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Renewal Season and Interest Rates

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The remainder of the fall and 2023 renewal season could be interesting. When considering global economic uncertainty, a strong dollar, elevated input costs, and the Federal Reserve insistent on killing the “dragon of inflation,” exercising prudence in financials and business strategy will be critical.

There is an old saying that “we do not know what we do not know.” In recent years, ample government payments and strong commodity prices for many enterprises has led to minimal financial monitoring becoming the mantra. This mindset is analogous to my first ride in a driverless car. We were on auto-pilot maneuvering through traffic in excess of 70 miles per hour and life was good. I then inquired, “What happens in a snowstorm or when a deer runs across the road?” The nonverbal shoulder shrug from my copilot said it all.

Adverse conditions are about to emerge in agriculture. Possible commodity price reductions with elevated expenses, including cash rents and leases, are bound to be an obstacle to profits and cash flow. This will require good judgment and sound, transparent financials to obtain cost of production and breakeven levels. A marketing and risk management plan with execution and monitoring may be the ticket to profits or minimizing losses.

A deep dive analysis on the financials will be required. What are the earned and unearned net worth changes? Unearned net worth can often lead to complacency in business and financials as well as an artificial sense of well-being.

While government checks have reduced cash flow and liquidity risks and, in some cases, eliminated the need to borrow on operating lines, be careful! Conduct a three-year analysis of government payments as a percent of net income. A theme in 2023 and beyond will be what will it take to get the business in the black without or with reduced government payments?

Next, examine how government payment windfalls were allocated. Were they used to build liquidity, for capital expenditures, to make a down payment on land, or for family living expenses? Remember, the strong financial years are often what get businesses into financial difficulty. Speaking of capital expenditures, ask the borrower for specifics.

What are the high priority needs followed by the lower priority wants for both the short-term and long-term.

Examine margin inversion that is the result of cash or lease strategies. What are the terms and are they critical for a viable operation? When margins are squeezed, all major costs need to be evaluated.

Of course, an input cost and inflation strategy is necessary. Are inputs available and at what cost? What are the alternatives and how does it impact production efficiency?

Watch for secondary sources of operating credit. For some producers, credit lines are maxed out and other sources of credit to fulfill working capital needs will be required, but sometimes are not reported on the balance sheet.

Internal reviewers and regulators will require more transparent financial information in this part of the economic cycle. Portfolios that have been performing at historical levels of acceptable credit that then decline will cause sticker shock that could result in credit underwriting standards changing very quickly.

It appears that the Federal Reserve will set the federal funds rate between 4.25 and 5.50 percent. This increase in interest rates will have a minimal impact on mortgage debt, which is often a fixed rate or set up on a five- or seven-year rate reset. However, be careful of debt with interest rate resets. Be sure to consider the implications when the rates have to be renegotiated.

The largest financial shock will be on operating monies, debt with variable interest rates, production loans, and intermediate debt. This is where a good set of financial spreadsheets or software can be invaluable for the financial analysis and during conversations with the borrower. The interest rate shock could be as little as two percent or as much as four percent and alter the cost of production and breakeven levels.

Going into 2023, the call to order is whether a business or household is financially liquid. For a household, living within your means and building a financial cushion and savings reserve of four to eight months should take precedence. For a business, the priority is strong working capital demonstrated by a current ratio greater than 1.5 to 1 or working capital to expenses greater than 25 percent.

A deep dive on working capital analysis needs to be done to determine whether working capital was generated through profits and cash flow or through a home equity loan or farm debt restructure. If the latter, remember the rule of three. Restructuring debt once is probably okay, twice is a stretch, and three times usually indicates there is a business or spending issue that needs distinctive action.

Buckle up and get ready for some financial shocks resulting from the unknowns. On the positive side, the next few years will be a great opportunity for relationship lenders with a side-by-side approach to navigating the economic white waters.

Global Economy

The Euro sector, including Great Britain, has a high probability of an extended, deep recession. This region contributes about 20 percent of the global gross domestic product (GDP).

Energy issues are impacting households, but much more for businesses. In many countries, inflation is near or exceeding 10 percent. Energy costs, including natural gas, are 10 to 20 times higher year-over-year. Despite building up reserves to curtail this inflation, some businesses are limiting or discontinuing production. Germany, the fourth largest economy in the world, is greatly impacted by energy. The movement toward green energy has increased the degree of uncertainty for businesses and consumers. China is in a growth recession and is Germany’s largest customer, which puts additional strain on the German economy.

Geopolitical changes in leadership in Italy and Great Britain and strategies to stimulate the economy have been a counter to the inflation curtailment by the European central banks. The Bank of England has had numerous rescue attempts of pension funds because of a liquidity crunch as a result of these inconsistencies. Will similar challenges occur in the U.S. and in other countries' pension funds? If so, will it be the “canary in the coal mine” of the global investment community?

