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Rain of grain

Do you happen to know when the nation's farmers planted more acres to corn than the consensus of informed opinion expects them to plant in 2013? The year was 1936. Or when farmland values in the five-state Seventh Federal Reserve District (the headquarters of which are in Chicago) appreciated as much over a three-year period as they did in the ZIRP-facilitated boom of 2010-12? It was in 1974-76. Now unspooling is the *Grant's* farm report. Cropland values, money printing and wheat are on the agenda.

Concerning the ruinous drought of 2012, Ben S. Bernanke has—as far as we can determine—clean hands. Yet, although the chairman personally raises not one bushel of corn or wheat, his experimental monetary policies affect all who do. Exhibit No. 1 is the continuing updraft in agricultural land values.

In constant dollars, reports the February edition of the *AgLetter* published by the Federal Reserve Bank of Chicago, "good" quality Seventh District farmland—i.e., Illinois, Indiana, Iowa, Michigan and Wisconsin—registered a 14% gain in 2012, the third highest in 35 years. Over the past three years, Seventh District land prices leapt by 52%, the most since the mid-1970s, when the CPI was roaring along at annual rates of between 5% and 12%.

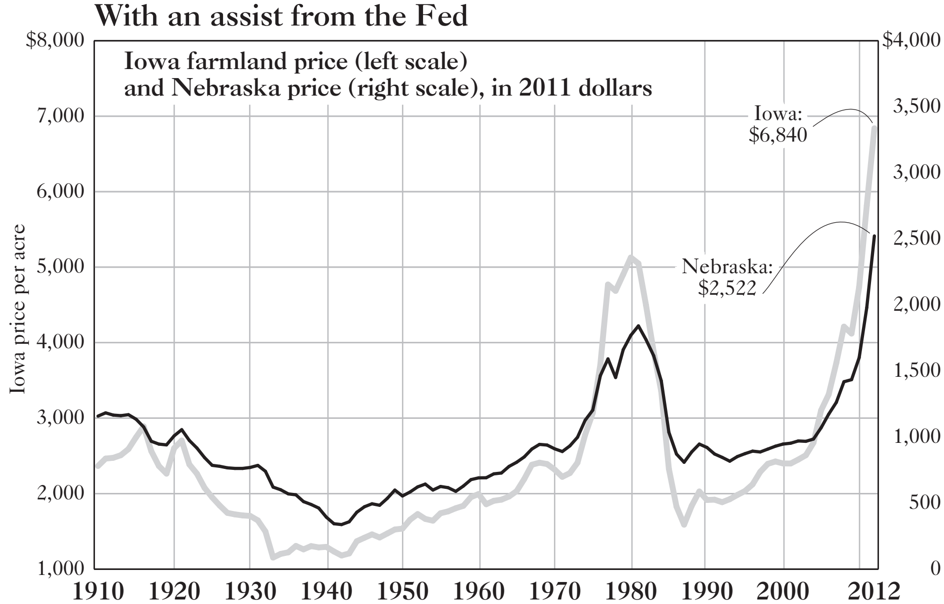
Well does your editor recall the obloquy that was heaped on the then Fed chairman, Arthur Burns, for letting the inflationary genie out of the bottle. From the vantage point of 2013, however, Burns seems not so much incompetent as unperceptive or unlucky. Between Jan. 1, 1974, and Dec. 31, 1976, the Fed's balance sheet expanded at annual rates no higher than 9.2% (that was in 1975). Over the same span of years, the real funds rate averaged as little as minus 4.1% and as high as positive 0.8%. By March 1980, the CPI would be zipping along at a year-over-year rate of 14.6%.

Compare and contrast the Bernanke years. Between Jan. 1, 2010, and Dec. 31, 2012, the Fed's balance sheet expanded at annual rates of as much as 20.8% (that was in 2011). Over the same three years, the real funds rate averaged minus 1.8%. Consumer prices rose by an average of 2%.

Chairman Bernanke's admirers will see in this comparison between Burns and himself the vindication of flexibility in policy making. Burns misread his era. He should have tightened but didn't (it's clear as a bell in retrospect). Bernanke, his fans contend, has correctly read *his* era. To beat back deflation, he has conjured trillions of dollars. Only imagine if he hadn't.

