FARMER MAC

DAVE'S GPS

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<u>Trends, Observations, and Perspectives</u>

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It is the height of summer and agricultural lenders have made it through another renewal season. Many institutions will move into the fall in full gear into strategic planning and preparing for the quarter-century mark and beyond. As an agricultural educational speaker and business owner, I have compiled some of the trends and observations I see that will stimulate thought and impact the strategic plans of customers, agribusinesses, and lending institutions.

Artificial intelligence (AI)

Interestingly enough, Dr. Tom Payne, Dean of Tennessee Tech, and I discussed artificial intelligence (AI) in our class *Interpreting Economic Change* at the Graduate School of Banking at Louisiana State University six years ago. At last year's American Bankers Association's Agricultural Bankers Conference, hallway conversations were beginning to emerge about the subject. The interesting perspective is that it has advanced at an accelerating rate in planning discussions. Recently, an agricultural lender used AI to develop contracts for land and equipment sales, saving the customer hundreds of dollars. Others are using AI to facilitate loans in the million-dollar range with minimal information. Recently, one lender mused that AI is the “Rocket Mortgage” for agricultural loans. AI is only going to grow in significance.

According to Agrian's CEO, at the start of fall 2020, AI was equal to a human IQ of about 80. By 2024, it will be the equivalent of 120 and is projected to increase to 1,200 by 2028. Every business owner must think through how AI will be integrated into a strategic plan. What will be the unintended consequences, both positive and negative, of artificial intelligence? How will it be used by the next generation, who by nature are more technology savvy? How will technology and data management be customized to each business from a production, risk management, finance, and human resource standpoint? Who has control of the valuable data? A group of South American farmers are already examining AI as a global competitive advantage. To put AI in perspective, let's draw upon the famous book *Megatrends* written decades ago by John Naisbitt. The more high-tech, the more you need high touch or the human horsepower to harness the power that technology bestows.

Cracks in agriculture financials

The reality of financial and economic risk is in full force in the hog industry. Will it spread to other sectors? When compared to the 1980s, agricultural businesses are bigger and more consolidated, which can wreak havoc on an agricultural loan portfolio.

The hog industry is overbuilt and demand is not keeping up with the supply. The Chinese hog industry is now back online. Trade agreements and a strong U.S. dollar are challenging demand globally. Regulatory forces in states such as California are challenging the methods of production. Strategically, every industry in a loan portfolio needs a risk assessment of both domestic and global sustainability.

Bigger numbers = bigger problems and opportunities

Building upon the previous discussion, the flywheel effect is in full play. When businesses are dialed in and the economic environment is positive, profits skyrocket. At the other end of the spectrum, in a down macroeconomic cycle, losses can quickly mount. This is why financial transparency and more intense monitoring throughout the year is critical. Remember, accrual adjusted statements usually reveal financial difficulties two years before they occur. This analysis will also discover business development opportunities in advance. What will be your strategic plan to monitor the numbers and the nonfinancial factors that can quickly flip the switch on performing loans?

Farmland has competition

Land values exploded in the era of accommodative monetary policy combined with lush government payments. This has provided lenders comfort from a balance sheet and equity standpoint. However, profits and cash flow service debt along with the occasional refinance when a hiccup hits a business or specific industry. A new era of higher interest rates and less accommodative fiscal policy has reduced the “TINA” effect on land, in other words “there is no alternative.” The returns on money market accounts and certificates of deposit are luring investments away from land, particularly with older producers. Yes, green payments for almost everything under the sun can be considered. However, what will be the unintended consequences in the long run? What will be the younger generation of producers' philosophy on land? Remember, land is the security asset of choice as over 80 percent of the U.S. farm balance sheet is farmland.

Food and energy

The food and energy sectors have been in a major paradigm shift. The movement from fossil fuels to green energy affects a large portion of the agriculture industry’s cost of production. A walk in the grocery store finds that new substitutes for traditional products, which are often packaged more attractively, are becoming more relevant in both domestic and global markets. How are the producers you serve making proactive adjustments to mitigate the impact of these issues on price and cost?

Human transition

The great exodus of institutional memory of the art and science of agricultural lending developed during the 1980s is about 90 percent complete. Will the balance of financials and non-financials be carried forward in today's world of efficiency, technology, and growth? Will the leading indicators of financial risk such as family or management issues, a run-up of non-disclosed account payables, and split lines of credit be discovered too late? Many lenders focus on risk rating and default rates, which are lagging indicators.

What is your institution's educational plan to attract and retain new staff and align the next generation of lenders with the next generation of farmers and ranchers? To those who are retiring, remember you may go through a period of mental anguish and at first become a “lame-duck,” but you will soon discover your next chapter. I highly recommend Azul Wells on YouTube for financial and life balance for all generations going through a transition.

From the customer standpoint, transition planning and education will be imperative. Transition management is the Achilles' heel of most successful businesses.
Your role as a lender, whether as a facilitator, educator, or monitoring loan covenants, will be critical.

