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DAVE'S GPS

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What Is Making Agricultural Bankers Nervous?
By Dr. David M. Kohl

The other day, a call came in from my good friend over the years, Mike Hinton. He was about to address an agricultural bankers' conference. Mike is a Hoosier and is the only person to play against Larry Bird in high school and while he was at Purdue University. In casual conversation, Mike indicated that he also was at the end of "Larry Legend's" famous trash talk. A conversation ensued about the variables that need to go into the discussion concerning what is making agricultural lenders nervous these days.

The beginning of the end

The last few years have been quite generous for much of agriculture. The government stimulus checks combined with rapid price increases before expenses and interest rate increases resulted in strong profits and cash flow. Supply chain issues and lockdowns due to the pandemic resulted in limited capital expenditures on machinery, equipment, and, in some cases, family living expenses. With the click of a pen or computer key, increased land values resulted in strong net worth gains through capital appreciation. Working capital levels approached commodity super cycle levels more than a decade ago. Now with storm clouds on the horizon, there may be a shift occurring from the good times of the economic cycle.

New kids on the block!

An observation from this summer's conferences and lending schools is that turnover, both in lending and in the farming and ranching sector, is in full gear. In a conference of over 100 agricultural lenders, only five were left that either farmed or had loaned money in the farm crisis years of the 1980s. While the attitudes for learning with the next generation and beginning lenders are very good, it will be interesting to observe how they will work with their customers during difficult times. Good economic times often result in transactional lending fueled by financial incentives and bonuses for loan growth. Economic downturns often create a shift towards relationship lending which requires more time with the individual customers by focusing on financial and business management, interaction, and even the status of mental health.

Ghost collateral

In recent months, my boots on the ground intel indicate fraud and greed, the cousin of fraud, are lurking. For example, one banker indicated that his customer's balance sheet listed 90,000 head of cattle and 140,000 bushels of grain. The farm inspection resulted in 10,000 head of cattle and 40,000 bushels of grain with a large amount of "ghost collateral" that could not be accounted for. Another case found that government stimulus checks were invested into a $1.5 million lake house with camper trailers that could not be accounted for.

Impact of interest rates

Many agriculture producers have not faced the impact of rising interest rates, particularly on operating money or interest that is going to be due at the end of the year. Sticker shock is going to occur for others that have term loans structured on three-, five-, or seven-year interest rate resets. There is a low probability that the Federal Reserve will return to zero bound interest rates like we experienced from 2008 to 2022. Higher interest rates and compressed margins will require increased working capital as a financial shock absorber, perhaps for multiple years.

Complacency

As lenders you will need to analyze how your customers managed the prosperity of recent years and how this affected your overall portfolio. Then, determine how well your customers are prepared to work through financial adversity. This includes a test of management resolve and character, which credit risk rating systems often have difficulty measuring. Complacency has resulted in once per year "drive by" financials for tax reasons by the customer base. Ownership of numbers and consistent monitoring and analysis is a two-way street for both borrowers and lenders.

Schedule F and family living expenses

Two of the most bogus data points in agricultural credit analysis are Schedule F net farm profit and family living expenses, which are both extremely important to risk and possible outcomes. Yes, tax records are important for documentation verification. However, revenues, costs, and depreciation are often manipulated to reduce taxes which can yield differences of 40 to 60 percent when compared to accrual adjusted income statements. Family living expenses have ballooned in recent years as inflation and the number of people living out of the business have increased. Short-term lenders beware as living expenses and true profitability symptoms show up first in the operating lines of credit, accounts payable, and credit card debt.

Weather and geopolitical agenda

It appears that both mother nature and government leaders have agendas. Every agricultural lender must have a "go to" source for local, regional, national, and international weather and its impact on prices and expenses. Trade, geopolitics, and political agendas must be observed to determine the impact on the customer base.

Does your customer base have the necessary marketing and risk management skills to execute objective decision-making in an uncertain environment? Unfortunately, many do not and will become exposed in an economic downturn.

Shadow lenders

The involvement of nontraditional and unregulated lenders, particularly with operating monies, has been increasing. Some say up to 30 percent of monies extended for operating are from these sources. While there is no problem with these sources of credit, many producers often forget to account for or list these sources of credit and amounts as obligations on balance sheets. Again, good economic times mask these sources, but a downturn sometimes creates an “October surprise” of higher debt obligations than expected.

Chasing the next big thing

There is considerable discussion amongst producers and lenders of the “next big things” in agriculture ranging from carbon credits and green energy incentives to unique sources of income such as hemp. Some of these avenues require considerable capital investment and long-term revenue streams for viability. Due diligence and analyzing unintended consequences need to be addressed on an individual customer basis.

Scalability and transition management

Finally, agriculture is not only consolidating, but it is going through an accelerating transition phase. Both require high levels of management expertise. Recently, in a discussion with an agricultural lender, we identified 10 larger dairies experiencing either accelerated growth or generational transition. All of the current owners were in the age range of 60 to 75 years old and operated well-managed businesses. However, we both agreed that seven out of the ten operations’ next generation of management had cracks or fissures in business and financial management and possibly their commitment to carry large amounts of debt from an individual or spouse’s standpoint. Very little effort has been placed on transition management, while growth expectations have been full steam ahead on all of these dairies.

The beginning of the end of the mini-profit economic cycle is in motion. Hopefully, some of these factors Mike and I discussed can be used when analyzing credit and communicating credit decisions, whether in a loan committee or an interaction with a credit analyst in your institution.

