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<u>The Black Swan Has Arrived</u>

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Wow, what a difference a couple of months has made in the U.S. and global economy and to society in general. I have taken a temporary sabbatical from traveling as the sudden impact event has “rocked ‘n’ socked” our lives. The focus of this article will be on the short, intermediate, and long-term impacts of COVID-19 and how agricultural lending will be impacted. I will also provide an economic update for the U.S. and global economies, which in recent years have not exhibited much change, but now appear to be moving by the minute.

This black swan event has created a paradigm shift in human behavior. It will be interesting to watch the impact of consumer behavior in the rich nations around the world such as the United States, European nations, and Japan versus the emerging nations that observed record growth of the middle class in recent years.

In the short run, behavioral emphasis has been on the basics of food, shelter, emotional support, and a sense of belonging. Commodity prices, specifically corn, livestock, cotton, and milk, have seen dramatic downside adjustments as people's eating habits and the demand for fuel has changed very rapidly. These changes, along with bottlenecks in the supply chain, have overplayed agreements that were made in the United States-Mexico-Canada Agreement (USMCA) and phase one of the China trade deal.

Moving forward, one will have to observe the duration of COVID-19 in the U.S. and abroad. In the intermediate and long-term future, it will be necessary to observe whether new strains of the virus emerge, impacting spending and investing activities. A positive element of the agriculture industry is that, for the most part, biosecurity protocols ensure the safety of U.S. food systems, which heightens the image of the U.S. agriculture industry domestically and abroad.

A concern in the intermediate and long-term future will be whether there is too much production and processing concentration in the agriculture industry. The quest for economic efficiency and production in optimal areas of the U.S. and abroad may have come at the price of resiliency. Will consumers, political leaders, and society advocate for more diversified production? Will lawmakers increase the use of anti-trust legislation in light of our current situation? These questions will have to be answered over the next few years. Whether it is inputs, outputs, distribution, labor, or employee safety, COVID-

19 and the resulting aftermath will cause supply chain disruptions and other unintended consequences.

For the agricultural lender, one must be concerned about third-party and counterparty risk. This risk is a result of a disruption in concentrated agribusiness and food sectors leading to the exposure of individual producers and agribusinesses in the loan portfolio.

It will be interesting to observe how the investment behavior of the last stronghold of the U.S. farm balance sheet will be impacted. Will potential farmland and real estate purchasers move towards cash holdings rather than investing in hard assets? To the contrary, will both farm and nonfarm investors seek farmland and real estate purchases as hard asset investments? Will all of the fiscal stimulus in the U.S. and abroad create an economic situation where interest rates will increase, or, worse yet, see a dramatic increase?

One will need to closely monitor the economic health of our major agriculture trading partners including Canada, Mexico, Japan, and China. Will they be in a position to accept and pay for U.S. exports? Will a softening of the tariff agreements occur in the short run? How will the outcomes of the U.S. and German elections move these economic factors in the future?

Economics in the year 2020 will also be shaped by weather in the U.S. and Southern Hemisphere. Year-end supply projections and numbers will be closely monitored due to weather changes.

Next, how much will supply chain disruptions impact input prices and the price of food, fiber, and fuel. Corn prices are already being impacted by ethanol plant shutdowns. While the livestock sector is benefiting from lower corn prices, it is also a downside because some livestock producers utilize the byproducts of ethanol plants.

Will the government support payments for agriculture continue and at what level and to what extent? For the past two years, these payments have been a profit and cash flow bridge for many producers, allowing them to service debt and pay bills.

Paradigm shifts, ranging from education delivery systems to online shopping and home delivery, will create winners and losers not only in the agriculture sector, but the economy as a whole. Will the young and beginning farmers and ranchers, who have been very entrepreneurial, adapt and find new innovative ways to be profitable in a consumer driven economy with shifts in preferences and habits.

Given these possible outcomes and other implications, what will be necessary for the remainder of 2020 and possibly into 2021?

- It is possible that lenders will relax loan agreements to accept interest-only payments and potentially principal deferment. However, if this occurs, written marketing and business plans prepared by the borrower will be critical for monitoring economic shifts.

- Relationship lending will be imperative internally and externally. Relationship officers will have to work closely with credit analysts and loan committees for solutions when working with the customer. Solutions must be a result of side-by-side customer conversations.

