AEI PREMIUM

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 10 | The Coming Storm

Sarah Mock: This is Nothing borrowed, nothing gained: The story of ag lending; past, present, and future. I'm Sarah Mock. Since I started working on this season, my understanding of the inner workings of ag lending and its connection to the farm financial system has increased exponentially. That should come as no surprise to you, who have -- we hope -- been on a similar journey. Naturally, I assumed that knowing more about something like the ag lending system, or having more data about it, would make me, and therefore all of you, better at dealing with it -- right? That's kind of the whole point of making this podcast, that by shining light on how this system works would help ag professionals operate in this space in a way that makes the more successful. You can imagine my surprise then, when I put this assumption to David and Brent, and this was their response:

Brent Gloy: We talk a lot about data, and I think that this may sound funny coming from me, but yeah, data is good and useful, but it's flawed almost always. And we love to compare data from different time periods and a lot of times they're not really comparable. It gives us, I think, a false sense of security. We make inferences from it that we really shouldn't and not just in credit, but in all kinds of things. And we already gave the example of the weather, but businesses of 40 years ago are very different than the businesses of today. And so going back and looking at data and returns from that long ago gives you some indication of how things have evolved over time, but it may not give you a lot of precision when it comes to doing things like pricing, credit risk, so it's not to say we can't learn something from it. We can, but we have to understand what we're learning from it and not over extrapolate.

Sarah Mock: I don't tell you this to undermine what we've learned over the last nine episodes, quite the opposite. As we start to think about the future and where we go and what decisions can be made with our new information, I think this is critical to keep in mind – more knowledge by itself doesn't lend itself to better decision making, even if it does lend itself to more confidence. There's more to it than that. Now that we have more knowledge about everything from the history of ag and money to the true mean of the debt-to-asset ratio to the farm financial system, we're ready to start translating what we've learned into strategies and tactics for dealing with a new environment that's

emerging right before our eyes. Where interest rates are higher, money is more scarce and the very rules of the farm financial system may be in flux.

That's what we'll be tackling today -- we'll start by understanding how ag lenders think about and manage through changing conditions, we'll add some specific insights on what obstacles our sources see on the horizon and hear what they think will set farm leaders apart in the coming years.

To guide us through much of this conversation, we have a familiar voice that, until now, we haven't gotten spend very much time with. Curt Covington has been in ag lending for nearly 45 years, after growing up on a farm in California's central valley. Curt spent time in Farm Credit, then Rabobank, then as the chief ag risk officer at Bank of the West, and finally retired as an executive vice president at Farmer Mac. After finding that retirement was not for him, he found a role at Ag America Lending, the largest non-bank ag lender in the country. In Curt's long career, despite the central role that lending has played in the farm sector, he's still surprised by how misunderstood the space is by the people who need it the most.

Curt Covington: It's really an interesting situation because you'd be surprised how many of our clients and farm clients across the country really don't understand how agricultural lending works. It's the old adage that, "Hey, you banked with my father, you banked with my grandfather. I should just be banked the same way they were banked." The world is different today.

Sarah Mock: This isn't just a funny quirk of the system either, Curt says, it's often a big problem, especially for farmers, because it can lead to serious issues -- the biggest of which, from Curt's perspective, is lending from the wrong organization.

Curt Covington: You want to make sure you're dealing with an institution that understands your business. And I know that sounds, really does sound trite, right? It sounds like a commercial for, some bank out there somewhere. The reality of the matter is you have no idea how important it is that you're dealing with a pragmatic lender who provides consistent and relatively meaningful credit to you during the good times and the bad times. I can find any lender to lend me money and agriculture. When corn is $8 or corn is $9 soybeans or $15 or $17, when land values continue to climb at a 5% or 6% clip a year where interest rates are nominally, nothing, but the current environment is going to be the test of the type of relationship you have with your banker.

So, I would say if you're just chasing dollars as a farmer, "who can give me the best deal." You're doing yourself, a disservice.

Sarah Mock: Curt was emphatic, in risky situations like we're likely to see going forward, having a lender that understands your business, and critically, can act as financial

advisor to your farm, is of the utmost importance. And what it means to understand a farm, Curt says, is to understand the inherent, cyclical risks of agricultural markets, and being committed to lending through the whole cycle. He's seen too many scenarios where farmers were left in the lurch by fair weather lenders.

