AEI Presents Nothing Borrowed, Nothing Gained: How Farm Financing Works, and When it Doesn't or The Countercycle and the Future of Ag Lending

Episode 9 | Farmland is Blowing Up

Sarah Mock: This is *Nothing Borrowed, Nothing Gained - the story of ag lending: past, present, and future*. I'm Sarah Mock.
Agriculture is a funny place. In most ways, it's a pretty ordinary business, inputs come in, outputs go out, and profits get made along the margin. But in a few specific ways, its unlike most other business sectors, not least because:

Jim Farrell: Agriculture, and I'm not the first person that's ever said this, it's probably the only industry where we think it's positive when the cost of the factory goes up. You don't see that anywhere else.

Sarah Mock: What Jim Farrell is referring to here is agriculture's unusual relationship to inflation. Not the dreaded price inflation that every sector is familiar with, where prices for the same goods and services climb, leaving individuals and organizations alike, with more and more limited purchasing power. Instead, this is asset inflation, the type that Paul Volcker described as "price inflation's first cousin." Case in point, in agriculture, when inputs and equipment get more expensive, there's a lot of angst and anger, but when farmland gets more expensive, it's often an occasion for celebration.
Today - this paradox is at the core of our discussion. First, we'll talk about the role of federal policy in driving asset inflation, then we'll track that inflation into impacts on ag debt, and finally, we'll dig into the ripples this makes in the wider economy, and the new school of investors is attracted to the farmland space.
All of this is critical background if we want to answer one particular question – the question that motivated this season in the first place. That is, what is today's debt to asset ratio in agriculture really telling us? It's been many episodes since we last broached that question directly, mostly because, understanding farm finance is hard - there are a lot of players, a lot of motivations, and a lot of context to navigate. But over the next few episodes in particular, we'll zero in on this

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question, given all the new information we've learned, and everything we know about the risks that are growing clearer on the horizon.
In terms of the roster for today's episode, you'll hear a lot from Tom Hoenig, former Kansas City Fed chairman, and again from Jim Farrell of the Farrell group, among others, but let's start with Nate Franzen from Dakota First, who will start us off with an essential summary of what the Fed's been up to in the last three years.

Nate Franzen: You probably read in the news how the Federal Reserve increased their balance sheets substantially here through the pandemic. That's really what they did. They went out and invested a lot of money in longer term investment vehicles like treasuries and as they did that, their balance sheet increased because they were holding more of those investments, but that created extra demand as well.
So, what they were doing is, putting pressure on those long-term rates to stay low. they wanted to fuel the economy by keeping those long-term rates low, which allows citizens to borrow money cheaply, buy homes and borrow their mortgages at cheaper rates and all those things prop up the economy. And because of the worries, the pandemic, that's what they did.

Sarah Mock: Yes, over the past couple of years or so, the Fed has kept interest rates near zero and the money supply high, in an effort to make sure that people go on spending, even in the face of lost jobs, lost wages, and less options for things like dining out and travel. But this is really just an extension of a longer-term trend, and without a doubt, it has affected agriculture, specifical, according to Tom Hoenig, the price of farmland.

Thomas Hoenig: Farmland as an asset value, has been affected by the monetary policy, just like other assets have. When I see the price of land in Iowa, my home state, I'm just amazed at the per acre price from when I was a boy. I just, I find it difficult to appreciate in the sense that so much of it is artificial. It is based on if there's a lot more money, you're going to increase those values.

Sarah Mock: I think it's important to parse what exactly Tom is getting at here, with the idea that low interest rates and cheap money inflate the price of assets. This is the end result of a phenomenon that we've discussed before, that when interest rates are low and money is abundant, players across the financial system get pushed out on the risk curve, making riskier and riskier bets to maintain their

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rate of return. Another effect of this is the bidding up the price of asset – and farmland is a prime example. Say I'm a fund manager, with $10 million dollars to invest, and relatively few prospects, if I see a promising opportunity, say, 2,000 acres in Iowa that I'm confident will earn a safe and durable 3% it's well worth bidding up the original purchase price – not because I think the land is eminently or increasingly productive but because things like commodity programs and crop insurance, assure me that a return will come if I invest, and the fact that farmland values haven't meaningly fallen since the 1980s means I can confidently get my principal back as well.
Jim Farrell, who managed farms for major funds and institutions using this logic, explains it like this:

Jim Farrell: Let's say you had a million dollars you wanted to spend, and you wanted to put it into a bond, you might not put it into a bond, but if you put it into a farm and you cash rent the farm for $400 an acre that's a one-year bond, okay. you're going to get your payment and you're going to get the capital back, okay, at the end of the year. And you get your money. So, when you look at it from the fund standpoint, they're looking at long-term appreciation, they're looking at cash returns and their expectations, on the cash returns have gone down, they still expect the appreciation.

