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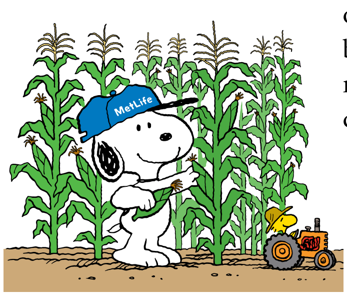
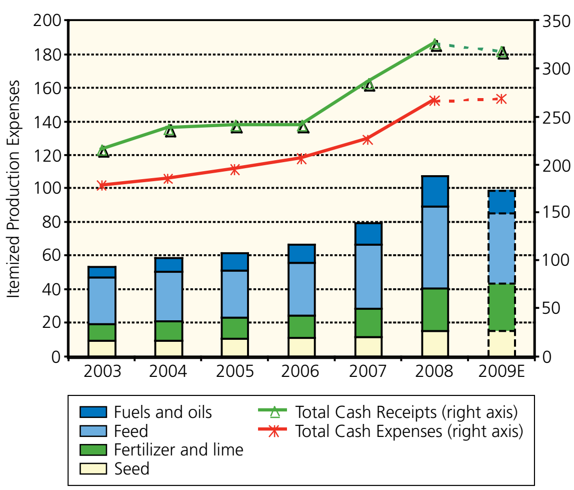
Farm Input versus Commodity Prices, More Trend Convergence?



The extreme volatility in agricultural prices over the past year could be a testament to the new economy. Whether up or down, prices generally seem to adjust faster to changing supply and demand conditions. Prices of raw commodities soared to a record earlier in 2008, only to give back two years of gains by last December. Fortunately, wholesale prices of major farm inputs eventually got onto a declining path, too. However, the pricing mismatch between retail farm inputs and commodities still exists. As a result, crop producers will likely be managing with declining profitability in 2009 until a better alignment between input and output prices takes place.

The correction in commodity markets in the second half of 2008, with corn declining nearly 60% between June and December, was unprecedented in such a short time period. Here, the blame can hardly be placed on a single factor, but rather a combination of events that eventually toppled the steep uptrend. Last summer, harvest expectations suffered from a late planting season and the Midwest flood that ensued. All the while, deteriorating economic conditions changed demand expectations even as grain production forecasts grew more optimistic in the second half of 2008. The sharp price reversal that resulted ended up as a wake-up call to speculators and fund investors who realized that the commodity bull market was rapidly losing steam and began exiting the market. Speculators provide needed market liquidity, even if they add to volatility at times of shifting investment flows, but they can hardly be the leading cause behind the last powerful bull market; this is mainly the prerogatives of supply and demand fundamentals. Prices steadily reached higher as demand outpaced supply — mostly led by China. However, a bumper grain harvest materialized last fall and raised expected inventories by as much as 11% in the 2008/09 crop year (USDA), pushing prices down. In addition, the US dollar jump in the third quarter of 2008 played an additional role in further pressuring prices at the farm gate. Thus, tightening margins could mark 2009 as a transition year, later followed by a more sustainable period of lower commodity prices and input costs.

Farm Production Expenses



Evolving price trends are also affecting the livestock sector, albeit from a different perspective. Lower grain prices translate into lower feed costs. Soaring export demand for livestock and meat products in 2008 helped support prices despite large domestic meat supplies. However, meat export demand could

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moderate for a variety of reasons, ranging from a less competitive US dollar to import restrictions — like beef in Japan or poultry in Russia. Additionally, the global economic downturn can lead consumers to pull back from meats towards starch-based diets, but it remains to be seen how consumer preferences are shifting in the current downturn. Even if an economic recession dampens demand growth, the economic stress on the consumer would need to be quite severe to actually pull total consumption down. In all, operating margins in the livestock sector could get more support from a supply side intending to cut production in 2009.

The previous **chart** illustrates trends in major input categories relative to farm cash receipts. Early indicators for 2009 point toward lower crop revenues and overall flat expenses, although declines are expected in certain categories. Fuel and oil expenses could experience the biggest decline in 2009 (y-o-y), as much as 20%, led by lower diesel prices. Fertilizers, however, have moved more slowly. Wholesale prices had come down sharply by 2008 year-end, but with many dealers left with higher-priced fertilizers on hand, it has taken longer to translate into comparable declines at farm retail. Therefore, farm fertilizer expenses are still expected to be higher by 10% in 2009 (over year ago). Ultimately, such stubborn input costs could create a disincentive to produce by either dampening acreage expansion or lowering crop yields due to lower input use — especially for input-intensive crops like corn and cotton. Therefore, a significant comeback in US corn acreage in 2009 could be challenging unless retail fertilizer prices decline faster. For corn, the large decline from 93.6 mi. acres in 2007 to 87 mi. acres in 2008, may not be followed by a bounce in 2009 if farm input prices do not sufficiently adjust downward by planting season.