Curt Covington: During the last run of both corn and bean prices during the last run-up of bomb and prices during the last run-up of other commodities, you saw a lot of lenders come in, who didn't know really a whole lot about the space, but they saw an opportunity to grow their assets, put more loans on the books. During the downturn in the corn market, during the downturn in the bean market, during the downturn in the nut market they're gone. But guess what? Some of them are starting to resurface again, right? That's not the type of lender you want to be with. And sometimes your banker's giving you wise counsel, and you may not appreciate it, but I would also say as a borrower, it's okay to ask your banker, "tell me about your philosophy. Tell me about the size of their portfolio. Tell me about your history," right. It goes both ways.

Sarah Mock: Right now, this last piece of advice is especially relevant, but can also be especially difficult to put into practice - grilling your banker about their lending philosophy can feel rude or disrespectful, something that could put an important relationship in jeopardy. But the reality is -- like asking the hard questions of any other professional - it's a really important, and simple, way to mitigate risk. After you've identified a lender that understands the sector and has a comprehensible lending strategy that aligns with your priorities, the next critical step, Curt says, and one that many farmers continue to underestimate, is preparing to meet with your banker.

Curt Covington: I've been in situations where the client comes in, they give me their tax return under receive used as a coffee cup holder on their dashboard, their balance sheets on the back of a napkin. And they think somehow that's good enough. The reality of the matter is that banker may have 50 large customers, or they may have 200 small customers. You're not the only customer that banker has to deal with. So being prepared. By having well-prepared financial statements, being able to answer all the questions that might come about what's next year's marketing plan look like for your crop. And oh, by the way, Mr. Farmer, I know that you've got children that you're transitioning into this business, or maybe you don't have children transitioning into the business - what's the plan. Here's some of the common answers you get? "Well, that's my balance sheet and that's my income statement, but you'd have to call my bookkeeper or accountant if you're going to ask specific questions. As far as my state planning, my attorney's done all that work. He did something called a trust. He's formed these LLCs. but I don't know really how that's going to impact because, let's face it, when I die it's their problem. Not mine." Technically that's not true then becomes the banker's problem as well.

Sarah Mock: Being well-prepared to meet your lender with financial statements, budgets, marketing, and succession plans is the best way to get the funds you need as quickly as possible. And there are a lot of different resources out there, from the farm financial standards council to the university systems to farmer peer groups that provide more information on how to do this preparation. Asking your banker directly what they're most interested in seeing in terms of financial information is also a good way to expedite the process.

Curt Covington: This is just anecdotal; I had a dairyman call me the day they provide us really high-quality financial reporting. I just found this so refreshing because you know I I'm young in the business, my dad is in the business. I got a brother in the business. Can you come teach us how to read these financials? Do you know, how do you know? It takes a lot of guts. Somebody woke up in the middle of night going, "How am I ever going to grow this business? If I don't know how to read these financials." Versus the other guy says, that's my account's problem. Not mine.

Sarah Mock: Curt never says this directly during our conversation, but the point he's making here is well-taken. One of the key ingredients in thoughtfully and strategically managing ag debt is knowing what you know and what you don't know and having a willingness to learn. I've spent a lot of time this season harping on how complicated the ag lending system, and credit in general, can be. Good accounting is rarely a cake walk. The idea is not that you need to know the minutia forward and backwards, and that you should never receive assistance or council from experts, but that you know as much as you can, and that you approach what you don't understand with curiosity and humility.

With this in mind, Curt says that your lender should be emphasizing, and helping you focus on, two main aspects of your lending profile.

Curt Covington: One is, do you maintain the proper level of working capital in your balance sheet? So as a general rule of thumb, I can't really tell you that pay out on the West Coast - It's a much higher requirement for working capital because there's really no safety net programs. If there's a freeze and the fruit crop freezes, you get a little bit of crop insurance, but there's no safety net programs. There's no way to hedge the crops. There's just nothing. And so, there's a high degree of working capital requirements out there. You come to the Midwest or crop insurance really drives the lending profile and some of the safety net programs that exist at the government level. It may be a lesser amount of working capital, but here's what I would say no matter what that number is, your working capital is your first defense against price volatility. So, of corn goes from $8t pack to $3. You've got to have plenty of working capitalists, because I'll tell you what land prices don't pay the bills.

Sarah Mock: But a demonstrated ability to manage price volatility with working capital, is only half the equation. The other half is managing a healthy farm-level debt to asset ratio.