Sarah Mock: These falling expectations on the cash returns side, Jim explains, have been a long time coming, and those changes map pretty directly onto the timeline of the Federal Reserve's easy money policies.

Jim Farrell: At the peak of say 1986, if you were to buy a farm at that time, depending on where you bought it - and there's a lot of factors that enter into that. But if I go back to my area where I grew up, you could still buy a farm and cash-on-cash return was 5%, maybe 6%. Most recently, if you're buying a farm as an investor, if you can get 2.5%, you're doing really well and in the 1990s, Morgan Stanley had a large fund. And we managed that fund for a time, at farmers national their goal at that time was a 7% return cash on cash, and they were going to own it for 10 years and they did, they owned it for 10 years - it was a Pennsylvania teachers' fund - they earned their 7% cash returns, and they had appreciation on top of it during that timeframe. So, fast forward to 2006 when I was approached by, Goldman Sachs, who was looking into the potential of starting farmland, and we were talking 5% returns at that time, and you might be able to get 5.5% there were some 6% opportunities perhaps down in the Delta areas and, that was where it was at. As you got further and further into this thing, when we got closer to

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11 and 12, those return expectations dropped closer to 3.5% or 4%, and then there were 3.5% or 3%. And today I'm on an advisory board for a farmland fund. And you try to buy property today, that needs improvements so that you can buy it at a price that might make sense, and you can add the improvements and increase the value through doing that sort of thing. That's how you get to your return expectations. And those expectations have dropped in part because there are no other competing investments that are considered flat or safe, to put your money in. So, it's a competition thing in my mind, it's been a competition for the money.

Sarah Mock: So, that's the basic model for the funds, right? They buy farmland, they get their cash rent, and they add it to the appreciation of the asset over time. That's how they get their 2%, 2.5%, 3% return. And funds have accepted this declining return for two reasons -- one, as Jim points out, there's simply not a lot of better deals out there, 2% might be low, but if U.S. Treasuries or a similar option is even lower, than your 2% is still a premium -- and two, because farmland is considered quite safe and reliable – especially for institutional investors. I'll let Purdue economist Mike Boehlje explain more about how one group, insurance companies, think specifically about the agricultural assets in their portfolio.

Mike Boehlje: Farmland is a very good diversification asset. And farmland is a very attractive investment if you buy it right and if you have a long-term holding mentality. what they do is they use what's called a buy and hold strategy - they plan to hold onto it for a long time. And farmland is a very good investment. It's a very good inflation hedge. One of the best inflation hedges there is out there in terms of the value it has got diversification benefits and that the correlation between the rate of return and farmland and the rate of return in the stock market is very low. And well managed farms can generate rates of return cash and capital gain very close to what you get in any other kind of equity investment. And so, it is a very attractive investment and so that's why insurance companies not only have this lending activity over here where they make loans to farmers, but they also have an investment activity that they have, where they put farmland into their portfolio as an investment.

Sarah Mock: Notably, for all the years and decades that this strategy has worked well for insurance companies, it also has, in extreme scenarios, totally broken down. In the lead up to the Great Depression, for example, insurance companies

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who had invested aggressively in the Dakotas found themselves needing to foreclose on, as Mike describes, an unbelievable amount of farmland acres, which had plummeted in value.
But all in all, for institutional investors this model has stayed the same, or pretty much the same, for decades, despite diminishing returns. And this is essentially the same business model that farmers who own their farmland use, or at the very least, should be thinking about it.
To help connect some of these dots, I want to bring in David and Brent, to add a bit a context on how farmers might think about their own businesses as a fund might.

David Widmar: It's easy to assume that the interest rate market impacts the cost of borrowing money and that's true, but the interest rate environment and that interest rate market also impacts a lot more. It impacts asset values; it impacts the types of investments that we're willing to do the types of risks that we need to take on to obtain some level of return.

