TIGHTENING IN THE AG BELT

The outlook for the agricultural economy becomes more pessimistic

The record revenue growth of the last few years has given way to tightening in the U.S. agricultural industry, and analysts say these conditions could last a few years.

Many reasons persist for the tightening, such as production outpacing consumption, a strong dollar's effect on exports, a decrease in commodity prices, and a drop in land values.

The fundamental reasons are as simple as supply and demand, but they could prompt further tightening this year in both the Tenth District and the United States, causing concerns among lenders, says Cortney Cowley, an economist with the Federal Reserve Bank of Kansas City, in her recent Agricultural Economic Outlook.

Production outpacing consumption

The U.S. Department of Agriculture forecasted global crop production to remain near record levels in 2015. Following the 2012 drought, production in the United States increased dramatically, and in November 2015, the USDA projected the soybean crop to be the largest in history and expected the corn harvest to be the third largest ever.

Although record setting, production in the United States has expanded faster than consumption. On average, U.S. inventories of corn, soybeans and wheat have increased more than 100 percent since 2013, while

consumption has increased just 7 percent over the same period, Cowley said.

Adding to the production predicament, world producers also have been on a record pace, with Brazil and the Black Sea region reporting near-record harvests.

Steve Wellman, who owns and operates Wellman Farms in Syracuse, Neb., views competition with South American countries such as Brazil, which was predicted to double its production capacity in 2015, as a pull on U.S. exports and a concern among domestic farmers.

"I definitely compete in a world marketplace," he said. "Outside competition is always a concern with a strong dollar and falling prices."

But he remains optimistic because soybean and other crop production have remained high the last couple of years.

"There is still demand both in the United States and globally," he said. "People have to eat."

Strong dollar hampering U.S. ag exports

Alongside the strong dollar and growing competition, relatively stagnant domestic demand and weak global growth are hampering U.S. exports of agricultural products.

"In fact, exports of food and kindred products, including processed meat products, have declined for 14 consecutive months," Cowley said.

Exports of agricultural products, including bulk commodities, also have declined.

Overall, exports decreased about 10 percent, on average, each month in 2015 compared to 2014. As of October 2015, the value of U.S. agricultural exports declined from 2014 by more than $6 billion. China accounted for 20 percent of the loss in export value, with other major losses stemming from Canada, Mexico, Brazil, Japan, Egypt and South Korea.

For example, China made up 9.9 percent of Kansas' export business in 2015, and a large percentage was in agricultural commodities. In the first half of 2015, the state's exports to China totaled $762.4 million.

Kansas was the one state in the Tenth District that experienced a decline in both exports to China and its total exports from the first quarter of 2014 to the first quarter of 2015, 4.2 percent and 8.7 percent, respectively. The main symptom was the strengthening of the dollar because Kansas, more than other states, exports more commodities, which are sensitive to changes in currency exchange rates.

"Anecdotally, contacts with ties to commodity markets in the Tenth District have reported that weak exports have negatively affected their businesses, and most have attributed a significant portion of such weakness to a strong dollar," Cowley said.

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Outlook for the ag economy

The supply-and-demand outlook continues to point to generally pessimistic prospects for the farm economy, Cowley said.

The strong dollar, booming production and weak demand have put downward pressure on U.S. crop prices, and depressed crop prices have continued to weigh on farm income in the Tenth District. Compared to the same period a year ago, farm income and capital spending declined for the 10th consecutive quarter and potentially have been exacerbated more by recent weakness in the livestock sector.

"In the third quarter of 2015, farm income showed a decline in every District state for the first time since 2011," Cowley said.

Lower farm income also has affected spending in the farm sector. In general, farmers have adjusted capital spending in line with declines in farm income. Household spending, however, has been slower to adjust.

As a result, Cowley said several survey respondents in the banking sector have indicated customers should reduce household spending to avoid further deterioration in credit conditions and that their securities and loans watch and classified lists could expand slightly over the next three months.

Farmland values and cash rents

These fundamental changes in the agricultural economy are having an affect on farmland values and cash rents.

According to respondents of the Tenth District Survey of Agricultural Credit Conditions, farmland values in the Tenth District dipped again in the fourth quarter of 2015.

Values of nonirrigated and irrigated cropland decreased 4 percent and 2 percent, respectively, from a year ago. With the fourth quarter declines, irrigated cropland values have fallen modestly in four consecutive quarters, and the value of nonirrigated cropland generally followed the same trend through 2015.

Ranchland values stalled in the fourth quarter as cattle prices dropped at the end of the year. Feeder cattle prices plunged more than 25 percent, causing profit margins in the cattle sector to deteriorate.

The Tenth Federal Reserve District encompasses Colorado, Kansas, western Missouri, northern New Mexico, Nebraska, Oklahoma and Wyoming. Every state in the Tenth District, except Oklahoma, experienced

Cortney Cowley, an economist with the Federal Reserve Bank of Kansas City, gave a presentation on the economic outlook for agriculture in the Tenth District during the Interregional Director Exchange in March at the Kansas City Fed's head office.

a decrease in farmland values, and Oklahoma, Colorado and Wyoming were the only states to experience an increase in ranchland values. Overall, the forecast for land values in the District is drab. Bankers expect all land types to decline again in the first quarter of 2016, according to the survey.

Farm income remains the primary driver for declines in both farmland values and cash rents. In the fourth quarter, 87 percent of survey respondents reported farm income was lower than a year ago. One of the primary reasons for diminished income is declining commodity prices.

Both livestock and crops have seen significant market price reductions. For example, the national average for soybean and wheat dropped 14 percent and 19 percent, respectively, while corn prices also declined.

The volume of farmland sales also dropped in 2015. Historically, changes in the volume of farmland sold and farmland values have moved together.

"Landowners may be less inclined to sell when prices have recently fallen, in hopes that prices might rebound in the future," said Nathan Kauffman, an economist and branch executive at the Kansas City Fed's Omaha office. "A more limited supply of farmland available for purchase, then, may partly explain why farmland values have retracted only modestly, as demand has remained relatively strong in the meantime."

Cash rents on professionally managed farmland likely will decrease in 2016, says Gary Schnitkey with the Department of Agricultural and Consumer Economics at the University of Illinois. He also says rents on nonprofessionally managed farmland likely will decrease as well.

"However, projected rent decreases are not large enough to cause farmers to have positive returns in 2016 given current projections of commodity prices and costs," he said. "The lagged relationship between returns and cash rents still exists."

Wellman said cash rents could have a big impact on land-lease farmers. Landowners have been reaping good profits in the past few years, and they'll want to keep making that same revenue despite decreasing demand and decreasing crop prices. That will make it difficult for farmers who do high volumes of land-lease farming.

"It will be a balancing act," Wellman said. "How do you cut back on your expenses without cutting back on production?"

One area where farmers are cutting back, Wellman said, is investing in new machinery.

Michael Boehlje, a distinguished professor at Purdue University, expects machinery to take a significant hit in the next five years.

"We lost 25 percent of the machinery industry in the 1980s," he said. "We plan to see more companies exiting from the industry."

He says U.S. aggregate net farming income is expected to decrease 30 to 40 percent in the next couple of years.

"The wealth increases of the last five years are coming to an end," he said. "We won't have a bust, but a soft landing."

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KEVIN WRIGHT, EDITOR

FURTHER RESOURCES

To read Cortney Cowley's agricultural outlook, view the Ag Credit Survey and other agriculture economic research, **visit www.KansasCityFed.org/research/agriculture.**

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.