FARMER MAC

DAVE'S GPS

12/28/2022

<u>Omaha! Omaha!</u>

By Dr. David M. Kohl

This edition of Dave's GPS has nothing to do with Peyton Manning's famous audible call. However, it was a rally theme for the 70th annual American Bankers Association Agricultural Bankers Conference in Omaha, Nebraska. The Hilton Hotel and the adjacent event center was the venue for 650 agricultural bankers, exhibitors, government officials, and industry stakeholders to convene for the conference. Pre-sessions on Sunday and three days of sessions with outstanding speakers covering a variety of subject matter provided a conference packed full of information, analogous to drinking out of a fire hose. A roll call, conducted by yours truly, discovered that nearly one-half of the participants were attending their first conference. The year's conference also featured the largest women's agricultural session on Wednesday morning. After enumerating 14 pages of notes, the following are a few of the nuggets of perspectives, pearls of wisdom, and thoughts about the future of agriculture and agricultural lending.

Strong portfolios

The buzz at the conference was that agricultural portfolios were the strongest in years. However, a mood of caution persisted as many attendees realized that customer portfolio strength has been the result of government payments, inflated unearned net worth resulting from appreciating land values, and profit windows where prices received increased faster than input costs.

It was the concern of some speakers and leading agricultural bankers that the elevated, elongated input cost structures and persistently high interest rates with a possible dip in commodity prices could foretell the start of negative margins and working capital and liquidity issues beginning in 2023 and gaining momentum in 2024 through 2026.

Land markets nationwide

Though not a scientific survey, the tone of discussions in the hallways and networking sessions suggested that land values would remain strong. There was the general 40-40-20 rule concerning new farmland acquisitions. Forty percent of the bankers indicated that farmers and ranchers, particularly the baby boomer demographic, were purchasing land often using cash or with little debt. Another 40 percent of lenders indicated a split between producers and investors purchasing farmland. The remaining 20 percent of attendees in regions around the nation indicated land purchases were made primarily by individual and institutional investors.

Accrual analysis and early detection

The Sunday early bird session, presented by the FINPACK team at the University of Minnesota, confirmed what many of us have always known. When analyzing the bottom 20 percent of producers, an accrual analysis will identify up to two years earlier how quickly this group is falling off the cliff financially. However, at the other end of the spectrum, accrual analysis will provide a leading indicator of how the top 20 percent of producers are performing. As such, accrual analysis can be extremely useful in business development and identifying growth prospects.

Family living expenses

The FINPACK team presented data concerning family living costs, which is often drawn from operating loans or operating monies. The average annual farm family living expenses were $69,000. When income taxes, social security taxes, and farm capital purchases were included the amount increased to over $90,000. A chuckle from a former teaching assistant in my Virginia Tech Class of 1983, who is now the CEO of an Amish bank in Bird-in-Hand, Pennsylvania, ensued. Bill indicated that this would be the living expense for four Amish families. This is why one size or one number does not fit all in agricultural credit analysis and successful businesses. He did admit that weddings and horses can change an Amish family's living withdrawals very quickly.

Farming the alphabet and a management mindset

In recent years, many agriculture producers have generated profits by farming government programs, or “farming the alphabet.” Mid-decade there will be a progression toward generating a profit not only through production but by using a management mindset. This will include utilizing some of the government risk management tools and programs, but also incorporating them into the good solid block and tackle basics of proactive management. Borrowers making long-term capital decisions based on non-recurring government payments can be the recipe for cash flow and financial liquidity issues.

Lending beyond the numbers

Agriculture lending is not all about the answers, it is often about asking the right questions. Sam Miller of BMO Commercial Bank and Nate Franzen of First Dakota National Bank discussed a list of items that every new agricultural lender needs to know.

- Agriculture is for the most part a family business and relationship problems between parents, grandparents, cousins, and other business partners can quickly deteriorate a credit.
- Business owners do not like to discuss problems and will avoid discussions at all

cost.
- Excess spending on killer toys, including “man sheds” and recreational vehicles, are alive and well and often do not show up on the financial statements.
- Management of workers and workforce productivity can accelerate as the business grows and create potential financial problems.
- The challenge is finding the problems, developing a plan, and digging out of the negative consequences.
- Soft issues matter. What do your customers dislike about the bank, your competition, and what needs to be improved?
- Integrity and honesty are alive and well. Sometimes it can take up to eight years of paper trails to document and identify key issues.
- You must understand and be aware of the two sides of succession planning. Estate planning is handing over the assets, which is often the easy part. Succession planning is the transfer of management, which takes trust and time.
- Risk management tools are available, but do they use them?
- Some borrowers lack confidence and suffer from imposter syndrome. Do customers have the confidence to run the business or will a larger business result in lower self-confidence?