It's a funny kind of deflation, only allow us to say, when credit spreads contract, junk bond prices soar and the measured rate of inflation (and how generously measured it is) remains in positive territory. Be that as it may, farmland prices in three Bernanke years more or less matched the gains they recorded in the mid-1970s under Burns, whose name is synonymous with inflation. So far, Bernanke's

With an assist from the Fed



sources: Federal Reserve banks of Chicago and Kansas City name is synonymous with that happy form of inflation called a bull market.

"Perhaps the most surprising aspect of 2012's strong gain in farmland values," the Chicago Fed notes, "was that it occurred in the midst of the worst drought in the Midwest since 1988." Or maybe it's not so surprising. The drought-shortened crop lifted prices, while interest rates charged on land loans dipped to 4.7% in the fourth quarter, a new low, the Chicago Fed reports.

Just how bullish the current alignment of agricultural stars is can hardly be exaggerated. Drought or no drought, American net farm income in 2012 is set to reach $112.8 billion, within a few percentage points of the record set in 2011. "Since 2008," according to a Dec. 10 bulletin from the Congressional Research Service, "farm asset values are up 26% while farm debt has risen by only 10%. As a result, the farm debt-to-asset ratio has declined steadily since 2008 and is expected to fall to 10.6%, its second-lowest level since 1960."

If, in urban America, the so-called new normal is down-in-the-mouth resignation to high rates of joblessness and low rates of economic growth, Midwest farmers seem infused with optimism. "Farmers' capital expenditures—including expenditures on machinery and equipment, trucks and autos, and buildings and facilities—were forecasted by respondents to be even higher in 2013 than in 2012. . . ," the Chicago Fed relates. "With the USDA predicting net farm income to rise 14% from 2012 to $128.2 billion in 2013, there would seem to be at least another leg to be run as farmland values continue their upward race."

There will soon be a race to the tractor if unofficial forecasts of 2013 planting intentions are on the beam. By the USDA's reckoning, the number of acres to be planted to corn this spring will total 96.5 million. Independent analysts project a total closer to 100 million acres, which, if realized, would be the most since the 102 million acres planted in 1936, when the Dust Bowl ravaged the American midsection and per-bushel yields per acre averaged not today's 160-plus but rather 18.6, the lowest ever recorded in USDA statistics stretching back to 1866. Say that American farmers do plant 100 million acres to corn—100 million acres being a little bit smaller than the size of the state of California—and that these acres, of which 95% are harvested, deliver the trend-line yield of 163.6 bushels per acre. The result would be a domestic corn crop of over 16 billion bushels, the most ever.

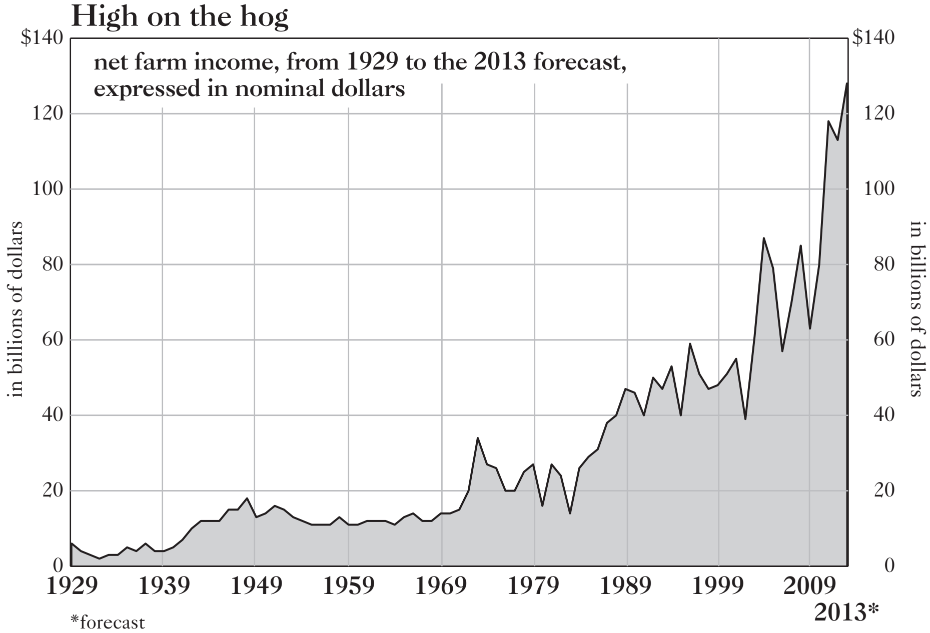
Such a bounty would be bearish for prices, other things being the same, and not only for corn, but also for the grains that compete with corn—wheat, for example. "Take a legal pad," Keith Bronstein, managing director at Endurance Asset Management and this publication's most valued resource on all things grown in dirt, tells colleague David Peligal, "and draw a line down the middle of the page to determine what's bullish and what's bearish for the grain complex. On the left-hand side, the bullish side, there are two things—and I'm really talking about the 12- to 18-month time frame, and not a five- to 10-year time frame. One is drought, two is a collapse of the dollar. That's it. Case closed.