The ongoing credit crunch is another factor likely to influence agricultural production in 2009. While credit might still be relatively easy to come by in US farm country, the lending community is now more conservative. However, the situation can be markedly different in emerging markets. Challenges in obtaining credit in large producing countries like Brazil or Argentina could dampen input use to a point where crop productivity — and even acreage — could decline. Such continued challenges in credit markets could unexpectedly pressure global output downward, supporting crop prices in 2009.

Finally, rapidly evolving currencies also play a role in US agricultural prices. Exports have benefited amid the latest five-year period where the US dollar steadily declined. Up until the summer of 2008, a steadily weaker dollar made US goods more competitive in the global marketplace. However, the strengthening of the dollar in the latter part of 2008 started to make exporters like Canada and Brazil relatively more competitive. Assuming the US dollar holds on to its late year gains, US agricultural exports are likely to decline in 2009, contributing to dampen overall farm income this year relative to record levels in 2007 and 2008.

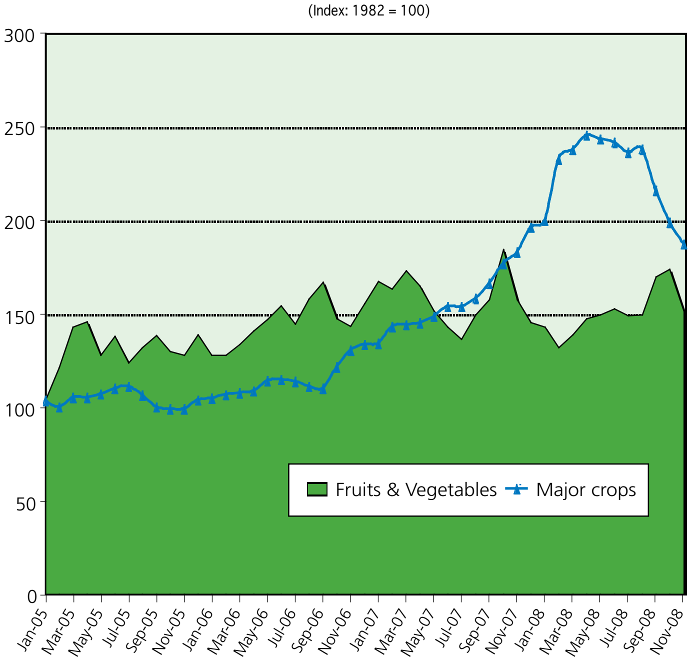
As the increasingly integrated global economy has sharply slowed down, agriculture is not immune from pricing fluctuations even if it remains a solid defensive sector. Downward shifts in demand are frequently mentioned in recessions, but its comparable impact on the supply side is often overlooked. Whether driven by stubbornly high input costs, limited access to credit, or simply lower farm-gate prices, agricultural production can adjust downward, but not necessarily immediately. In the end, a faster adjusting farm economy can be painful to market participants on the downside phase of the cycle, but the same market flexibility could also lessen supply/demand mismatches going forward and lessen income volatility in production agriculture.

Upside with Specialty Crops Amid Commodity Market Correction

The correction in major commodity prices from last summer's highs is likely to bring renewed interest in specialty crops like fruits, vegetables and nuts. As the slowing economy causes "trading down" in consumer food demand, the specialty crop industry

Producer Price Index — Grains vs. Produce

(Index: 1982 = 100)