Brent Gloy: It impacts the opportunity costs and what seems attractive. When the cost of capital is really low, all kinds of things seem attractive. And so, prices get bid up and people do all kinds of things that they wouldn't do if the cost of capital were higher.

David Widmar: I think it's, an open question, what's the cost of capital? Or what's the reasonable cost for borrowing money? Or what kind of return do we want to see for the assets we buy? Or what kind of return do we want to see for the money we have parked in the bank?
One of the challenges here, that we've seen over the last 10 years is low interest rates to borrow money is also low rates of return throughout the economy. So, we see asset values that have increased, and that has in turn caused lower rates of return on farmland, on stock markets, on the money we put in our savings accounts. So, if you lower interest rates or you're willing to accept a lower rate of return on an asset, you inflate the valuation of that and that feels really good in the moment, right? You think, I already have a hundred acres of farmland and this next a hundred acres, I bought has a valuation that's 50% higher than what I bought this farm two or three years ago for. So, that feels really good. You know, our book values went up. But on that new piece of ground, we might have locked in a really low rate of return for forever. And when we're in this low interest rate environment, that's what happens when we're buying assets is we're locking in, low rates of return.

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So, there are lots of ways that could, have implications, do interest rates stay low and do we have just low rates of return for forever or do interest rates start to turn higher? And those assets get revalued and, that create some challenges for those who own assets today, but for opportunities for folks who might be buying those assets in the future at a higher, rate.

Brent Gloy: Well, and the whole reason, what the Fed does at the short-term rates is important, is because, in some ways that is a return. So, it's setting the returns and saying the short-term returns have to go up. And you can't talk about return without risk and, what the Fed is setting is the most riskless return that there is. And so, it forms kind of the base of the return curve. As they start to raise that base. It means that the returns on all of the assets have to rise. How do returns rise? And we should be a little more specific, it's the rate of return. The rate of return rises by, either having more income from the same asset that you've invested in. Or, having the same income and the value of that asset falling, so that its rate of return is held constant. And the reality is those things all change all the time but what the Fed is doing is moving that, most basic of interest rates up a little bit, and as a result, all of them have to adjust. And so, it sets off a chain reaction in the economy of revaluing, and recalibrating rates of returns and asset prices. And that's why there's so much attention paid to it. But how that happens is, complicated and it plays out over a long period of time.

Sarah Mock: Predicting how changes to the interest rate will affect asset prices is a tricky business, and history is only so helpful in informing our outlook, because as Tom mentioned before – every moment in financial history is, essentially, unique. No era has played out exactly like another. But at its core, this whole phenomenon is driven largely by just two factors: In this case, the Fed's easy money policies combined with the steeply de-risked state of U.S. ag production And the trend has been clear – the combination of these makes farmland an incredibly attractive investment. That fact has kept ag property values rising for decades, which has been a boon for both farmers and their lenders.

Jim Farrell: So, if you're in the banking side of - yeah, it's positive as heck. Especially if I'd been refinancing, operating capital, like we were doing back in 2017 and 18 and 19, because there wasn't enough profit to pay the operating capital back, but asset values had held strong. Some of that due to some of the payments from the Trump administration's, tariff payments that were being paid out and some of that from other

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factors. But the reality was that you were able to refinance these on a longer-term payout, using the collateral of land values that had gone up.

Sarah Mock: But -- and there's always a but – these recent trends may also be distorting our understanding of the debt picture in agriculture.

Jim Farrell: I think there's a bit of a misunderstanding about how much land actually carries debt. And so, you'll hear it said that “Oh man, so much of the land carries no debt,” but what's the unknown is how much of that land is actually carrying, debt as collateral on refinanced purchases and things like that. Or is collateral against the last farm I bought, so it's a double-edged sword. You need to have a strong ag economy, which is based in large part on the asset value of land, which is 80% of the assets typically. But yet seeing prices go up 20% and 30% is nuts. In my opinion, it makes no sense whatsoever.
I would argue that I think we've appreciated the asset, right now, to the degree that we can. I think in some cases we've over appreciated the asset I think we've gotten a little bit too high. Some of this recent buying, frenzy that took place with the Ukrainian invasion that really drove things up beyond what I think probably made sense. And I've been wrong on that before. I could be wrong on that again.