"Now let's begin on the right-hand side of the page by saying that somewhere in the vicinity of 85% of the time, weather is normal," Bronstein continues. "Therefore, it's not so crazy to think in terms of normal weather. What does normal weather produce? If you went back in time to last fall, when we saw the corn production in South America, the market cognoscenti said, 'thank God for that because we've had a corn shortfall here in the United States and they're going to fill in the holes of demand until about February or March, and then they'll run dry and then look out above, because now the United States is the only source of supply.'

"Well," Bronstein goes on, "that premise was completely wrong. So what happened? One is, they're still selling corn. It's not magic. It's just that their corn supplies were maybe a little bit bigger and the demand worldwide for corn wasn't that it was so much less … just that it was continually satisfied by various alternatives. One of those alternatives is feed wheat. India is selling feed wheat into traditional corn-consuming channels. That has never happened before. And all of a sudden, that's filling holes. It's the old story that the cure for high prices is high prices. And we had a couple of years of high corn prices and poor supplies, and the world has done what the world does. It adjusts. Now, logistically and in terms of overall supplies, it's still going to be dicey for the next few months. I'm not pretending it won't be. But we're kind of getting through this without having anything hysterical happen in terms of price."

Of course, as the USDA's own chief economist, Joseph Glauber, recently observed, one might have said the same thing last year. Indeed, many did. "Yet," Glauber notes, "instead of a record corn crop, we saw record high corn prices. Instead of [cattle] herd

High on the hog



*forecast
source: USDA Economic Research Service

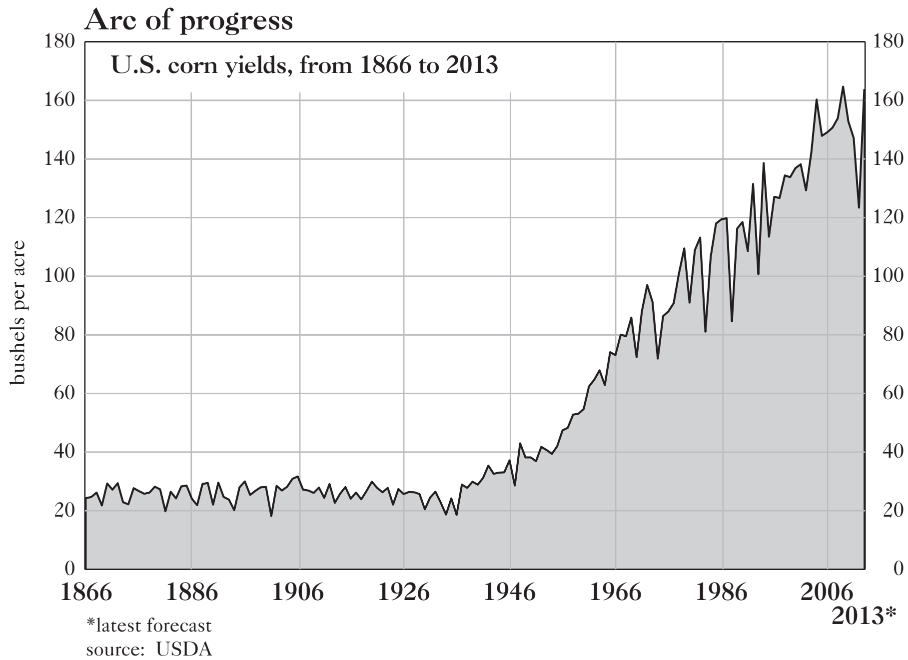
rebuilding, there was further liquidation as livestock margins tightened. So while the outlook for 2013 remains bright, there are many uncertainties."

To be sure, Bronstein concurs, nothing is certain. But some things are fairly dependable. "Going back to my days at the Chicago Board of Trade, there was an aphorism: 'Short crops have long tails.' Four of the last five crop cycles have been short crops. We've had two bad crops out of three in South America and two in the United States. So we could be setting up for one of the biggest tails anyone has ever seen." That is, given some normal weather, crops could be immense, with prices to match.