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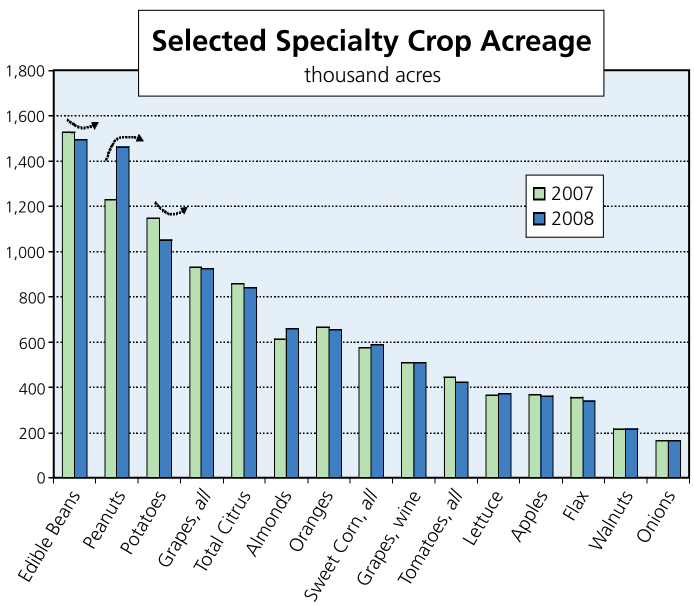
could set the stage for expanded acreage in 2009. Market drivers include relatively more attractive pricing to growers — now that the acreage competition from grains and oilseeds is easing. There is also the benefit of greater visibility with specialty crops in food retail stores, which typically outperforms the food service sector in a recession. The previous **chart** illustrates the relatively steady pricing environment for selected specialty crops relative to the price spike seen in major grains and oilseeds in 2008.

The wide variety of specialty crops grown, with their own regional production characteristics, can make it challenging to paint the industry with a broad brush. For instance, sectors like citrus have experienced a 30% decline in acreage over the past decade because of canker and greening diseases coupled with damaging hurricanes and urban development. Meanwhile, other sectors like the California tree nut industry — led by almonds — have embarked on a major acreage expansion program with growth averaging nearly 3.5% per year since 1993. All the while, other sectors like vegetables and small fruits have had a relatively stable acreage over the years. However, potatoes could see renewed price and acreage strength in 2009 amid a cutback in acreage in



2008 and an economic downturn favoring defensive foods like potatoes. The **bar chart** above compares recent acreage numbers for the leading specialty crops in the US. California and Florida continue to capture the majority of the acreage base. However, numerous other states on the West Coast with Oregon and Washington, the Midwest and even the Eastern Seaboard are expected to play a steady if not a greater role going forward.

"Buying local" campaigns, which got a boost from high fuel-related shipping costs, continue to be popular with consumers while benefiting local growers across the nation. Other demand drivers include evolving consumer tastes and preferences towards smaller citrus fruit as consumers have sought the convenience of eating on-the-go. However, a major economic downturn could modify buying patterns again, supporting less expensive food items with a stronger presence at the grocery store rather than at the restaurant. The latter often underperforms in an economic downturn. Consumers clearly are more focused on containing expenses. With an economic slowdown firmly in place, trading down the food value spectrum appears very likely. In a recession, consumers are known to spend less in restaurants to the benefit of grocery stores. Although more subtle, they can also shift from red meat to lower-cost poultry, coupled with rice and potatoes, all likely to be more popular in a recession. Interestingly, fruits and vegetables can manage to be resilient in a downturn because of its particularly strong presence at food retail.

The value of the US dollar is another factor likely to impact the performance of specialty crop agriculture. After more than five years on a declining trend, the US dollar made a sharp reversal in the third quarter, influencing trade patterns. In tree nuts where exports can capture as much as 2/3 of production (e.g., almonds), the stronger dollar can dampen foreign demand. On the flipside, the same stronger currency can support imports. Interestingly, fresh fruits and vegetable markets are not typically impacted as much by currency fluctuations because of greater reliance on the domestic market. Limited shelf life raises shipping and handling costs over long distances thus containing major trade activity in these segments to imports from nearby Mexico and Canada.

In an integrated global economy, changing prices can happen more rapidly, as we have seen with commodity price trends. However, such flexibility also implies more rapid "trickling down" the supply chain, helping to contain production expenditures. Lower transportation costs have also resulted amid declining energy prices, all of which can contribute to shore up growers' margins. In all, the momentum for 2009 appears to be tilting in favor of specialty crops following several years of unabated acreage competition from major grains and oilseeds, pointing toward a return of the pendulum toward a more diversified crop production sector of agriculture.

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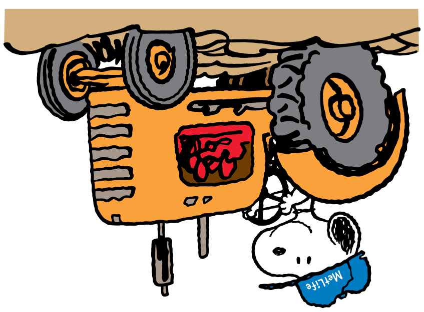

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