Curt Covington Debt to asset, is a killer to the business because here's the thing, long-term debt doesn't go away court and say dollars the debts on your balance sheet and corn's $4 long-term debts on your balance sheet. Guess what? Your lender doesn't care if the corn is $8, doesn't care of corn is $3. They want to get their payment. Typically, you buy assets and take on debt during good times, but you actually pay for that debt during the difficult times and that's true with equipment it's true with land. It really doesn't make any difference.

Sarah Mock: Given the risk that's currently on the horizon, I asked Curt about what he looks for, as signs that a farmer might be at risk. And perhaps unsurprisingly in our highly connected digital age, there is one big red flag that he sees all too often.

Curt Covington: Going dark. Meaning, perhaps you're coming up to renew the loan or maybe there's a payment that's due and, what's your generation call it, ghosting you? One of the first telltale signs in a problem relationship, as an example, is when your client doesn't return your phone calls. Some of the other items that concerned me today - farmers that continually have an appetite to grow without really understanding the consequences of what they're asking you, “Hey, look, I just want to buy that hundred acres. It's not a big deal. It works, right? It's right next to my other property.”

Sarah Mock: But the problem with this mindset, Curt says, is it fails to acknowledge how much agriculture has evolved, and that there can be a tremendous amount of risk in this kind of transaction.

Curt Covington The size of farming operations has gotten much larger as a general rule of thumb. And spent a consolidation. It becomes a much more complex business. In the old days when I was a kid, my father was a hell of a good farm, but that's all it really took was to be a really good farmer.

Your input costs were reasonable. Interest costs were mostly reasonable except during the farm crisis, you could market your crops at a reasonably good price. You didn't have a lot of competition. Farmers that maybe were borrowing a couple million dollars or maybe a million dollars, 10 years ago, today are borrowing $10, $15 million still think that they can get away with providing, a set of tax returns, a poorly prepared balance sheet and say, “Hey, look, what's the problem?”

The reality of this whole situation is the biggest red flag is when you're growing that business and you're not putting in the right people to help you manage that business. And the reason they don't do that is because they see that as a waste of money. Why would I hire a controller or a CFO or someone to manage my operations while I can manage the marketing? They just don't see value in that.

Sarah Mock: For Curt, the importance of this point about good management goes much deeper, when he's considering whether to approve major loans to ag businesses. He's been telling growers he works with for years now, about how he analyses the quality of a farm manager.

Curt Covington Bad managers spend probably 50, 60% of their time still doing the doing. They've hired, you know, a foreman, manager, someone to run the farming operation, but no one does it as good as the owner. And by the way, that may be their son or daughter, just got out of college and probably has some really good technical skills. Then they spend about 10% of their time negotiating with people, right? Negotiating with with their suppliers, negotiating with, taxing authorities, and negotiating with CPA, negotiating with family members. And most importantly, waking up in the middle of the night negotiating with themselves, they spend about, 30% of their time making decisions and frankly, very poor decisions because they've never really flipped that model around and said, "I 've got to stop doing the doing. You know I brought the kids in, or it brought a management team. I have to stop doing the doing, and I got to start doing the managing."

Not that it's not important, but you're still going to spend the same amount of time negotiating, but really spending the balance of your time, really making good decisions with good sources of information, financial information, crop information, marketing information that's where all the money is made today. All the margin is made outside of the actual farming itself. And what's interesting about that. It's hard for people to transition to that because if you ask those farmers, have any of you ever had a boss that couldn't make a decision? Most of them are afraid to raise their hand because their dad's sitting next to them. That just describes ultimately the problem. If the person in charge can't make a decision, won't make a decision, or doesn't know how to make a decision or doesn't have the information to do it - ultimately in today's agriculture environment, you're behind April.

If people think that regulators are just going to sit back and allow bankers just to give somebody more and more money without asking for better financial reporting, they got another thing coming.

Sarah Mock: The good news, according to Curt, is that many farmers have seen this writing on the wall and have either stepped up to significantly better financial reporting or are in the process of doing so. He estimates that about 1/3rd of farm borrowers are in that first category depending on which sector you look at -- dairy for one, he acknowledges, has almost universally transitioned already. Another third he described as getting poked now, coming up against the reality that, if they don't take the leap, their

bank isn't going to increase their line of credit, or may in some cases, even ask them to seek financing elsewhere. The final third of farmers still don't get it, Curt admits, and he's seen many in that group have to move from bank to bank as their lenders get sick of dealing with a customer that's difficult, and therefore relatively high risk.

