Headwinds in Agriculture

Key Points:

- **Farmers & Ranchers:** Agriculture has always been a cyclical industry. After benefiting from multiple years of record high prices for agricultural commodities, U.S. farmers and ranchers are now struggling to adapt to the new economic reality of persistently low crop and livestock prices and stubbornly high production costs.

- **Rural Communities:** The financial strain is being felt across Rural America with agricultural businesses and retailers seeing declining profits and strained balance sheets. Loan volumes with agricultural lenders like the Farm Credit System and commercial banks have increased. Borrowers will also likely shoulder gradually rising interest expenses as The Federal Reserve raises rates.

- **Industry Outlook:** The longer-term outlook for U.S. agriculture is upbeat and hopeful as world consumption of agricultural commodities continues increasing, but market fundamentals remain major obstacles in the near term. A strong U.S. dollar continues to drag on U.S. exports; global commodity oversupplies are weighing on crop and livestock prices; and rising farm debt levels amid weak farm incomes hint at further financial strain across the agricultural supply chain through 2017.

- **Trade & Farm Safety Net:** Key to supporting the financial health of farmers, ranchers and the rural communities that depend on them will be robust international trade and a reliable farm safety net. Policy makers must lead on both fronts to help U.S. agriculture transition through its current down cycle.
World commodities are traded in U.S. dollars. As a result of the strengthening U.S. dollar, countries with weakening currencies like Brazil, Argentina, Canada, Australia, Russia, Ukraine and the European Union have increased agricultural production since the farmers there are paid more for their products. Ideal growing conditions around the world have also contributed to the global commodity oversupply. The result has been persistently low commodity prices.

U.S. dollar strength is depressing agricultural commodity values.
International trade is crucial to U.S. agriculture, accounting for about 20 percent of the volume of U.S. agricultural products. As illustrated in the above chart, the value of U.S. agricultural exports fell in 2015. The strong U.S. dollar has weakened U.S. agricultural export competitiveness by making U.S. products more expensive abroad. International trade deals have become even more essential in helping U.S. farmers and ranchers sell their products in a competitive global market.

**U.S. exports have been weakened by the strong U.S. dollar.**
Farm cash receipts have fallen.

As a result of subdued international trade and global commodity oversupply, prices that farmers and ranchers receive on the products they grow, like wheat, corn and cattle, have fallen substantially in recent years. With the U.S. dollar expected to remain strong through 2017, farm cash receipts will likely remain under pressure.
Agricultural commodity prices have fallen sharply, but the cost to raise those products has fallen only slightly, causing farm incomes to retreat at a faster rate. Net farm income is projected to be down by 50 percent from the peak in 2013 to 2017. USDA's Economic Research Service (USDA-ERS) predicts further erosion of net farm income in the years ahead.

**Farm expenses have been more resilient than farm receipts, resulting in a steeper decline in net farm income.**
With net farm income down sharply, farmers and ranchers have taken on more debt to continue operating. When adjusted for inflation using 2009 dollars, total farm debt has reached levels similar to the 1980s Farm Crisis. Countering this increase in farm debt, though, is the higher value of important farm assets like farmland.

*With farm incomes dropping, the growth of farm debt when adjusted for inflation has accelerated.*
The Farm Credit System (FCS) plays an important role in financing agriculture, currently carrying 41 percent of the total farm sector debt load. The role of ag lenders has grown in recent years to meet the rising financing needs of farmers and ranchers as production expenses continually increase and profit margins erode.

FCS plays an important role in ag lending.
Until recently, the value of farm assets tended to increase with farm income. Now, declining farm incomes are putting downward pressure on farmland values. About 80 percent of farmers’ and ranchers’ net worth is held in farmland. While land values are under pressure from falling farm incomes, the inflationary effect of low interest rates has prevented land values from falling faster. However, with the Federal Reserve System (The Fed) signaling that more rate hikes are likely through 2017, land values are expected to succumb to more downward pressure. The net result would be a weakening of farmers’ and ranchers’ overall financial position.

Farmland values are driven by net farm income.

Source: USDA-ERS.
Farmland in the major crop-growing regions of the U.S., especially the Corn Belt and the Northern Plains, have seen the steepest declines in value. Private industry estimates on farmland values show steeper declines than what USDA data currently indicate.

Land values are slipping in the Corn Belt and Northern Plains.

Source: USDA-ERS.
The Federal Reserve Bank of Kansas City, which covers the 10th District states of Kansas, Nebraska, Oklahoma, Colorado, Wyoming, northern New Mexico and western Missouri, reports that community banks are displaying a deterioration in farm credit conditions.

Farm loan demand is rising while loan repayment rates are falling – signaling increased farm financial stress lies ahead.
It’s not just farmers and ranchers who are struggling. Earnings among CoBank’s ag retail customers have dropped sharply as farmers and ranchers reduce purchases of machinery and farm inputs like seed, crop protectants and fertilizer. Net operating profit, which is a key measure of financial performance, was down 82 percent in 2016 for ag retailers. With farmers and ranchers expected to remain under financial strain, further compression of profit margins among the businesses that sell to them is expected to continue through 2017, adding further strain to rural communities that depend on agriculture.

**Businesses that sell farm inputs to farmers and ranchers are also stressed.**
The farm sector debt-to-income ratio is a leading indicator of the health of the farm economy. Debt-to-income, which shows farmers’ ability to pay down liabilities, is forecast by USDA-ERS to rise above 6x in 2017. A ratio of 4-5x is seen as a concerning level. Comparatively, the debt-to-income ratio in the 1970s reached worrisome levels for the four years leading into the 1980s Farm Crisis. Long-term, the severity of the farm financial situation will depend on how fast debt levels rise and how fast The Fed raises interest rates. Higher interest rates ultimately will have the dual effect of depressing land values and stressing borrowers at a time of elevated debt levels.
Summary

- The strong U.S. dollar, subdued international trade and low agricultural commodity prices are driving farm cash receipts lower.

- Farm expenses have been slow to realign with cash receipts, stressing farm income and impelling farmers and ranchers to take on more debt.

- Falling farm income will depress farmland values – the main asset held by farmers and ranchers.

- Farm financial distress is rippling through the entire ag supply chain.

- While the farm economy is not currently in a crisis, the rising farm debt-to-income ratio indicates more financial stress lies ahead.

- International trade deals and the farm safety net will serve important roles in improving farmers’ incomes in the future. Policy makers must lead to help U.S. agriculture transition through the current down cycle.

CoBank’s Knowledge Exchange Division welcomes readers’ comments and suggestions. Please send them to KEDRESEARCH@cobank.com.

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