulted in complacent behavior. Quickly taking ownership of financials will be a character and management attribute that will need to be highlighted in loan committees, credit analyses, and loan narratives.

Positioning for the economic flipper

While many of you reading this column are very comfortable with debt to asset and overall equity levels, the top half of the balance sheet needs to be scrutinized. What is the liquidity position? Is the current ratio greater than 1.5 to 1? Is working capital to expenses and working capital to revenue greater than 25 percent? Were profits used to build working capital or was equity used to refinance and create a liquidity cushion? Do your customers have the discipline to maintain liquidity reserves? How will long-term inflation, shortages, shocks in the marketplace, and weather impact the liquidity position? This is where a customer with a high financial and business IQ, while still vulnerable, is in a better position to weather the extremes and economic shockwaves.

Finally, be careful of the customer who feels that agriculture profits and prices are on a new plateau. Some individuals attending my recent speeches are commenting that prices cannot go down because the government will never let us fail. Lenders beware!

Global and Domestic Economy

For this issue, the global and domestic economic analysis will be combined because they are intertwined. We will also focus on inflation.

Inflation is a major trend being experienced worldwide. Central banks in the United States, Canada, and across Europe are developing strategies such as interest rate increases and a rollback of monetary accommodation to put the genie of inflation back in the bottle. It is my opinion that the current inflationary period is more than a central bank issue and is a result of a convergence of events.

There is a lyric in the old song by the rock group Chicago that is very appropriate for the current inflationary times, that is inflation is, "A hard habit to break!" The convergence of trends has rocketed the Producer Price Index (PPI) to 11.2 percent, headline inflation which includes food and energy to 8.5 percent, and core inflation to 6.5 percent. These are the hottest readings since the early 1980s.

Supply chain issues are not likely to retreat as de-globalization continues to accelerate. Critical components used in the technology of many manufactured goods are produced in nations that are geopolitically at odds. For example, an extra 400 pounds of aluminum and 150 pounds of copper are used in electric vehicles when compared to fossil fuel powered automobiles. A large portion of these metals are mined in warring regions of the world and in China.

COVID-19 is working its way through the Chinese economy. Strict authoritarian policies have shut down 40 to 50 percent of the manufacturing industry and the effects are rippling throughout the global supply chains. Discontent is occurring in the populace, particularly in the larger cities. The strain on restaurants, goods, and services is slowing Chinese economic growth. The duration of the cycle will impact both exported and imported goods such as oil, food, and fiber products.

The Russo-Ukrainian War will have an impact on food and energy supplies both short and long-term. Ukraine is the breadbasket of Europe, in much the same way as the Midwest is for the United States. Production of agricultural goods in Ukraine is estimated to be down 20 to 40 percent and transportation and distribution infrastructure have been compromised both for the short and long-term.

Oil and energy will continue to be very volatile, not only as a result of the Russo-Ukrainian War, but Chinese economic growth and the global movement toward green energy and the disinvestment in fossil fuels. The supply and price of fertilizer and components like nitrogen, potash, and natural gas will be in question, particularly in 2023. This uncertainty will plague major agricultural regions and will result in higher food prices and transportation costs.

Of course, weather in major agricultural regions will need to be monitored. The Western U.S. is very dry as well as areas in the Southern Hemisphere. Mother nature could

potentially have a much bigger impact than any central bank action.

The saved government stimulus funds are now being spent in the service-based economy for hospitality, travel, goods, and services. This could elevate inflation well into 2023.

The labor force shortages and union contracts are creating inflationary cost structures for many businesses. Generally speaking, when unemployment is low, productivity declines as a result of less skilled workers in the workforce. This invariably results in inflation.

Finally, closely watch geopolitical strategies over the next six months. An emerging trend appears to be Western nations, or rich nations, versus authoritarian countries and emerging nations. This could create a whole new set of risks and outcomes for global trade, on which U.S. agriculture is very dependent. The Federal Reserve could increase interest rates similar to previous periods, which could yield similar results to the 1980s.

Leading indicators

The Leading Economic Index (LEI) is still positive, and the diffusion index has remained above 50. The yield curve is inverting, which occurs when short-term rates exceed long-term rates. It will be interesting to see how quickly changes in interest rates will be observed in the leading economic indicators such as the LEI.

Oil prices have been tamed at around $100 per barrel. This is the result of the opening of the strategic oil reserves, the ethanol mandate, and the slowing of the Chinese economy. The question becomes, at what duration and level of prices does reinvestment in fossil fuels occur?

The Purchasing Manager Index (PMI) is still above 50, which is indicative of a growing sector. However, this number is below 50 in many European nations. The Russo-Ukrainian War is impacting supply chains for many industries, but particularly for those that source components from Ukraine.

The U-3 and U-6 unemployment rates are at record low levels at 3.6 percent and 6.9 percent, respectively. However, some layoffs are starting to occur such as in the mortgage and banking sector which is now starting to feel the effects of rising interest rates.

Housing starts are still strong at greater than 1.5 million units annually. Closely watch this sector as prices are being reduced on 12 percent of homes nationwide as of this publication. Inflation is impacting real wages and affordability with interest rate increases. Closely observe these metrics in the latter half of 2022.

One of the leading economic indicators to watch closely will be the Index of Consumer Sentiment. Surprisingly, this number increased from the high 50s to the mid-60s.

However, this metric is still flashing red lights because consumer spending drives two thirds of the U.S. economy.

Factory utilization is still quite strong as many sectors are still experiencing strong demand and periodic shortages due to supply chain issues. Has inflation peaked? More importantly, our previous discussion in this article would suggest that it is not a question of inflation peaking, but for how long will inflation persist?

Lending and economic analysis will be both an art and science. Closely watch the numbers, but examine the practices and the character behind the financials, or the art. This can assist in identifying risks as well as business development opportunities.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	119.8	✓		
LEI Diffusion Index	70%	✓		
Purchasing Manager Index - PMI	57.1	✓		
Housing Starts (millions)	1.793	✓		
Factory Capacity Utilization	78.3		✓	
Unemployment Rate	3.6%	✓		
Core Inflation	6.5%			✓
Headline Inflation	8.5%			✓
Oil Price ($/barrel)	$110.46			✓
Yield Curve	1.81			✓

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