This possibility of getting - for lack of a better word - fired by your lender, is not out of the question, and as interest rates rise, credit becomes more expensive and lenders lean conservative, it's going to become more common.

I asked Curt how lenders think about good clients versus difficult clients, and he offered a really useful framework.

Curt Covington You might need to close your eyes and visualize places. So, imagine if you had four quadrants, and on the up and down axis, the north-south, would they call that the y-axis right. The up and down axis. If you're in the upper half of that axis, you have good repayment ability - means you've shown that you've operated successfully and profitably. The bottom half of that y-axis is where you don't have good repayment capacity. So, you're either up in this area or you're down in this area, or maybe you're somewhere in between. On that x-axis is collateral. So, if you're over in the right-hand side of that axis, very strong collateral position, good real estate, or good equipment equity and good equity in the crop, right? The other side is not so good collaborative - real estate, not good collateral, equipment's alright - just the collateral position that the bank has is not great. Now that you've done that if you take all your customers and plot where they are. So, if you're on the upper right-hand quadrant, you're a top-notch borrower and that's where you need to spend your time and your money.

If you're in the upper left-hand quadrant, you actually want to consider working them out of the bank. Good repayment, but really bad collateral. So, if they ever have a fault, if something ever falls apart on the ability to pay you back, you don't have any collateral to fall back on. So how many of those do you have to get in the bottom right-hand quadrant? We refer to that as the restructure area where you own this loan, no one's going to take it off your hands, where you've got good collateral, right? But repayment stinks. It never makes a dime - always is struggling, low working capital, that farmer can't quite seem to get out of their own way and that type of deal you may want to restructure the credit, which is a dirty word in banking, right? Cause when you talk about restructuring the credit, maybe giving them more relief on their term loans and maybe even giving them interest rate relief, that's an Armageddon no one likes to be over there, a banker or a borrower, by the way.

You get to the bottom left-hand corner. That's where it's the dead-on-arrival. Collateral's bad, repayment capacity is bad. You basically settle with the borrower where if you owe me a million dollars lift, I'll just settle for $500,000 just to get me out of this thing. If you look at that every day and you look at your portfolio of loans as a banker, and honestly, if you share that same chart with your borrower and explain to him "You're over here, I want to get you over here. Or you're down here in the bottom right-hand my goal is to move you up and over. That's my goal. So, is that where you want to be?"

"I guess I want to be an acceptable borrower of yours. Okay." What does it mean to be an acceptable borrower? Your interest rate's better, your terms are better, our relationship gets better. Your reputation in the community gets better. All the good stuff, right? Sleep at night. You don't have a pain in the butt banker calling you every quarter or whatever."

How do you get there? You get there by understanding what it takes to get there. It's just doesn't happen. So, for me, that's how every banker should look at their portfolio. And I think they need to share that with their clients and say, "You're not in my green box area over here. You're in my red box and I don't want you there."

Sarah Mock: I think this is valuable framing for thinking about how to manage decision-making around debt going forward. And the reality of today's decision-making environment, is that interest rates are rising, the money supply is shrinking, and credit is going to get a little tighter. I asked Curt how he sees farmers being affected by these factors in the near future.

Curt Covington: The person that sees it first is not the farmer that's got a real estate loan. It's in the operating side where the farmer goes in and he, before he walks in to see his bank, he goes and picks up his mail and he found out that his borrowing rate just went up 50 basis points or a half a percentage point. And then all of a sudden, the Fed raises rates again. And guess what? They get another letter in the mail and the Fed raises it again. They get another letter in the mail. He says, "Wait a minute. What's going on here?

Your operating loan is a variable rate home. Almost all of them are. And so, if interest rates go up, your cost of borrowings, the power goes up and here's the deal interest is just like fertilizer. It's an input cost. I don't care what anybody says. It's rent on money you borrowed. And so, if you're working with really big margins in your crop - okay, so rates go up, a half a percentage point, and you're only borrowing for half of your needs to farm your crop to go. Yeah, I can deal with that. I don't like it, but I can deal with it. But if you're financing 80 or 90% of your crop and you really don't have a lot of margin, because your fertilizer costs went up this year, your chemical costs went up this year your labor costs went up this year, and now your interest costs go up this year. All of which for some of them have gone up as much as 40%. Not only is your margin been squeezed by your traditional input costs, but now you've just taken more margin away. From the increased interest costs. So that's where you see it first.