**Sarah Mock: Despite Jim's assertion here, it actually does make sense the farmland values have been shooting up in the last three year. Because the Fed dropped interest rates dramatically and pumped trillions into the economy, that almost certainly set off a new round of bidding wars, back by new money.
But I think what Jim is getting at here, is the somewhat obvious fact that these increases in price, are not dependent on new productivity, they're driven almost exclusively by the new money -- which means that if the money, say gets sucked out the economy through Fed action or gets significantly more rare or more expensive, that would fundamentally change the trajectory of farmland pricing. In a way, this is ag's version of the company that takes out a loan to do a big stock buy-back. The action makes businesses look more valuable, but it's not actually leading to more productivity, and in that way, it's a kind of mirage, which is apt to dissipate when the interest rate increases.**

Whether I was talking to Jim and Tom or Mike Boehlje long before them, there was a general consensus amongst our sources – that farmland is somewhere between overvalued and a full-on bubble. Given that it's very difficult to know that

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a bubble is brewing while it's happening, it's worth understanding what the risks might be that a bubble is out there -- in particular, what are the risks that farmland values might decline in the near future? I put this question to Brent and David:

Brent Gloy: I think we live in a world where people are optimistic that farmland values aren't going to go down. I think everybody understands that they can. But we just don't think that's around the corner ever. And right now, in all kinds of things, I see more of these kinds of systematic risks happening that I didn't think were supposed to happen very regularly and they seem to happen more often than I would've thought. So, it's a wakeup call to me that maybe we've been greatly underestimating some of these bad case outcomes and just how bad things could actually be.

Sarah Mock: The behind the scenes here is that Brent farms in western Nebraska, and the weather in recent years has impacted his thinking around the idea of the risks he faces and how likely they actually are.

Brent Gloy: Not to say that there's going to happen - probably low probability events, but if they happen, they're catastrophic and I don't think we've figured out how to handle that very well. And I think the only thing we really rely on at the end of the day to address that is that the government will help. If those really bad things happen that hurt everybody the government will help.
That's what happened with COVID, it was a really bad thing that, everybody thought was completely out of left field, but when you think about it, probably wasn't really that wild of a scenario and actually was probably much milder than it really could have been. And I don't think we've adjusted our beliefs on that as a society, we're just like, "Oh we made it through that. We can make it through anything now." And if something like that happens well, the government will help us out and it'll all be better. And I do think that when it comes to farmland, it's one of those things that everybody in the back of their mind knows it's possible. It could go down and maybe substantially, but we just don't see that happening anytime soon. And we'll ride the train a little while longer, because surely, we would be able to see the train wreck coming, we would have time to get off before it actually crashed.

Sarah Mock: So, you've switched from Gore's first group of people who just believe it's about the fundamentals of the market to his second group of people who don't really believe in the fundamentals of the market but are confident that they'll get out before it gets terrible.

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Brent Gloy: Yes, yeah exactly. I don't think the fundamentals are completely out of whack here in the farmland market right now. I really don't. But that doesn't mean that they can't change much more rapidly than we want to believe. That's the whole problem. Like right now, yeah. You can look at it and go interest rates are really low and incomes are really high and that all makes sense. The problem is it can change, and we just don't know how. rapidly it can change. So surely if it changes, we'll see it coming.

Sarah Mock: I'll add here that Galbraith, for one, had some serious doubts that it was actually possible to see a market crash coming. Or I suppose that even if you do, so will everyone else, and there will be no way to get off the hypothetical train, because no one will want to take your seat. The people on the train in this metaphor, are farmland holders, both individual farmers and ranchers and these big firms and funds that have bought up hundreds of thousands or millions of acres.

It might seem that that group, which is asset light, the new and beginning farmers especially, might be spared, but in the meantime, as asset values continue to rise, renters and lessees are faced with their own version of the same challenge according to Jim Farrell:

Jim Farrell: There's a substantial amount of absentee ownership ground that gets cash rented out. And when asset prices go up, cash rent go up too. And that is very definitely, inflationary. I don't have a problem with land values going up, but I think interest rate policy at the Federal Reserve is driven land values, much higher than land values would ever have gone had we normalized interest rates as Tom might have suggested we would do back in 2010 and 11. And if we'd taken interest rates back to something in the area of 2.5%-4%, which is where they started from, that would've had a different impact on land values. Land values obviously are good if you're a farmer who has, lots of land that you own and you can use that as collateral to buy another 80 next door, even though it's an outrageous price, you can average that all together. But where it really comes home is if you're a young person, like I was in 1977, and you're trying to start farming.

