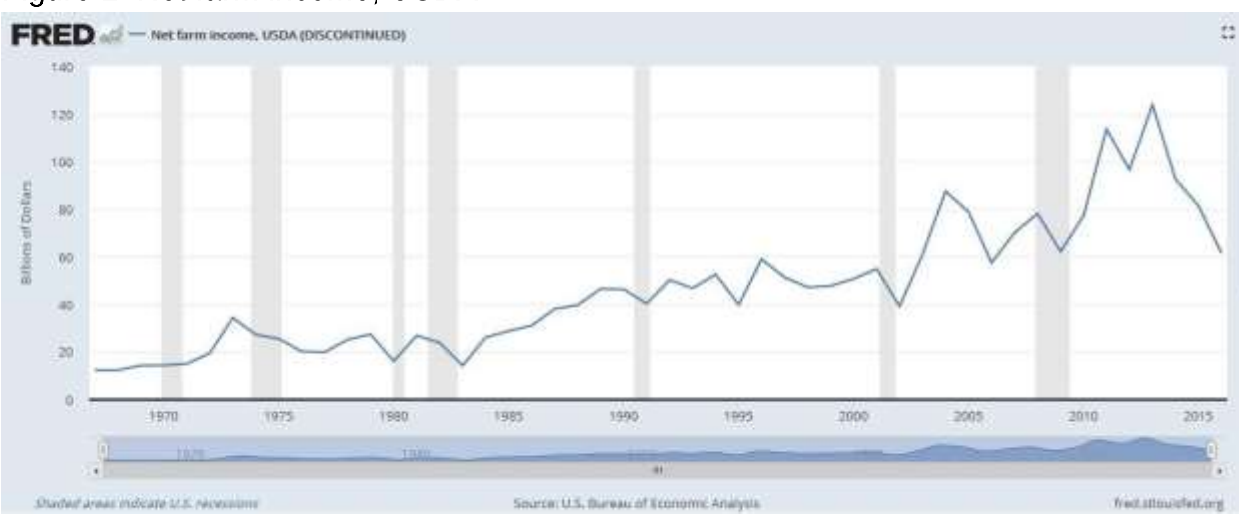
Big Picture Perspective

The agriculture economic reset is now over half a decade in duration after the “golden years” of the commodity super cycle from 2006 to 2012. My visits with lenders, producers, and agribusiness people over the last several months have provided some interesting perspectives.

A recent survey of agricultural lenders asked them to rank the factors creating financial stress in their portfolios. Not surprisingly, negative profits led the pack, followed by high family living costs. A common symptom of the first two factors that were enumerated was the buildup of current liabilities such as accounts payable, trade debt with suppliers and agribusinesses, and credit card debt. Other lenders mentioned the inability of producers to pay down their operating loans. Many of the lenders reading the column can identify with the next highest ranking in the survey, which was the loss of experienced agricultural lenders.

Figure 1. Net farm income, USDA.



Let’s place these survey results in context with an examination of net farm income data from 1960 to 2016 (see Figure 1). Net farm income in the great commodity super cycle increased 216 percent from 2002 to 2013. Net farm income from 2003 to 2016 was nearly equal to the net income of the previous 36 years in agriculture. The commodity super cycle was not fazed by the great recession in 2008 and 2009, which was centered in urban and coastal areas. Since peaking in 2012, the elongated downturn, known as the “grinder,” will be the reality for agriculture for a while. The agribusiness community will need to come to the realization that net farm incomes will more than likely be similar to pre-super cycle returns. There is a combination of reasons that would suggest this trend.

Global competitors, such as Brazil and Argentina, have been adding farmland at a rate of 2.6 million acres per year for the past 50 years. This is equivalent to adding the arable acres of Maryland and half of Vermont every year. Africa has the largest amount of arable land on the globe at just over 30 percent of the total acreage. This region of the world has not been farmed intensively and, with the right conditions, could become a global competitor.

Another component not on the long-term radar screen of the news media is China's Belt and Road Initiative. This is similar to the Marshall Plan when the U.S. and their allies reconstructed Europe and parts of Asia following World War II. While $120 billion in today's terms was utilized in the postwar plan, China has already matched this amount with $1 trillion earmarked. These funds will be invested in infrastructure, ports, and other activities in the Southern hemisphere to efficiently increase the flow of commodities to the Asian region. This will create more intense competition for North American and U.S. agriculture.

Net farm incomes are affected by the activity of central banks in the U.S. and around the globe. The financial crisis brought the perfect conditions for high profitability in agriculture. Quantitative easing by the Federal Reserve resulted in a low value of the dollar. This made U.S. exports very favorably priced overseas and spurred growth in exports. A decade of low, flat interest rates also compounded this growth, resulting in record profits and substantial appreciation in farm and ranch land.

The opposite effect is likely to occur over the next few years as the Federal Reserve increases interest rates, which should strengthen the U.S. dollar. My recent travels to Canada have found that Canadian producers were beneficiaries of the weak loonie, or the Canadian currency, to the strong U.S. dollar. Profits were being generated by the Canadian producers due to their ability to gain export market share resulting from the "soft" currency and uncertainty in U.S. trade policies.

Any future interest rate increases will be driven by the urban, coastal economies as opposed to agriculture and the flyover states. It will be interesting to see the impact of interest rate increases on the value of farm and ranch land and the farm balance sheet, both of which have been resilient in the farm economic downturn.

While most producers were able to operate profitably from 2006 to 2012, a normal distribution of farm income will likely occur in the next few years. Farm and ranch costs have had upward pressure from labor, interest rates, oil, fertilizer, cash rents, and land costs. This, combined with pressure from the Southern hemisphere and other global competition, will work to reduce future net farm income.

The implication for agricultural banks is that strong underwriting will be required. Attention will need to be placed on the management abilities of the borrowers. Working capital and debt levels will be more closely monitored. Special emphasis will be focused on the borrower's ability to plan, strategize, execute, and monitor. Volatility can provide opportunity for those producers who are able to proactively take advantage of market changes. Determination and strong character to follow through on the plans will determine which businesses are able to garner a bigger share of a smaller profit pie.

Management Tip

Weather is a major variable in production areas of the globe. This could be one of the variables to provide temporary relief from the factors mentioned in this article. I strongly suggest that readers of this column follow Eric Snodgrass, a meteorologist from the University of Illinois who produces a weekly podcast. Monitoring weather trends can be a powerful management strategy on any farm and ranch business.