FARMER MAC

DAVE'S GPS

12/24/2021

Moving Forward in Cincinnati

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The 2021 American Bankers Association's National Agricultural Bankers Conference was held in Cincinnati, Ohio. While last year's conference was virtual, this year 375 bankers and agriculture professionals made the trek to the banks of the Ohio River. This was my 44th consecutive year spanning six decades of speaking at and attending this conference. Let's discuss some of the perspectives and themes that were prevalent at this year's venue.

Sunday's pre-conference session, hosted by FINPACK and Farmer Mac, was packed full of information. The FINBIN database, managed by the University of Minnesota's Center for Farm Financial Management, was very revealing concerning the importance of the government's role in net farm income in 2020. Analysis of crop farms finds that 62 percent of net farm income resulted from a government check. For dairy farms, 72 percent of net farm income was from government support payments. A surprising result was that on hog and beef farms, the percent of net farm income from government checks was 127 and 108 percent, respectively. The hog and beef farms in the analysis would have had negative net farm income if it were not for the government payments. Zeroing in on crop farms, government payments comprised 86 percent of net farm income for the largest farms in the database, with over 5,000 acres. One could say that the government coffers lifted the financial fortunes of many involved in the agriculture industry. However, government payments may be a non-recurring source of net farm income. I suggest that you pay close attention to reports, such as the FINBIN analysis, as you benchmark your customers. When analyzing year-end financial statements, three questions must be asked:

1. What percent of net farm income was derived from government payments?
2. Are government payments non-recurring or reoccurring?
3. How were government payments distributed or spent?

A theme across the conference sessions was digital strategy. Jackson Takach, Chief Economist and Head of Strategy, Research, and Analytics at Farmer Mac, did an excellent job engaging the group with surveys about their practices and perspectives concerning technology. The need for efficiency in loan underwriting and collateral valuations was seen as a priority. Jackson emphasized that developing a digital strategy was a three to five-year process to integrate the technology, process, and talents of the organization. However, I would add one more caveat: a digital strategy also has to align with the existing and future culture.

Financials and economics

Attending outlook sessions for both crop and livestock found that the presentations were bullish on the price side. The dairy industry may see the highest milk prices since 2014. Corn and soybean prices are projected to remain quite strong, along with beef and hogs. A major concern for farm profits are inflated costs and the possibility of input shortages such as fertilizer, spray, farm equipment, and parts. The implication of possible margin compression and negative profits is a distinct reality in 2022 and possibly intensifying in 2023. Close attention to working capital lines and customer needs will be a call to order in the 2022 renewal season.

Dr. Mike Swanson, Senior Vice President, Agricultural Economist & Consultant at Wells Fargo, indicated that export markets are valuable, but paying close attention to value-added consumers and the Mexican economy is also important. A North American trade strategy, with attention to Mexico's youthful population, could reap benefits in the future. Dr. Jason Henderson, of Purdue University, had a similar theme. His perspectives were that demographics drive markets and generally everything. He indicated that at the end of the day, business and banking are both about people. His conclusions were that this is a period not like the 1970s era of stagflation, marked by low productivity and high inflation. The aging population of rich nations will indicate slower growth and automation investment will also spur productivity. Both presenters indicated that soil and water health will be a high priority. A carbon market strategy led by consumers and governments will shift strategies in agriculture.

The Farm Financial Standards Council, of which I was an original facilitator, came out with recent recommendations concerning financial ratios. The original recommended list of “sweet 16” ratios was expanded to 21 and now is down to 13, or a baker's dozen. However, the agriculture industry can use some of the original ratios for benchmarking and peer analysis.

Casual conversations and perspectives

One of the benefits of attending these conferences over the years is networking and engagement with various individuals. Some interesting points and perspectives were discussed.

Some of the hallway discussion indicated that land values in some areas of the country have increased by as much as 15 to 30 percent in the past nine months. A few of the bankers attending the conference were concerned that land values and overhead costs are creating a cost structure that may not be globally competitive.

The theme in the European agriculture sector is “farm to fork.” Europe is mandating that pesticide and fertilizer usage be reduced by 50 and 40 percent, respectively, by 2030. Europe, which is now an exporter of agriculture production, could become an importer due to these mandates.

A new term circulating is greenflation, which is inflation as a result of the unintended consequences of rapidly transitioning from fossil fuels to green energy. With higher fuel and fertilizer prices, there is no doubt that the agriculture industry will be the poster child of this new term over the next couple of years.

The banker policy arm is very concerned about FinTech's or "synthetic banks" that are not regulated, along with credit unions. The possibility of the postal department extending loans to seven to eight million people that are seen as underserved had some interesting debate and discussion at the conference.

A community banker's reflections on the pandemic brought to light an interesting viewpoint. At this particular bank, parents were allowed to bring their children to work. This built on the bank's strong family culture and allowed the children to observe mom and dad in a work environment. Perhaps this provided a venue to develop the next generation of bankers?

Finally, a worst management practice was overheard. A few of the bankers attending the conference were required to pay their own way. In my opinion, this is one of the worst management practices as education, training, and interaction with the industry is critical.