All the land I farmed was on a 50/50 share crop in 1977. When I quit in 1986, four of the five farms I farmed were cash rent. And today cash rent almost universally is collected up front. You take the cost of fertilizer that's up and seed that's up and then if you add another 15% or 20% to the cost of cash rent, which, I think, based on some of what we're seeing in land values - I think over the next few years, we could see that kind of an increase unless things back off - you're talking about a substantial amount of money

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to put an acre into ground because you have to have all that money up front in some fashion.
So, if you're a kid 30-, 40-year-old kid, if you will, you've got to be able to finance all that and you don't have a lot of room for error,

Sarah Mock: Risk can often be a kind of amorphous idea, seemingly it can mean almost anything, but here, Jim uses the idea of "room for error" to capture it quite succinctly. See, the idea that high rental rates and high land prices leave little room for error means that, though there might be a significant upside to these opportunities, or positive risks, there's also significant negative, downside risks. The biggest one of all, in fact, of going broke and being put out of the game all together.
Low interest rates can really take the sting out of making big investments, but just because it doesn't hurt today, doesn't mean it never will, especially if conditions may change. Like say – if the Fed spends three quarters of 2022 ratcheting up interest rates. That's after the break.

[[COMMERCIAL]]

Sarah Mock: With all the talking we've done about institutional investors and how farmland investors think about farmland ownership as a business model, I think it's worth digging in a bit more to what might happen when conditions change fundamentally, and the Fed decides to raise interest rates, as it's doing today?
I put that question to Tom Hoenig, and he also emphasized the riskiness of this position especially in the common case where these funds are themselves, investing debt.

Thomas Hoenig: I think part of what, these equity funds and investors funds that come in, they leverage too. They lever up and, it doesn't necessarily get reported as an ag loan. It depends on a whole lot of things how they record this. But to me, if they are using leverage to do this, they are increasing risk. It's it just one follows the other. And if you are leveraging, and you're basing it on expected cash flows off that investment, and that cash flow, is diminished, over time and the asset value itself is diminished. The lender - it may be a large, bank lending to a different equity fund or whatever - then you would have a leverage squeeze, if you will, that I think could create instability among some of the larger say regional banks, or even some of the larger center banks. And that would be very destabilizing.

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Sarah Mock: This point is critical – because I think it's easy to assume that, though farmers and individuals might be taking out loans and mortgages to purchase farmland, certainly billion-dollar investment funds are using cash, right?
Tom's point – of course they're not! The vast majority of those buying farmland (and all kinds of other financial assets) are doing it with leverage, that allows them to magnify their investment capacity and – we can only hope – diversifying their portfolios with multiples of the amount of assets in their actual funds. Obviously, this is still risky, because leverage is always risky, and what Tom is describing here is a cascading effect, not dissimilar to what happened with Penn Square and Continental Illinois in the 80s. In this case, the question will be what happens when a fund, that is likely levered itself, starts to see declining cash returns from say rent? Perhaps because as interest rates continue to rise, cash rents level out or even decline. Will the fund still be able to meet its obligations? And if not, what might that mean for the banks that fund the funds? Tom says he sees two pretty different potential outcomes there.

Thomas Hoenig: If the lending is going on by regional banks, that could be very destabilizing within a region. If they are allowing the leverage to become ever greater based on their expectation that the asset value will be stable or rising. And based upon the expectation that commodity prices can only go up. If that's happening at the regional level, then that would be very destabilizing, should the open market committee's tightening both quantitative tightening - that takes liquidity out of the system - and interest rate tightening that makes the cost of this leverage more expensive that could, affect agriculture as well as other industries.
If it is in some of the largest banks, the very largest banks, I will tell you this, that would probably be better in the sense of stability because they are always bailed out by the government. And they would be bailed out again because of not just the effects on agriculture or on those hedge funds or on those equity funds, but on the broader economy that those banks affect. And, that seems almost perverse, doesn't it, but that's how I've experienced things and that's how I see it should they continue to concentrate those loans in the largest banks. Which is in a one sense, unfortunate, because it leads to further concentration of that industry that is that banking industry in the future, but for the moment, it would be a factor affecting the largest banks favorably. But the producers won't be helped by that. They will still get foreclosed on if they're leveraged.