Sarah Mock: Given the uncertainty of where interest rates are headed, and what that will eventually mean for the overall economy, I asked what advice he'd give to that first group of farmers - the ones who are already working with stepped up financials.

Curt Covington: Stress test your projections. In other words, if interest rates do continue to rise, if inflation continues to eat away at my margin there is no better exercise - but it is so painful for farmers to do this. What does it look like if I get 200-bushel corn, but instead of it being $8 corn through 2023, as an example. What does that look like if for whatever reason, we started fixing the supply problem with corn, right? What happens if corn prices fall off to $5 or $6, whatever it is and then look at and say, holding all my input costs constant, what is my bottom line look like? Then, next, put the revenue where it was, come back and say, what if, I still get $8 corn, but my input costs continue to rise another 10%. What does that look like? Reset everything and say, "okay, what is my interest costs?"

So now you've looked at all three major components and say, okay, what does that mean for me in which of these things are likely to happen? I think you probably can cross off revenue dropping from corn from 8 to $5 next year, but I could see input costs continuing to rise. I can definitely see interest costs, continuing to rise. And you merge those together and say, "What does it look like?" And you look at it and go, "I still have really pretty good margins. Maybe I will go talk to my banker and see about buying that. Or maybe I'll go ahead and replace that old harvester and maybe upgrading right to maybe a little bit newer, but not brand-new harvester."

Or you may look at those margins and go "It's a bad idea, right. We're going to hold tight here. We're going to hold tight and we're going to work our way through this because in situations like pursing today are going to create great opportunities for those that have cash."

Sarah Mock: Stress-testing is a powerful tool when preparing for an uncertain financial future, not only because it helps provide real information that is helpful in decision-making, but because it's an exercise that helps us get familiar, and in a way comfortable, with *all* of the eventualities that are really on the table.

In a lot of ways, that is exactly what this season has been all about-- it's about understanding the nuance of risk that is already existing in the system, and which might become more prominent as conditions change. Curt's insights are invaluable when we think preparing for uncertainty, but his advice begs the question, "is there more specific action to be taken today, given the specific threats we know are on the way?"

That's after the break.

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Sarah Mock: Before we dive into strategies and tactics for the specific financial risks of this moment - let's do a level set. What factors are influencing the farm financial system today? Jim Knuth from Farm Credit summarized it aptly.

Jim Knuth: I think it's very clear that we're continuing this journey into uncharted waters. I don't think anyone's ever seen an economic environment quite like this, where we're coming off a global pandemic. We have the highest inflation rate in 40 years, we have raising interest rates, we have energy costs, we have supply chain issues, we have a war between Russian Ukraine - You can go on and on.

Sarah Mock: Despite the fact that interest rates are rising today at a pace that we haven't seen in decades, reminds us that that might not be the alarm bell that it seems.

Jim Knuth: We've had to reset expectations, about, "Hey, what are your rates? Well, they're higher." But we remind them that rising interest rates don't necessarily mean high interest rates. So, they certainly are higher than the absolute historic lows that we experienced during the pandemic. But nobody in my lifetime has seen rates like that. You can go back to the chart for 200 years. Will we ever see them again? Golly, I don't know. So, we're probably still on the low side of normal, right at this moment.

Sarah Mock: Then of course, there's also the reality that much of the most substantial debt in agriculture was fixed during an era of historically low interest rates. Jim says that at Farm Credit- over 90% of real estate loans are fixed. meaning that, in the short term, these rising interest rates will mostly affect operating lines of credit only and though there might be some strain there, the good income conditions over recent years means that many producers have paid down operating loans and aren't borrowing much short-term money. But there's an important piece of advice here from Jim especially for producers who are currently flush with cash and looking at their existing debt with an eye to paying it off.

Jim Knuth And of course, one of our pieces of advice is don't repay that debt because over the next one or three or five years as you have opportunities to buy a farm or grow your business or expand your acres, you'll be taking on new debt. And you certainly don't want to use your working capital and pay off that low interest rate debt. And then you'll have to take on more higher interest rate debt that a little discipline today in terms of our working capital, our cash, our liquidity positions should pay off in the years ahead.

The fact is agriculture, especially grain production. has done a really good job of rebuilding its working capital. That's your short-term risk bearing ability. Partly because they haven't been able to necessarily spend that money because of lack of availability of equipment machine. Or other supply chain issues. Or they just haven't been a successful bidder on a land auction, but for whatever reason we have. Excellent working capital in agriculture today. So, let's keep that discipline. Let's keep that working capital. That'll really help pushing us on the down cycle.