And if corn prices tumble, so would wheat prices. Especially vulnerable would be wheat for December delivery, pitched as it is at a premium of $1.79 per bushel over corn. Yet, in the here and now—see the contracts for May delivery—the two grains are quoted within two cents of each other. At such a small premium to corn, wheat is today being served to poultry and livestock in the American Southwest and Southeast. The critters would have to make do with corn alone if the December price relationship, wheat to corn, persisted.

"How are we going to get—or keep—wheat into feed rations," Bronstein muses. "Well, it's going to have to get considerably cheaper on corn. It's going to be a race, and if we had this normal yield I'm talking about in corn, this is going to be a race to the bottom. And wheat has given corn a big head start, so a lot of that space has to be filled in. I think that while corn prices, in a normal yield scenario, have reasonable downside in the December forward futures, wheat potentially has a much greater downside. The wheat price is really sticking up there like somebody's got to take a hammer and hit it."

Reflecting on the continued ascension of land prices, Mike Duffy, Iowa State University economics professor and surveyor in chief at the annual Iowa Land Value Survey, marveled



that 2012 was "one of the most remarkable years in Iowa land value history. This is the highest state value recorded by the survey, and the first time county averages have reached levels over $10,000 [per acre]. While this is an interesting time, there is considerable uncertainty surrounding future land values."

Duffy could say that again. Only consider that prime Iowa corn ground is trading at $11,000 an acre. Assume that this rich earth brings forth 200 bushels an acre, and that the landlord captures 35% of the gross. At $7 a bushel, today's elevated spot corn price, a landlord would earn a pretax rental yield of approximately 4.45%. At $4.50 a bushel—not an unreasonable expectation for this season, we think—the rental yield would drop to 2.86%. At $1.94—the average corn price as recently as 2005—the yield would dip to $1.23%. Then, again, land prices would probably do a little dipping themselves.

"Of course," Peligal notes, "there's more to agricultural America than the Midwest. The Palouse region of eastern Washington has begun to attract some value-seeking land buyers. This is the dryland portion of eastern Washington, which receives such rain as the gods choose to dispense from moisture coming off the Pacific. Never to be confused with the sprawling Corn Belt, the Palouse produces soft white wheat, which makes its way to China and Japan and then into noodles and dumplings.

"The spot price of old crop wheat today is a very full $7 a bushel," Peligal continues. "The Palouse can serve up 90 bushels of wheat per acre. Again assuming a 35%/65% split, landlord and farmer, the landlord would be looking at pretax income per acre of $220. Divided by a land price on the order of $3,000 per acre—up from about $1,500 per acre five years ago—he or she would be looking at a pretax yield of 7.4%. But, again, we think, grain prices are due for a tumble. At $5 a bushel, our hypothetical landlord is looking at a yield of 5.3%; at $4 a bushel, a yield of 4.2%. This is hardly the stuff of Armageddon. But just as Bronstein says, markets do adjust."

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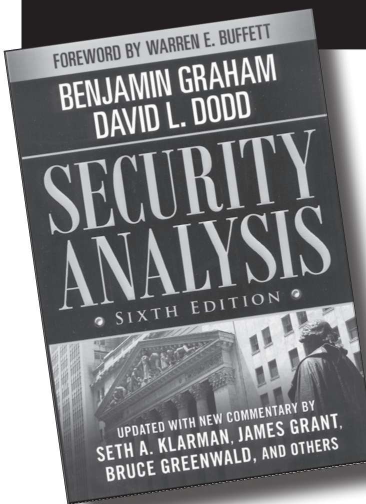

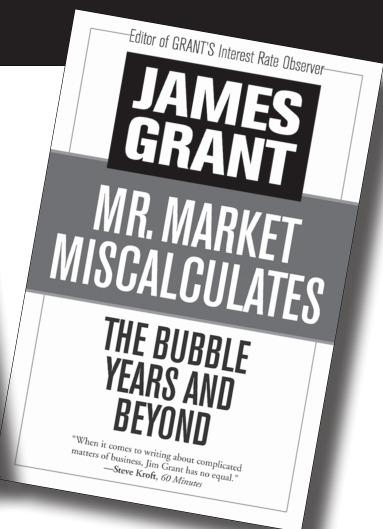

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