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Sarah Mock: For Tom, some of this is still just a possibility, something that could happen depending on how the economic conditions pan out and how the Federal Reserve manages the current moment. But at the same time, he says, some aspects of this grim future he paints, are likely unavoidable.

Thomas Hoenig: Leverage is such a powerful tool if it is moderate and it's consistent, but if the Federal Reserve, as it has in the last decade, creates enormous amounts of liquidity and here's how I describe it to you - if you create an economic system, which includes agriculture, includes industry, includes different sectors that have an equilibrium around a national policy interest rate of zero. You change the entire dynamics of that marketplace and that economy around the new that equilibrium of zero, if then inflation, asset and price inflation breaks out, and you decide that you could no longer sustain that zero-interest-rate environment. That means you have to move to an equilibrium at a much higher rate, even 4% or 5%. That is an enormous adjustment for an economic system, and it will not be painless. And that is why the sooner you address the issue, pain there will be, but the less ultimate pain there will be for that economic system. And that's why I hope that the Open Market Committee, since it no longer has a gold standard or any other kind of objective discipline to it, no rules-based system - that's why I hope it can maintain its discipline, but not exceed what is necessary. And that is a very difficult, shall we say process to manage for that committee and frankly, no one has that kind of knowledge. You are estimating guesstimating, experimenting and that is, what lies ahead of us all.

Sarah Mock: "It will not be painless," is not the most reassuring forecast for the coming months and years, but it's not exactly clear from what Tom' says, what that pain might be. Jeff Conrad from AgIS Capital offered this analysis:

Jeff Conrad: This rapid increase of interest rates that we've seen recently, combined with what I think everyone anticipates in the next 12 to 18 months are not going to be good for agriculture. And a lot of times I'm talking to ag people, and I said, it's not going to be good for anyone. And., I think the ag sector, we've seen the cap rates in U.S. row crop, land driven, so low, that if we see Interest rates go up 200, 300, 400 basis points. It has to have, some downward pressure on farmland values.

Sarah Mock: The cap rate -- or capitalization rate – is a measure of risk that's similar to return on investment, though evaluated not over the life of the investment, but in the current moment or on an annual basis. Jeff's point here

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then, is that current rates of return on ag real estate have been driven so low– due to high land prices, that if interest rates continue to rise, demand will likely falter as the math starts to look even less appealing, and farmland values should, at some point at least, begin to plateau or decline.
But despite this pressure, Jeff says, there are also new factors in the farmland world that weren't present during past periods of rising interest rates -- namely, all of those funds and investors from outside of the world of production ag.

Jeff Conrad: There is a lot of capital out there and people - both institutions and high net worth individuals - have become more and more comfortable buying and owning farmland and quite often leasing it out.
The ag sector took such a big hit at that point in the late 70s and early 80ds. And I remember when values were falling in the cap rates were really going high. I think now because capital markets have developed more and capital's more fluid, I don't think we'd ever see the cap rates go then high or the land values would fall that low, because I think you'd start to see non-ag money come into the sector to hold up those values. Now someone could push back and say, "Yeah, it's not true everywhere." And that is true. Institutions tend to like to invest in certain areas, high-net-worth individuals are more broadly investing across the country though. Now there's these crowd funding groups that are coming into the sector and you can invest $20,000 on buy part of a farm. There's a lot of outside capital available to come into the sector and types of equity capital that we didn't have in the 70s and 80s.

Sarah Mock: **So where does this leave us? We know that for the last 20+ years, the Federal Reserve has, more or less, kept interest rates low and money abundant, which has raised the profile of agricultural land as a desirable investment for big institutional players and high-net-worth individuals alike. This, in turn, has driven up the value of farmland all across the country, depending on who you talk to, to levels well beyond what might be considered rational given the actual productive value of the ground. These inflating assets can distort our understanding of debt in the ag sector, because – essentially – the debt-to-asset ratio, is kept low not necessarily because debt isn't rising, but because asset values are. At the end of the day, agricultural debt, and so much of agricultural lending, is inextricably linked to this value of farmland, because of its use as collateral and because 80%+ of wealth in the ag sector is tied up in it.**
But I think what we've heard today should, at the least, give us pause about how much risk may be bound up in the idea that farmland value will not go down.