Old school

When playing in the noontime basketball association (NBA), the best compliment you can get from the younger generation as a vintage player is that you are “old school.” That is, you move well without the ball, pass, cut, defend, and know your role. The hallmark of an effective lender or businessperson is personal success. The other day, I was reading the Bruning Bank newsletter from Bruning, Nebraska. The newsletter has been in existence for over 40 years. Frank Bruning, the founder of the newsletter, had a great quote. He said there are three main concerns that people have of their friends and their bankers:

1. Can I trust you?
2. Do you know what you are talking about and what you are saying?
3. Do you care about me personally?

Whether it is the basketball court, lending, or business, these core values go a long way in business and life. When we analyzed the recent bank failures, it was quite obvious that they did not check the boxes on those three questions. It is amazing what a small-town community bank in Nebraska could teach larger, corporate businesses.

Global Economy

The midyear summary can be sized up in one phrase: They are out of sync! Examination of the global economy begins with China, the second largest economy in the world. Both the short- and long-term demographics are becoming more of an issue. Not only does China have a declining population, now surpassed by India, but the country is now experiencing the 4-2-1 issue. This means they have four grandparents, two parents, and one child, which is suppressing growth. For example, the number of five-year-olds are half the number of 10-year-olds in China.

China is experiencing a debt hangover and is in a deleveraging phase of the economic cycle. Total government, consumer, and household debt is 295 percent of GDP. Chinese household debt is 110 percent of GDP, the same levels of the U.S. prior to the financial crisis of 2008. Chinese households, which saved $2.4 trillion during the COVID-19 lockdowns, are applying some of the savings to pay down mortgages that total nearly $6 trillion and are on variable interest rates. This is due to the lack of confidence in declining exports and manufacturing, technology, and growth expectations in the five percent range less than half a decade ago concerning their GDP.

In the Asian region, India is now the fifth largest economy in the world, surpassing Great Britain. With a youthful population, India is placing its bets on technology components and manufacturing. However, a demographically fragmented country at the regional level and misalignment in social and political issues will cause India to experience lower acceleration of growth than neighboring China.

In Europe, Germany and the Euro sector are in a recession, defined as two consecutive quarters of negative GDP. Despite this, this region of the world continues to raise interest rates to curtail inflation. This is contrasted with China that is lowering interest rates to stimulate the economy and the United States, which is currently in a hold position at the time of this publication.

The war in Europe continues to place focus on food inflation as a result of Ukraine being one of the breadbaskets of the world. Energy prices are softening as a result of a slow growth economy in China, and oil and energy output still being strong in OPEC.

Domestic Economy

Discussion about being out of synch is very appropriate for the U.S. economy. Many leading economic indicators would suggest that we are already in a recession, or a recession is just around the corner. However, the service-based economy, travel, and entertainment have maintained a robust status due to the $2.9 trillion saved fiscal stimulus, which has now dwindled to $700 billion.

The Leading Economic Index (LEI) has been down more than three-tenths of one percent for numerous months, which is usually a prelude to a recession. The diffusion index is registering at 30, consistent with most of the year 2023. The lag effect defined by Paul Volcker, former Federal Reserve Chairman, appears to be alive and well in these metrics. Volcker indicated that central bank adjustments have a lag effect of 8 to 18 months.

Oil prices have stabilized despite OPEC cuts. Slow global economic growth, particularly in Asia, and less transportation such as ocean traffic and other distribution modes here in the United States have moderated this indicator.

The Purchasing Manager Index (PMI) is still in contraction mode in the mid to high 40s, another bellwether of a recession.

Employment metrics remain strong, with unemployment at 3.7 (U-3) and 6.7 percent (U-6). Job growth has been strong in blue-collar and service sectors, but contracting in technology and white-collar segments.

Surprisingly, despite interest rate increases, housing starts have jumped to over 1.6 million units annually which is above the 1.5 million mark that illustrates strength. Factory utilization is registering in the high 70s, which is a strong metric.

While headline inflation, including food and energy, and producer price inflation has been declining to 5.3 and 1.1 percent respectively, core inflation has been slower to decline at 5.3 percent. Part of this is due to the housing industry, which makes up almost 30 percent of this metric.

Labor productivity, which has been negative for a number of quarters, has been a contributor to sticky core inflation. When people are not productive it costs more to produce outputs, resulting in inflation.

A closely watched economic variable is the Index of Consumer Sentiment, published by the University of Michigan. This index is still very concerning at 64.4 and has been under 75 for almost 2 years.

In summary, this fall and winter will be interesting times. If the Federal Reserve continues to raise interest rates and these indicators continue in the negative range, there could be a hard recession ahead of us.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	106.7			✓
LEI Diffusion Index	30%			✓
Purchasing Manager Index - PMI	46.9		✓	
Housing Starts (millions)	1.631	✓		
Factory Capacity Utilization	79.6%		✓	
Unemployment Rate	3.7%	✓		
Core Inflation	5.3%			✓
Headline Inflation	4.0%		✓	
Oil Price ($/barrel)	$75.19		✓	
Yield Curve	-1.76			✓

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