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<u>Economic Outlook: 2015 and Beyond</u>

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Over the years it has been enjoyable writing on various topics and then meeting many of you in sponsored events throughout the upper Midwest during winter. To kick off this new round of farm management newsletters, I am focusing on an economic outlook for the New Year. The cold winds of December are reminders that Old Man Winter may be around for a while, and now is the time to start planning for 2015 and beyond. I will draw upon perspectives from my travel and interaction with thought leaders from the U.S. and abroad.

The famous commodity super cycle, which fueled record profits and land values that no one could have predicted, is in the rearview mirror. To put this cycle into context with other historical super cycles of the last century, it was astronomical in duration. Previous super cycles around World War I, just after World War II, and then again in the 1970s lasted two to four years. The recent super cycle was a decade in duration, bestowing prosperity particularly on the grain and energy sectors in agriculture.

The drivers of the super cycle have waned. The emerging nations, including the BRICS and KIMT nations of Brazil, Russia, India, China, and South Africa along with South Korea, Indonesia, Mexico, and Turkey, have economies that are either slowing or in recession. Ethanol and biofuel mandates that have driven markets may be reduced. The Federal Reserve's economic stimulus in the form of low interest rates and weak currency value appears to be withdrawing. Some estimate these central bank strategies have added 40 percent to the corn and soybean markets, which was capitalized into land values. Of course, the weather has provided ample rainfall (outside of California) and growing degree days, which have resulted in record supplies.

The easy money has been made in the grain industry, and now margins are flipping to the livestock industry. Top-flight managers who manage both fixed and variable costs, live modestly, and have reserves of working capital can still generate a profit. This winter will be a game of "chicken" on land rents as many will balance the possibility of losses of land with projected negative cash flows. The big question is the duration of the down cycle. If it is short, lasting one year, repayment ability will be hampered. If it extends two to three years, liquidity will be impacted as a means of repayment. However, if it is similar to the lower prices during the economic period of 2002 to 2006, producers will experience loss of equity due to reduced cash flow and the decline of land values.

The livestock sector is feeling its oats! This is a result of a strategic shift of resources and assets out of livestock and into the grain sector. One only has to travel in a Hertz rental car in the upper Midwest to observe dairy barns and hog facilities vacant and hedgerows and pastureland being utilized for grain production. This past decade of record grain profits resulted in a vacuum in the livestock industry with reduced numbers of animals and farms. Many ask, what is the duration of livestock prosperity? Two years minimum can be expected; however, at recent national bankers' conference, some livestock experts suggested the cycle may be up to five years long because livestock numbers are down worldwide and consumers in emerging nations are demanding more protein in their diets. That being said, high prices will generate profits early in the cycle while lower costs will be the economic factor later in the period. I caution producers in this sector that the worst financial and management mistakes are often made during the best of times. This current period of high livestock prices reminds me so much of the late 1970s. Grain prices spiked, followed by livestock, and then interest rates increased, followed by a crash. Hopefully, history will not repeat itself.

The worldwide economic view finds Europe teetering on the brink of recession. This is partly the result of uncertainty concerning energy supply lines that actually pass through Ukraine. Central bank stimulus has failed to ignite the two largest economies in Europe, Germany and France, and the possibility of deflation is top of mind throughout the region. The world's second-largest economy, China is in a distinct slowdown. The economic growth rate is at a five year low. This is critical to the U.S. agriculture sector since China imports a considerable amount of grain and livestock products.

The U.S. economy is analogous to the best house in a bad neighborhood. All leading economic indicators suggest solid growth in the economy for the next six months. Reduced oil prices around the holiday period provide more money in the wallets of Americans. That being said, one must examine the possibility of headwinds in the economy such as federal debt, which is at $17.5 trillion, and a possible rise of interest rates in mid-2015.

Finally, in any economic outlook for agriculture, one must discuss land values. High quality premium land is still holding its value or slightly increasing in price nationwide. These prime properties not only have good to excellent soil, but they have access to water or infrastructure and in some cases are in close proximity to concentrated areas of livestock or the energy sector. Marginal land due to productivity, access, or ability to utilize technology is starting to observe stability in prices or a slight decline.

It appears that producers who are diversified in crops, livestock, and other businesses and that have built some financial liquidity are doing well. Also, those who have marketing and risk management plans that are executed and monitored are adjusting to the economic playing field. Others who have the philosophy of go-go at all costs, with high personal withdrawals and financial leverage may have to change from an offensive to a defensive posture in management and growth expectations.