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Because whatever the situation is today, if farmland values were to decline, that would change everything.
It might be easy, then, to point the finger at the Fed for inflating farmland prices, and for making it more costly for existing operators to expand, but as Jim pointed out in the beginning, many farmers and ranchers have also substantially benefited from this influx of investors, because it's inflated the value of their existing assets, making it easier for them to get credit as well.
There's a bit of a spilt milk situation happening here, maybe farmland values would not be so high, had the Federal Reserve had a slightly higher interest rate target, and maybe that would have fundamentally changed where the sector is, financially, today. But the past is behind us, farmland assets are, at the very least, inflated, and whether realistically or unrealistically so, only time will tell.

What is clear today, is that interest rates are on the rise now, and part of what that means is that other investments in the economy will begin to look attractive again. Farmland is likely to have more and more competition as an investment vehicle, as the economy reorients itself. But when, and how, and what will the result of that be? Here's Brent:

Brent Gloy: Oftentimes all these risks are very hard to know and all the events, as David says, that have to cascade. It's just really hard to know when it's all going to come apart. I do think we can know when it's like going too crazy though. We can at least have an indication of when people are becoming like ridiculously exuberant and those are worth watching for those periods, because it just means when you have all that exuberance bid in the least little tribulation is going to cause a big problem. And so, it's worthwhile to be on the lookout for when people are, too exuberant too euphoric.

David Widmar: And recognizing just because you've identified, that doesn't mean the outcome is going to be exactly like the last time that occurred. It's just recognizing that we've saw this pendulum swing in this direction. Beware. It's like a tornado watch - be careful. We've got these conditions that are, signifying for risk. So maybe you as an individual can't ever predict what the outcomes are going to be, but how can you position yourself and your business to just recognize you've entered this dangerous environment?

Sarah Mock Today, the marker of that dangerous environment is, without a doubt, rising inflation. But again, though price inflation is a relatively new phenomenon,

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asset inflation in agriculture has been ongoing for decades.
But as Paul Volker reminds us, asset inflation and price inflation are related, when the price of assets rises, prices for goods and services follow. Inflation can be a normal part of long-term economic cycles, but the problem is, as David and Brent point out, the Fed has a mandate to limit inflation -- and that is probably the biggest reason why it should be at least a yellow caution flag when watching the market. I'm going to include a bit of a longer segment here, because I think it's important to understand how difficult it is for the Fed to even attempt to carry out that mandate, and how many things can go amiss in the process.

Brent Gloy: When we get inflation, at least in the United States, it hasn't happened all that often. And so, we know that something is a foot, there's something going on that's causing weird things to happen because if we lived continuously with 10% inflation probably wouldn't be that big a deal but when you're used to much lower rates of inflation, we know something's going on. And so, it's worthwhile paying attention to that. But more importantly, I think it's, problematic because it's probably going to trigger the central bank to act.
The central bank, through their control of the credit, can have a huge impact on the economy and the fundamental problem with that is that lever they're going to pull on used that doesn't just - they move it, it causes X, which causes Y and causes Z, and we're done. They stick it in, and it starts gumming up all kinds of different things.
And it's really hard to know exactly how all that's going to shake out. And so, I think that's the big problem in some ways with the inflation is that it gets the Fed to try and do something to change the business cycle and the Fed has a lot of impact on the economy, but those impacts are not easily seen, and they're not seen immediately. So, it takes a long time for all that to work through. It works through in somewhat mysterious ways. And so, anytime we get that inflation, and it causes the Fed to start act boldly it's worth paying attention to because strange things can happen. It's possible they could, engineer the soft landing, but I think that's a little bit deceptive in and of itself. It's not like, they're not really engineering. They just change this little - it's like a really complicated engine and it's not like they're changing the fuel supply directly, they're messing with like maybe a couple of the injectors or something on the diesel engine and trying to slow it down. It's way more complicated than just slowing the fuel down and the motor slows down. It doesn't work quite so simply. They're monkeying with little parts that do cause changes, but it's hard to know how it's going to impact the whole