Sarah Mock: Jim and John Blanchfield's perspectives, among others, coincided pretty directly on these points, and both emphasized that even though interest rates are on the

rise, it's often a missed opportunity to not lock rates in now, especially given that refinancing in the future is usually an option.

John Blanchfield: I would tell any farmer rancher. Though to, this podcast is if you've got the opportunity to lock in an interest rate at today's rates, which even though they've gone up some they're still very good rates compared to what we've seen and anybody who's been in farming or ranching for any time at all, knows and understands that

Sarah Mock: Besides locking in today's rates where you can and holding on to low interest debt in favor of maintaining working capital or paying down higher interest debt -- Jim offers some other helpful guidelines to keep in mind as we navigate the months ahead.

Jim Knuth: Your cost structure always matters. There are times where prices or margins are so high - we can just think we can make just about anything work, but in the long run, high costs, high leverage, high break-evens in agriculture don't work. And so again, your cost structure always matters. And so, again, we're really advising people to be thoughtful about their capital expenditures, their expansion plans, et cetera, what they do during these times. We also go back to the great lesson we learned in the, after the ethanol boom days that high margins are not permanent in agriculture that our high margins tend to last for short periods of time - 1, 2, 3 years. Our margins tend to normalize in production agriculture and the fact is when we have a bigger revenue pie, whether it's per acre or per pig, or per cow, steer, whatever every, everybody wants a piece of that revenue. Again, if we're selling $6 corn, two years from now, our seed costs have gone up, our cash rents have gone up. So again, our high margins don't last.

And these are just some basic lessons that we learn from the last up cycle that I think a hundred percent apply to today and going forward. The reality of it is that agriculture's financial acumen has really gone up over the last 10+ years. And I say that in terms of when I started in this business 30, 40 years ago you heard a lot of sayings, like “farming is a way of life.” “Farming is a passion.” Maybe there was a lot of focus on just being a good producer. But I think today people realize that just being a good producer probably is not good enough to truly thrive in today's environment and going forward. I also have to be a good businessperson too. And while we can have passion for agriculture and that way of life, and we're growing the food that feeds the world and there's great purpose in that. That frankly agriculture has become a business too, not just a way of life, but again, I believe that's really healthy because I think that will help agriculture, not just survive, but thrive in the years and decades ahead.

Sarah Mock: Tom Hoenig, the former President of the Kansas City Fed offers a less certain picture on what might be on the horizon given the challenges in the broader financial system. He notes that the federal reserve dramatically expanded their balance

sheet in the last three years doubling it from four and a half trillion to nine trillion dollars and that's in addition to a 50% increase in government spending between 2019 and 2020.

Thomas Hoenig: So now the Federal Reserve, the open market committee is saying we are going to break inflation. They're doing it this time in two ways - they've raised interest rates and they're going to raise them some more, who knows for sure, but they're also doing, what's called quantitative tightening. They are trying to shrink the balance sheet, which is taking liquidity out of the economy. It's taking that liquidity that had put in over the last two to three years. And it's trying to pull that out, which means there's less money available and therefore lending becomes more difficult, interest rates are higher, the markets become more volatile. You can see that in the stock market, but you can also see that to some extent in the commodities market. And so, we are in danger of reliving that experience once again - perhaps the market isn't as leverage as time, but I suspect in some areas it is, and we will see some difficult challenges ahead.

If the open market committee. Sticks to its plan to break the back of inflation. If it does not stick to the plan, then we'll have greater price inflation. And this crisis will only be delayed. It won't be solved. And that's the challenge that this country faces in the next two to three years, I suspect.

Sarah Mock: Tom reminds us that the Fed's inflation target is 2%, and the bank's effort to curb inflation only began in March. The last 8 months have been economically stressful, but the expansionary period was years long, and the contractionary counterbalance could need to be just as lengthy as individuals and business swing from borrowing large amounts at low interest rates to borrowing more moderate amounts at higher rates.

Thomas Hoenig: So, you think of today with an 8% inflation and these asset values having increased, this is going to take years to unwind hopefully successfully. Yes, there will be losses, but not a crisis, not a major series of bank failures, that's what we want to avoid. Now taking that inflation out, isn't just a snap of the fingers. It's a very difficult, shall we say systematic process to bring that inflation back out and to do it without creating a crisis is even more delicate process. And that's the challenge they've created for themselves. And America has to have the patience to get through this. And I think that will be difficult.

