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Industry Speaks

Reflections on the Irrational

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Abstract

This article analyzes the various components of the current financial crisis and its implications for agriculture. While financial markets have been overrun by steep losses, violent price movements, and irrationality associated with a classic bubble, agricultural markets still have sound fundamentals and their underlying real assets may prove to be a safe haven during these trying times.

Keywords: economic slowdown, global recession, agricultural commodities, demand, financial crisis.

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It is difficult to insert a dose of logic while in the midst of irrationality. Irrational is what prevails in almost all markets at this time.

The flight to quality by investing in U.S. Treasury Bonds is odd since they have the same incredible quality as ever but still pay nothing more or less than before. The fight to cover deficit positions of Index and Hedge explains much of the fall in agricultural commodities prices during the last weeks. Funds withdrew in the third quarter approximately USD 50B investment in commodities index funds tied to its own holdings according to Barclays Bank. Positions decreased from USD 175B to USD120B.

Strong fears of how the global recession will negatively impact food consumption also prevail in the market. Are these fears real? In the short run world GDP forecasters believe that the slowdown will decelerate the global economy ending in 2009 from 1.5 to 3%. Developed countries will not grow in 2009 more than 0.5 to 1%. Hence, the bulk of the growth forecasted for 2009 should come from emerging countries.

Even with slowdowns resulting from the financial crisis, analysts forecast GDP growths of 3.5 and 7 to 8% respectively for countries such as Brazil and China The demand for food and energy in these countries together with other Asian and Middle Eastern countries should remain strong. That's why despite the crisis, I do not see by looking at the fundamentals a significant slowing in food commodities in the short term.

Recall that most agricultural commodities have a fairly inelastic demand, especially with those that are part of industrial or processed food supply chains. "The last thing people will do is stop eating,¨ Warren Buffet once said while eating a hotdog during the dot.com bubble. He was responding to a question about why he kept investing in food companies and was short in dot.com investments.

Retail grocery-store prices leapt 7.6% last month from a year earlier, driven in part by a 14.2% rise in cereal and bakery prices, the Bureau of Labor Statistics reported. The USDA expects food prices to increase by as much as 5% next year, following an estimated 6% gain this year.

If we study other bull markets in agricultural commodities in modern history from 1906 to 1923; 1933 to 1955; and 1968 to 1982; all of them lasted more than twice as long as the ag commodity bull market we've been in since late 2001. All previous bull markets had significant corrections but the curve was bullish in the long term. This suggests that the recent fall in prices of some commodities might be temporary.

On the demand side, few analysts spoke about China's historic new policy, to start raising the income of farmers (740 M people left behind in income per capita). The motivation was to more closely align standards of living in rural areas to those in the cities. The new rural policy, as they call it, will try to reduce emigration from rural cities by increasing provincial economic activity.

Few analysts paid enough attention to Obama and McCain during the last debate where getting energy independent from countries like Iran, Venezuela and others was of the highest priority. This energy independence, in large part, will come from plant biomass. Obama even compared the challenge to the equivalent of sending a *Man to the moon*, an idea launched by Kennedy. A challenge which the majority of the world once thought impossible to achieve.

On the supply side we have the little discussed question among economists. How will the developed countries increase their budgets when they are already carrying large deficits and announcing bailout plans that increase daily? For example, Great Britain (USD692B), Japan (USD100B), Germany (USD780B), Spain (USD66B), USA (USD700B plus everything already invested).

That amount of government intervention may come from three sources (a) taxpayers (increasing the risk of recession in the short term), (b) printing more money (dangerous for inflation concerns) or (c) reducing the budget in other areas.

Whatever the source, these countries are the same ones that subsidize the global supply of food at approximately USD360 billion a year. So cuts will have to be in order so that their deficits do not become chronic and unpayable. One strong area of government expenditure is in agricultural subsidies. Therefore, this financial crisis should accelerate a trend already underway, the decline in the amounts for agricultural credits and subsidies in these countries.

Continuing with the analysis of supply, we see that the American harvest is ending well. Stocks are being replenished, (although we do not yet have the final results in soybean). Countries like Australia and Russia are rebuilding part of their stocks from previous bad harvests.

On the other side are commodities such as soybeans. Brazil has not increased their planted acreage because high (until this latest devaluation) oil and fertilizer costs at the time of planting created negative margins. According to satellite images in Mato Grosso there are approximately 650k fewer planted acres this year and the director of Global Sat expects 3.5 M tons less harvest.

If restrictive policy on taxes and exports continue jointly with the decrease in outputs prices, the Argentine farmer will face a similar problem. That's why we should see a price correction even though global supplies aren't falling. In other commodities such as corn, Argentina is the second-largest world exporter and will decrease their planted area and output by around 28% as the government has shut down exports. Wheat harvest is estimated at 10M tons against the16M that were expected by the USDA.

All this makes us think that despite the irrationalities we saw last week, shares of Monsanto and Syngenta falling by approximately 30-40% in a week or so, and corporations such as Nokia, Motorola, Exxon-Mobil falling 30% to 9 times their annual profits, the fundamentals for the upward trend in agricultural commodities remain. The latest report from the United Nations predicts that prices for agricultural products will continue this upward trend. Food companies have outperformed the broader stock market in the last three months, with their shares are down 18% versus a 29% decline for the Dow Jones U.S. Total Market Index. I agree with Michael Lewis, global head of commodities research of Deutsche Bank and Kevin Norrish, Senior Researcher Commodity Barclay who say the fundamentals are still in place and that this is only a pause in the uptrend.

Nevertheless, I and others believe that the crisis will continue. The question is the length in the pause, will it be months or years? It is certain that there will be downsizing in some agrifood chains (as it is already happening in the Brazilian agribusiness which is heavily financed by banks), less credit for ag commodity exports and imports (we know of some problems with Russian Letter of Credits), some defaults, and high volatility of the market.

I also believe that there will be a scenario of deflation in all assets no matter the color or the geography, and huge fiscal deficits no matter the ideology of governments. This scenario will lead at the end of the day to a great inflation scenario after the significant injections of money by government and after lowering interest rates to their minimum in order to jump-start the economy.
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The question is the timeframe, and when and how all this will happen. But in the medium and long-term upward trend in agricultural commodity prices will continue. Paraphrasing again Warren Buffet to close this article, "this will be a time of crisis but also a time of great opportunities," and we add—for the food and agricultural sectors.