China, the second-largest economy in the world, is in a growth recession which means they have growth in the one to four percent range after they had growth rates in the double digits a decade ago. COVID-19 lockdowns and real estate value declines due to capital restrictions on developers imposed by the government have placed the real estate industry, which is 29 percent of the Chinese economy, in a slow growth or declining mode. Weather issues, specifically dry weather, have hindered production along with slowing economic growth in the Asian region. China’s slowing economy is one of the first major challenges for President Xi and will ripple through other nations in the Asian rim.

Energy and food nationalism is wreaking havoc in developing and emerging nations. For example, India has limited rice and wheat exports to the Philippines and Indonesia. Russia and Ukraine have limited exports of wheat and sunflower oil to as many as 50 emerging nations, placing these countries into recession mode.

Globally, expect economic growth for 2023 and 2024 to be at three percent optimistically, 2.1 percent standard range, and one percent pessimistically. Global economic growth needs to be taken into consideration as the agriculture industry is very dependent on exports for revenues. On average, one in five dollars of agriculture

revenues is derived from exports, but this number is higher for some commodities such as over 50 percent for soybeans and approximately 75 percent for cotton.

Domestic Economy

Headwinds include inconsistencies in monetary and fiscal policies, similar to the aforementioned Euro sector. The Federal Reserve is aggressively raising interest rates to curb inflation while the government is stimulating the economy through various fiscal policies and strategies.

The aggressive movement from fossil fuels to green energy and strategies from OPEC to reduce output has created extreme volatility in the energy markets and has prolonged high energy prices.

While high income households are still burning through stimulus savings on travel and hospitality, this spending may be in the final stages.

Cryptocurrency, the equity markets, and now real estate are feeling the impact of higher interest rates with less accommodative federal action. The Federal Reserve has been reducing their balance sheet anywhere from $75 to $95 billion per month. These factors will eventually impact consumption. A strong dollar and a weakening global economy could put manufacturing and export-oriented agriculture businesses into difficulty.

Economic Dashboard

The dashboard of economic indicators finds the Leading Economic Index (LEI) is in recession territory. This metric is down four-tenths of one percent for more than six months and 3.4 points over the period. This is very similar to the metrics from the Great Recession over one decade ago.

Copper prices are in the $3.35 to $3.45 per pound range, which is indicative of a slow growing U.S. and global economy.

The bright spot has been the Purchasing Manager Index (PMI) and factory utilization which are both still in a strong position at greater than 50 percent and around 80 percent capacity, respectively. Companies are filling back orders; however, a word of caution, orders of cars and trucks are being canceled and inventories of manufactured goods are building.

The unemployment rate is still low at 3.5 percent for U-3 and 6.7 percent for U-6. However, the workforce participation rate is lower and labor productivity was negative 7.4 in the first quarter, negative 4.1 in the second quarter, and overall negative for the first half of the year. The lack of productivity creates inflation in goods and services.

Housing starts fell below 1.5 million units annually. Expect this metric to slow as interest rates increase and individuals become reluctant to sell houses to give up their low mortgage rates for a new house when mortgage rates have doubled year-over-year.

Finally, inflation has been persistent despite the Federal Reserve's measures. The Producer Price Index (PPI) is at 8.5 percent, which is often used in contract negotiations. While lower than the cycle high of 11.6 percent a few months ago, the PPI is being very stubborn despite corrective action.

The latest reading for headline inflation was 8.2 percent year-over-year, down from 9.1 percent. This reduction is the result of the decline in fuel prices due to the drawdown of the U.S. strategic oil reserves and less demand from China as their economy slows down. Core inflation, excluding food and energy, has actually increased to 6.6 percent, which has frustrated the Federal Reserve. Increases in housing and medical costs, which comprise about 50 percent of core inflation, have placed upward pressure on this metric. As a result, expect the Federal Reserve to raise the federal funds rate to 4.25 percent at a minimum by the end of the year. This will equate to about a 7.25 percent prime interest rate. Interest rate sensitivity shocks will need to be considered for customers during the renewal season based upon the latest outlook.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	115.9			✓
LEI Diffusion Index	50%		✓	
Purchasing Manager Index - PMI	50.9	✓		
Housing Starts (millions)	1.439		✓	
Factory Capacity Utilization	80.3	✓		
Unemployment Rate	3.5%	✓		
Core Inflation	6.6%			✓
Headline Inflation	8.2%			✓
Oil Price ($/barrel)	$90.27		✓	
Yield Curve	0.56			✓

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