Sarah Mock: Some problems in ag are structural with all the outsides money, but there's also the risk that the open market committee doesn't stay the course long enough.

Thomas Hoenig: But I do know that, whether it's agriculture or anything else that excess leverage, whatever excess leverage is, creates its own set of corrective requirements and those can be harsh.

And so, my real advice to people is know what your leverage is, understand the downside of that, take your calculated risk. At the moment ag prices, overall, they're up, to the extent that stays this case, depending on world events and among other things, then they should cash flow and we should be able to avoid a crisis. But on the other hand, if the crisis ends, if production, is there, if, the system continues to. Titan monetary policy and, prices start to fall, and it affects commodities as well. Then you could see some hardship happen in the agriculture sector as well, but I can't see the future any better than anyone else can. You have to judge accordingly, and I would not be taking more debt at this point, for sure given the uncertainties that lie had and, the way I grew up I was not a first-generation farmer. My father was raised on a farm, but it's still in my family and they did not lever during the 70s, like others did.

And the less levered you are, the better you withstand those kinds of crisis. I think. There could be a crisis. There will be a recession. I think I'm fairly confident that, that as this tightening continues that there will be a recession. How serious a recession is. I do not know. It depends a little bit on, and, I would say how steadfast, the central bank is in its own policy.

Sarah Mock: The question of how steadfast the Federal Reserve's open market committee will be in its policy is still very much an open one, influenced by regular economic updates that are similarly hard to predict. The common theme that connects Tom, Jim, John, Curt, and really most of the sources that we've heard from throughout this season is caution.

That may seem like a bit of an obvious conclusion, especially in times of uncertainty, but I think it bears driving home in light of all the new information we know. Because of course, being more cautious when risks increase makes sense, right? Seemingly that's where we are right now. But at the same time, hasn't what we've learned over the course of this season shown us that there is actually a lot more risk already built into the existing system than most people are recognizing? This question -- is the risk on its way or is it already here - has fascinated me over the past months, so I brought it to David and Brent for discussion.

In general, the conclusion was - it's both. There probably are a number of underappreciated risks in the current ag lending system, and there are more on the way. But the conversation got interesting when we got into the question of how people are responding to these growing and changing risks -- from David and Brent's perspective, it's not the way you might expect – or what the Federal Reserve might hope.

Brent Gloy: Yeah, I don't think people are making hardly any changes. To me. It looks pretty much like business as usual in the ag sector. I don't see that people are honestly, I don't think people are very concerned and at this point, why would you be, you've got all nearly historically high commodity prices.

And I think this is when the discipline goes out is about to go out the window. In fact, because I just look at it and you go in this industry right now, even though sentiment is pretty low, I just don't see that people are making any changes. Maybe I'm wrong, David? I don't know. I don't think people are that worried about things right now.

David Widmar: I think they're worried. I don't think they're worried about the right things. And so, it's one thing to be worried and having concerns, but it's another thing to be focused on the right thing. I guess there's this idea of this is really something that I've been focusing on is, "Are you staying focused on what you're working on and are you working on the right things?" I think those are two different things. And I think, again, going back to this rising interest rate environment is okay, we have to shift our attention and shift our focus and maybe even our business model and maybe even the way we go about securing capital and financing goods, we need to focus on how we can shift that. And we want to make sure that we're moving our business or positioning our business to that reality, I guess there's one thing to say, are we disciplined or are we focused enough? It's another thing to say, are we disciplined on the right issues? Are we focused on the right issues?

Brent Gloy: I think that's a 100% right. And I don't think people are worried at all right now about how extreme events could be, if commodity prices were to fall significantly or something, I think P it would be a big problem in the ag sector. And I don't think people are that worried about it. And there are a lot of things that could cause it to happen. There are a lot of things that cause it to go a lot higher though, too. That's why there's I feel like there's kind of complacency and I don't know exactly why because it looks to me like, the range of outcomes is potentially very wide, I think that you could, you could argue the upside though too.

David Widmar: If you're going to pick up an article, it's only going to focus on one of those things. it's and it's probably your bias is going to be revealed by which ones you're reading. But there are some articles that are only focused on the upside and there are some articles only focused on the downside. And if you want to be a great manager and you want to think about this, you have to read all of it and you have to really sift through all of those moving pieces.