Domestic Economy

It does not seem possible that we are approaching the second anniversary of the global pandemic. New variants of the coronavirus, geopolitical agendas, and mainstream and social media have created an environment ripe for volatility and have heightened the uncertainty in decision-making. This places more emphasis on the leading and lagging economic indicators to gauge where the economy is heading and whether we are experiencing headwinds or tailwinds.

Leading Economic Index (LEI)

The Leading Economic Index (LEI) is up approximately nine points since the beginning of the year. In recent months, both the LEI and the diffusion index have been strong. The diffusion index, which measures whether the ten variables comprising the LEI are trending positive or negative, has been above 80% for the past two months, signaling a growing economy in the near future.

Oil

Oil price is a key metric to closely watch for the direction of the U.S. and global economy. Increased demand for fuel and energy globally, fossil fuel disinvestment, distribution challenges, and supply chain issues have contributed to a recent spike in oil prices. This element has been a key contributor to inflation in the agriculture sector as many expenses are related to energy such as fertilizer, chemical, and distribution costs, all of which are rising rapidly. The opening of emergency oil reserves and new variants of the coronavirus could impact oil prices. Expect swings from $60 per barrel to $100 per barrel in the first quarter of 2022.

Copper prices

Copper prices have remained strong despite manufacturing disruptions as a result of supply chain issues, distribution challenges, and COVID-19 related restrictions. As long as copper prices are above $3.80 per pound, expect growth in the U.S. and global economy.

Purchasing Manager Index (PMI)

The Purchasing Manager Index (PMI) remains strong above 50, which is indicative of growth in the U.S. economy. In recent months, in China and some European countries, the PMI has dropped below 50, which may foretell challenges in the manufacturing sector in those regions of the world.

Unemployment rate

The number of filings for unemployment benefits is at the lowest level since 1969. The U-3 and U-6 unemployment rates are in the mid-to low four percent and below eight percent ranges, respectively. The Federal Reserve will watch this metric, along with the inflation rate, when making decisions regarding tapering bond purchases and interest rate increases in the coming months.

Housing starts

Housing starts are still strong at greater than 1.5 million units annually. A slowdown could be expected if interest rates increase, and inflation creates challenges in the building sector.

Factory utilization

Factory utilization is still solid, resting slightly above 75 percent. Again, labor and supply chain issues may be dampening expectations in this area.

Inflation

Wow, what a difference one year makes! Both core and headline inflation rates have been much higher for over 10 months. The amount of stimulus and the double-barreled approach of accommodative fiscal and monetary policy by central banks around the world let the “inflation genie” out of the bottle. The convergence of unprecedented stimulus, supply chain issues, shifts in energy strategies, and shortages in the job market are now building the case for semi-permanent inflation. Why semi-permanent? Any black swan event or an aggressive stance on fiscal or monetary policy could dampen inflation. However, it may take 12 to 24 months to cool inflation numbers. This period of inflation is not the stagflation of the 1970s or the post-World War II inflation, but probably somewhere in between.

Consumer sentiment

One metric that could decrease the inflation rate is lower consumer sentiment in the U.S. and globally. The Index of Consumer Sentiment, published by the University of Michigan, suggests consumers are less confident. Recently, this metric has remained in the low 70s to the mid-60s range. Watch this number very closely following the holiday season as it might dictate where the economy is going in 2022.

<u>Global economy</u>

When writing this article, the Omicron variant of COVID-19, which originated in South Africa, is trekking around the globe. However, Europe has observed a spike in cases of the Delta variant which has created partial and total lockdowns in certain areas. This is important because Europe represents 20 to 25 percent of the world economy.

This winter, watch the pipeline and energy issues. Much of the energy supply has to come through some very politically tense regions of the world. If a flare up would occur, growth of the European economy could be inhibited. New leadership in Germany may put in place incentives to grow the economy and make it less export driven. Tourism, an engine of the European economy, will be modest at best as uncertainty regarding the virus variants and travel restrictions hinder growth.

The Chinese economy is embarking on a plan by President Xi to become less dependent on exports with more consumption by its citizens. However, the recent restrictions on real estate to cool speculation in the marketplace is having an impact on their economy. This is critical because 29 percent of the Chinese economy is dependent on real estate and 90 percent of the citizens own a house or have invested in real estate to be developed. So far, the Chinese central bank and government have limited the market crash through some of their stimulus programs. However, growth of the economy, which was nearly eight percent over the past few decades, is now in the four percent range.

Other parts of the global economy outside the United States, China, and Europe are experiencing slow to modest growth. Japan, Southeast Asia, New Zealand, and Australia are very dependent on the Asian region which is experiencing a slowdown in economic growth. The outlook for 2022 will be considerably different post-government stimulus and accommodative central bank policy in the United States and throughout the globe.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	119.9	✓		
LEI Diffusion Index	85%	✓		
Purchasing Manager Index - PMI	61.1	✓		
Housing Starts (millions)	1.679	✓		
Factory Capacity Utilization	76.8		✓	
Unemployment Rate	4.2%	✓		
Core Inflation	4.9%			✓
Headline Inflation	6.8%			✓
Oil Price ($/barrel)	$74.20		✓	
Yield Curve	1.39		✓	

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