Big picture

Here are some overall themes gleaned from this year’s conference:

- Environmental, social, and governance (ESG) principles will filter down to the customer level driven by activist investors and society demanding it from larger agricultural and nonagricultural firms.

- Rail and waterways are very critical in both output and input strategies for your customer base.

- The days of globalization are gone. Regionalization and moving supply chains to trusted trading partners will characterize the next decade. Trade is critical for U.S. agriculture because trade and export markets represent one out of every five dollars of net farm income.

- The Federal Reserve will likely overshoot interest rates which could create extremely volatile prices and input costs.

As one can see, the Agricultural Bankers Conference was an excellent event for lifelong learners wanting to maintain a competitive edge while serving the agriculture industry. Next year, the conference will be in Oklahoma City for the first time. I personally invite you to the great city with the National Cowboy and Western Heritage Museum, the National Memorial downtown, and many other attractions. Hopefully, we will see you in 2023!

Global Economy

The global economy is moving into a synchronized recession. Europe, which represents nearly 20 percent of the world economy, is in retraction. This is due to high inflation as a result of rising food and energy prices. Europe, particularly Germany, became very dependent on cheap energy from Russia along with China to market their manufactured products. This has resulted in a reversal in export strategies with European goods being shipped to North America, which clogged the eastern seaboard ports. Europe's bright spot has been its tourism from the U.S. which has been spurred by a favorable exchange rate and saved stimulus by U.S. citizens resulting in a record number of visitors in various parts of Europe. To gauge the length of the European recession and how long inflation will persist, watch energy costs in the next year and NATO unity.

Moving to China, the latest estimates report the economy is growing in the two to three percent range. This would be considered a growth recession in context to a decade earlier when double-digit growth was the norm. China continues to struggle with a real estate slowdown despite lifting some of the restrictions on developers. The COVID-19 zero tolerance policy has also been modified due to the citizens' discontent in many regions of the country. Expect high levels of sickness and death, especially in older and at-risk people, as the pandemic runs its cycle. The slower growing global economy along with a 40 percent decline in exports to the U.S. have both restricted China's growth. Expect China to have close relationships with Russia and countries in the Middle East for political, military, agriculture, and energy strategies.

Emerging nations continue to struggle with food and energy inflation. This is particularly important in areas where over 30 percent of the household budget is spent on food.

Domestic Economy

The U.S. economy could be summarized in one word: uncertain. The leading and lagging economic indicators tell the story. After two quarters of negative growth, an unofficial recession, the third quarter gross domestic product jumped to 2.9 percent. Stimulus savings and low unemployment have allowed the economy to motor along.

The Leading Economic Index (LEI) indicates all signs of a recession in the next year. The index has been down over three-tenths of one percent for six of the last seven months and 4.4 points overall. The diffusion index, which measures whether the factors comprising the LEI are trending positive or negative, is up slightly at 40.

Oil prices have moderated as a result of pumping out of the U.S. strategic oil reserves and China's slowing economy, which consumes nearly 15 percent of global oil. Copper prices have rebounded recently due to global demand and a shortage of production.

The Purchasing Manager Index (PMI) has fallen below 50, indicative of a manufacturing sector slowdown. Very closely watch the automobile industry as inventories are increasing and delinquency on auto loans is skyrocketing. Factory utilization, while strong, is now experiencing some decline falling below 80 percent capacity.

Unemployment is still in the lower range at 3.7 percent and 6.7 percent for U-3 and U-6, respectively. Expect the unemployment rate to increase as large layoffs are becoming the norm in the technology sector and as stimulus checks are running out.

Housing starts are less than 1.5 million units annually and are expected to decline as the Federal Reserve's actions make owning a home much more difficult.

Inflation continues to decline. The Producer Price Index (PPI) is at 7.4 percent, headline inflation which includes food and energy is at 7.1 percent, and core inflation without food and energy registered at 6 percent. Expect interest rates to continue to increase as the Federal Reserve attempts to move toward a goal of 2 percent core inflation and 4 percent headline inflation.

The Index of Consumer Sentiment is still in the 50s, which is a dire sign considering that consumer spending drives 70 percent of the U.S. economy. With stimulus savings of $1 trillion being reduced by $200 billion a month and credit card debt increasing, the public appears to recognize that storm clouds are on the horizon.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	113.5			✓
LEI Diffusion Index	40%		✓	
Purchasing Manager Index - PMI	49.0		✓	
Housing Starts (millions)	1.427		✓	
Factory Capacity Utilization	79.7		✓	
Unemployment Rate	3.7%	✓		
Core Inflation	6.0%			✓
Headline Inflation	7.1%			✓
Oil Price ($/barrel)	$83.42		✓	
Yield Curve	-0.73			✓

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