- Budgets must be developed and an emphasis on both farm and ranch spending and personal financial habits will be critical. What are the top spending and investment priorities given various scenarios? The use of spreadsheets with financial scenario planning will be one of the top tools in the toolbox for both lenders and borrowers. Closely monitoring projections and activities will be priority number one.

- Training and education will be critical during this unusual period. What will be the balance between online and blended education versus face-to-face education for lenders and borrowers? How can these alternative educational venues be used to effectively educate on a moment's notice in a rapidly changing environment?

Riders on the Storm

Domestic Economy

This black swan can be considered a dirty bird when it comes to the U.S. and global economies. The effect on the economic indicators is only the beginning of a record drop that may be with the world for a considerable period of time.

When examining the Leading Economic Index (LEI), this economic indicator demonstrated the largest drop in history from 111.7 to 104.2. In this case, one did not have to wait for a 0.30 percent reduction over a consecutive three-month period to know that the U.S. economy is headed for a recession. When compared to the Great Recession, the LEI declined 2.4 points over a five-month period, which illustrates the magnitude of this drop.

The diffusion index measures whether the factors comprising the LEI are trending positive or negative. This index registered in at 35 percent for both February and March, another nail in the coffin of a steep, elongated recession.

There is an old saying that oil prices which are too high or too low are bad news for the economy. Demand destruction from fewer automobiles on the road, less commercial airline flights, and oil storage facilities reaching their capacity is resulting in record low oil prices. When writing this article, oil futures were at $8 per barrel. We have not seen prices this low since the 1990s. The question becomes whether this decline will wreak havoc on ethanol, fracking, and other sources of energy that have maintained strength and stability for the U.S. economy.

Core and headline inflation rates are decreasing. Headline inflation is significantly lower due to lower oil and fuel prices. Copper prices, a leading indicator of global economic growth, have shown significant declines as well.

The Purchasing Manager Index (PMI) is 49.1, which is just below the level indicating an expanding economy. Expect the PMI at the next reading to be between 30 and 40, in recession level territory, because much of the manufacturing complex has gone into hibernation.

Over 25 million workers out of the 150 million plus workforce are unemployed. Expect the unemployment rate to jump to 14 to 22 percent, plus or minus. With much of the service sector idle, the increase in the unemployment rate will have a ripple effect on the consumption trends for wholesale and retail goods.

Housing starts declined from 1.5 million units annually to approximately 1.2 million units. This sector needs to be closely examined for the next few months because one in seven jobs in the United States is linked to the housing sector.

The Index of Consumer Sentiment, which was above 90 for a large percentage of the past few years, took a nosedive analogous to Clayton Kershaw's curveball. This drop off the table decline is the largest in history. How low can it go and how long can it last?

The flight of funds into U.S. treasuries is reflected by the historically low rates of the 10-year and three-month T-bills. It appears that the inverted yield curve of the past few months will be a leading indicator of a recession.

Global Economy

The news is not much better globally. China's growth registered in at negative 6.5% in the first quarter of 2020. This is significant because it is the first negative growth rate recorded since economic records were maintained in 1992.

According to the International Monetary Fund (IMF), Europe's growth rate is projected to be negative 7.5% versus the U.S. at negative 5.9%. Surprisingly, the IMF indicated that the Chinese growth rate would be positive 1.2%. Growth of the Chinese economy is going to be contingent upon the Chinese domestic retail sales improving and whether Western consumers such as the U.S. and European nations will be buying and have the incentive to continue buying Chinese goods. Expect to see some backlash toward China and its manufacturers in the coming months due to COVID-19 originally starting in China.

At best, global export trade is expected to be down 10 to 15 percent, according to the IMF. This includes agriculture, manufacturing, and technology trade. Disruptions in supply chains and tough negotiations between global leaders may create some very volatile times in global trade in the months ahead.

The bottom line is that this could be the steepest and longest recession in decades. Behavioral economics is in full gear, resulting in new paradigms of doing business and managing personal finances.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	104.2			✓
LEI Diffusion Index	35%			✓
Purchasing Manager Index - PMI	49.1		✓	
Housing Starts (millions)	1.216		✓	
Factory Capacity Utilization	72.7		✓	
Unemployment Rate	4.4%	✓		
Core Inflation	2.1%		✓	
Headline Inflation	1.5%	✓		
Oil Price ($/barrel)	$21.33	✓		
Yield Curve	0.62		✓	

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