Global Economy

The global economy can be coined at best as one of slow growth. After 30 years of unprecedented growth, China is experiencing economic growing pains as a result of a convergence of five variables.

1. First, the one child policy has created the 4-2-1 issue, meaning there are four grandparents, two parents, and one child. There are not enough young people to spur economic growth and spending in addition to supporting the older generations, resulting in a slowing growth rate in the economy.

2. Next, manufacturing technology, the engine of growth for the past three decades, is being hindered by a slowdown of exports to the United States, Europe, and other Western nations. China's exports to the Western nations are down 40 percent and total exports are down 14.4 percent overall.

3. Chinese citizens are not spending the $2.4 trillion saved in the three-year COVID-19 lockdown because of concerns about both the Chinese and global economies.

4. Next, housing prices are correcting and many local and regional economies in China are heavily in debt. Some localities are even defaulting on payments.

5. Finally, the government crackdown on technology is a factor leading to high unemployment amongst 20- to 30-year-olds with college degrees. Unemployment is over 20 percent; however, some insiders indicate it may be as high as 50 percent. This is creating unrest in some sectors of China.

Europe has bounced back to positive economic growth after two consecutive quarters of economic growth in the red. European economic growth has been curtailed by stubbornly high inflation that requires increases in interest rates. Europe is very fortunate to have Americans spending stimulus checks and running up credit card debt through tourism, which has helped to circumvent a steep recession.

Global snapshots

- Shifts in manufacturing are being observed, moving from China to Southeast Asia and now to Mexico.

- India, the world's second largest producer of rice, has placed restrictions on exports. This is resulting in a shortage of rice and high prices of a food product that much of the world uses.

- A slowdown of exports in pork and milk to China is being experienced economically by large integrators in the U.S. and also producers. This could ripple to other economies. Yes, global economics does matter here in the U.S.

- India's demand for oil, combined with OPEC and Russia cutting supplies, has resulted in late summer increases in gasoline prices.

- Global freight traffic is slowing down and is being reflected in the trucking industry in the U.S. as well as with air carriers of goods. Yellow, the third largest trucking company in the United States, just filed bankruptcy and laid off over 20,000 people.

Domestic Economy

Is the U.S. economy running on empty or at the beginning of the end?

I have been watching too many Forrest Gump clips on YouTube, but it potentially sizes up the U.S. economy running on empty. Signs of the beginning of the end of the economic expansion are occurring. Stimulus savings, once at $2.9 trillion, are down under $500 billion and credit card debt just exceeded $1 trillion. Increasing credit card debt is an early sign of possibly the beginning of the end of the economic expansion. Next, delinquency rates on automobile loans are rising and layoffs in the technology and trucking industry are signs of possible issues that the economy may be running on empty.

Red hot economies such as in Nashville, Austin, and various other areas fueled by government incentives for green energy initiatives are currently in expansion. However, will these economies crash when the government and large corporations curtail some of these economic incentives, particularly if a nationwide recession were to occur? There is an old saying that “if it grows too fast it is a weed.” Can the green initiatives stand on their own economically without government support payments and what will be the impact to employees and communities if it does not? The race from fossil fuels to green energy is only in chapter one. It will be interesting to see how it plays out in subsequent chapters of the overall journey.

Leading and lagging economic indicators

The Leading Economic Index (LEI) still exhibits signs of an economic slowdown, both in the primary index and the diffusion index. The saved stimulus payments and the run-up of credit card debt has affected this metric’s accuracy in predicting a recession. In other words, a recession has not happened yet because we have all of this excess money.

Oil prices have bounced up, as discussed earlier, due to supply cuts by OPEC and Russia and increased demand from India and the United States. It is going to be interesting to see if the price increases will be sustained through the fall and winter, which could hamper U.S. economic growth.

The Purchasing Manager Index (PMI) is below 50, which is a sign of a contracting economy. This is also the case in China and the Euro sector.

The unemployment rate is still low. However, recent rounds of layoffs in the transportation and technology sectors could be an indicator of higher unemployment rates in the future. Labor productivity in the U.S. was positive last quarter after five consecutive quarters of negative productivity.

Housing starts and factory utilization are quite strong. Limited inventory of existing homes is bolstering the housing starts metric. Onshoring is a factor behind the strong factory utilization capacity numbers.

The Index of Consumer Sentiment, published by the University of Michigan, is in the low 70's, a sign that the consumer is still not confident despite the rise in retail prices.

Headline inflation is tame at 3.2 percent, well within the Federal Reserve's desired range. On the other hand, core inflation is at 4.7 percent. This is a result of higher housing and medical costs, which comprise over 40 percent of core inflation. Watch this number and personal consumption expenditures (PCE) as a gauge of future interest rate changes by the Federal Reserve.

In summary, this may be the beginning of the end of the economic expansion, but it is difficult to predict recessions because many of the factors above would suggest we are not running on empty.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	105.8			✓
LEI Diffusion Index	50%		✓	
Purchasing Manager Index - PMI	46.4		✓	
Housing Starts (millions)	1.452		✓	
Factory Capacity Utilization	79.3%		✓	
Unemployment Rate	3.5%	✓		
Core Inflation	4.7%			✓
Headline Inflation	3.2%	✓		
Oil Price ($/barrel)	$84.82		✓	
Yield Curve	-1.46			✓

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