Brent Gloy: Yeah. We can have bad weather outcome next year. Things are going to go insane. There's a revolution in Argentina - what would happen then? You could think of all kinds of things and make things go crazy. I'm not saying that they're likely. Yeah. We probably shouldn't put this in the podcast because I'd be like the $15, $20 corn guy or something. I think they could be really cheap though, too.

David Widmar: Brent called it - Argentina revolution, $20 corn.

Brent Gloy: It's very interconnected and highly non-linear like weird things can happen at these extremes. And so, I think it's a time for prudence caution, discipline.

Sarah Mock: Thinking about this kind of extreme edge cases can be one of the fun, and anxiety-inducing producing aspects of the stress-testing work, but it's also critical to

keep in mind Brent's final point here -- all of these events and potentialities are interconnected and highly non-linear. For example, a revolution-riled Latin America might cause corn prices to skyrocket, but if corn is $20 a bushel-- what would happen to ethanol production and demand? Needless to say, the knock-on effects and feedback loops are significant and incredibly difficult to predict. Maybe at this point you feel like we've strayed too far into the realm of futurism, but it helps make the point that this is what risk mitigation is -- it's not about only considering and preparing for the most likely outcomes, it's about understanding the full range of possibilities, and something about their likelihood. One instinctual way to understand our sense of how probable an event is - ask yourself - like Brent and David often do - would you bet on it?

Brent Gloy: if I would've told you two years before the pandemic in 2020, we're going to have a global pandemic. It's going to shut down the us economy. X many millions of people are going to get sick. What would you have done? And I think most people would not have predicted that we would come out of it on the other side with record high commodity prices and record high stock valuations. That's not what I would've put my bet on. And I've got bet right here with one of my friends, I bet that it would be below $5 in the next five years. I made that bet on 22 March,

David Widmar: I was thinking about that bet just the other day. I was trying to find the email when you sent it to me. So, it was just a few months ago then I thought it was a couple years ago now.

Brent Gloy: I've got time on my – I've still got a few years, it's I wouldn't have guessed this, even if I would've known the outcome. Sometimes really hard to know and this seems to me to be environment where it's really hard to know, because as I said, what the reason I think inflation is a warning sign is because it makes it more likely the Fed's going to act. When we have a lot of inflation and if Fed acts, the weirder stuff can get.

David Widmar: And they're going to act in a way that they haven't acted in the last 40 years. So, we've had 40 years of declining interest rates and they're signaling that they potentially will act in an environment where they start to raise rates. I'm not saying we're going back to 1980s, but if they raise rates, two or 300 basis points, that's going to feel like a very different environment for us given the long gentle slope that we've had over the last - kind of like the frog in the pot. We've slowly cooled ourselves down to 0% interest rates. And we just finally realizing all the implications and we're thinking through all the realizations of that. And now we're changing the temperature of the pot.

Sarah Mock: As we shift from understanding the past and present to trying to predict and prepare for the future, and as we wrap up our story about ag lending, I think an important insight to keep in mind is that credit and debt- especially for farm businesses - is not so easy to classify as necessarily good or bad.

As Brent mentioned during one of our very first episodes, debt is a tool -- sometimes it's the right tool and sometimes it's not, but it can also be the right tool sometimes, used in the wrong conditions.

Brent Gloy: It's clear that what credit does is magnifies outcomes. And so, if you have a really good idea and, it makes a lot of money you can make your idea a lot bigger with credit. You don't have to have every dollar that you invest is, so you grow your business or your idea a lot bigger than you would with without credit. And so, it magnifies the good times, but when things don't go so well, it makes the bad times a lot worse. So, you all of a sudden can't pay your credit back and it causes that failure. And so, it tends to expose, the businesses that aren't doing as well. If they have too much credit, they, get replaced and, economics is very much that kind of survival of the fittest, that's a little bit of a simplification, I think and sometimes I find that, very difficult because I often tell people that, if you're caught wrong in the credit cycle, it doesn't matter how good a business you have. You might have a very fundamentally sound business. You're good businessman. You're making lots of money, but if you get caught wrong in the credit cycle and the interest rates go really high, it can put you out of business, even though the underlying economics of your business were good. If you have too much debt at the wrong time. It can be a really big problem.

Sarah Mock: What happens when we can't avoid the trouble that's coming? That's next time, on the season finale of *Nothing Borrowed, Nothing Gained*.

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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 Curt Covington, Tom Hoenig, Jim Knuth, and John Blanchfield 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:

Curt Covington: The good times never last.