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David Widmar: It lacks the precision that we might assume that it involves. And so, when we see the Federal Reserve raising interest rates, 75 basis points it's easy for us as individuals, maybe because of the way we process information, the way that the media's presenting it, or maybe the way the Fed's presenting themselves is this was like a very calibrated adjustment of the fuel pump to really dial it in. They've checked all the references materials; they've got all these complicated models and diagrams and they all agree that this is the right process. But in reality, it's more you're on the edge of the field and you're just trying to figure out how to get this diesel engine to run. And so, you're just pulling on levers and hoping that it works. And I think there's a fine degree between they scientifically know that if you change this, this exact outcome will happen versus, throwing spaghetti at the wall and seeing with sticks. I guess those are the bounds. It's maybe less scientific and let's talk about why it's not really that exact is some of it's the mystery of the science and some of it's the mystery of the human expectations and the human beings. And so, humans are going to respond to this, be it individuals like myself and whether or not I should go buy a new pickup or buy a new home? Versus companies who are deciding, should I deploy new capital? Should I give raises? And so, there's all these expectations so the Fed not only has to think about, what they're going to do, but also how the U.S. and the global economies are going to respond to that and then there's that feedback loop. There's this great Ben Bernanke quote about, predicting the weather is difficult because of all the particles. But in reality, economic forecasting is more difficult because you have to predict the particles, but also how the humans are going to respond and they, in turn, are going to impact the particles themselves. And so, there's this sort of feedback that goes back and forth and so it's a big job. It's difficult.
Brent Gloy: That's why I think it should be a flag because when they start doing that it, we don't know exactly how it's all going to work out.
David Widmar: And I think oftentimes I hear producers, concerned about the Fed's next decision to raise interest rates. And I think sometimes we get hyper-focused on that, but we lose sight on, the Fed is an important and a very significant player in the interest rate space. But they're not the single player there, there is a broader debt market.
And while the Fed, does set a target price for a particular, interest rate market, in that particular price, the fed funds rate. It's a cornerstone, in the entire global, interest rate market. They're not a hundred percent linked.

Brent Gloy: And I think the greatest misunderstanding is that people think, the fed raised interest rates can slow the economy. It's almost like you listen to them on the radio. And they're like, "The Fed raised interest rates today. So boy, the economy's

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going to slow down." Like when? Like in six hours or 12 hours or what are we talking about?
And that's the timeframe that people are approaching it with and it's really wrong. It doesn't work that fast. Monetary policy is one of the bluntest instruments that exists. Really what's happening is they're trying to slow down credit creation in the economy. But that has to feed through millions and millions of people and people going to the bank today and saying, "Oh, yeah, I'll take that loan out today." It's a little bit higher but it has to hit points where somebody says "No." And it takes a long time for that to work through the system. So, there's just this great. I think misunderstanding, not in that the Fed isn't important, the Fed is very important and interest rates are very important - but how they work is greatly misunderstood.

Sarah Mock: As we try to understand the current state of the ag economy, and where it might be headed in the near future, I think these points from David and Brent are critical in that they emphasize the sheer amount of uncertainty that we're playing with here on the edge of a radical change in the financial environment. Inflation has mounted, both on the asset and price sides, and the Fed has already begun to act. Tom will have the last word today, on what that means for us going forward:

Thomas Hoenig: Monetary policy acts with long and variable lags. So, the policy actions you take today, don't have their full effects for up to a year, 18 months. And what happens is the open market committee Doesn't see its effects of its policy today and being humans, they're impatient. They want inflation to come down quickly. And so, they continue to raise rates beyond what's necessary to bring inflation down so that they tighten so much that it actually precipitates a more serious recession - and there are different degrees of recession - and precipitates a more serious recession than might otherwise be required to bring inflation down. And there for the times become harder effects, not just, general public, but agriculture as well as other industries.

Sarah Mock: How to prepare for hard times in ag lending? That's next time on *Nothing Borrowed, Nothing Gained*.

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If you've enjoyed the show, please rate, review, and subscribe wherever you listen to podcasts, and lookout for Ag Economics Insights, on social media @ ag economists or email us directly at askus@aei.ag.
This show was edited, produced, and cohosted by me, Sarah Mock, along with my cohosts David Widmar and Brent Gloy. Special thanks to recurring guests Jim Farrell, Nate Franzen, Mike Boehlje, Tom Hoenig, and Jeff Conrad for sitting down with us, and further gratitude to the show's managers Emily Raineri and Sarah Hubbart, and the rest of the AEI team, including Jeff, Michael, Mason, and Aerin.
Until next time, remember:

[00:58:08] Curt Covington: The good times never last.

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