COVERSTORY

DROUGHT DECISIONS

A once-in-a-generation disaster creates concern – and opportunity – for U.S. farmers

By Bryce Knorr

The big one.

We knew it was coming eventually, and now it has.

Though heat singed two corn crops in a row, the historic weather of 2012 came seemingly from nowhere, a "flash drought" that spread like wildfire, turning the promise of bumper yields into cracked, parched soils that may cut corn production by 25% or more when all is said and done.

But while crops were devastated, the pain was spread unevenly. End users, including farmers who raise livestock, suffered as corn and soybean prices rocketed to record highs in July. Pure row-crop farmers, by contrast, largely escaped free and clear, as long as their fields had adequate crop insurance coverage.

While 30% of farmers we surveyed in late July and early August were unsure of the drought's impact, only 19% believed they'd lose money this year or next. And 28% said they'll make more money due to high grain prices.

One farmer breathing a sigh of relief is Allen Sasse, Beason, Ill. He met with his insurance agent in July, and was confident

PHOTO BY MIKE WILSON

"In the short term, high prices are attractive, but once this demand is destroyed, we can't just build it back overnight," says Allen Sasse, Beason, Ill. "It's going to take a few years to recover."

his risk management plan was working thanks to a Revenue Protection policy, even as his crops withered in the field.

"This will end up being an OK year financially — not a home run, but enough to smooth the bump in the road," says Sasse. "I'm starting to think now about the next two years — how we can better position for the future."

Indeed, farmers face a fistful of decisions in the wake of the drought, from marketing to financial management. And with an early harvest assured in many areas, planning for 2013 and beyond can't wait. Crop rotations must be finalized in time for fall fieldwork, and tax considerations weighed in light of fluctuating income and expenses that are rearranging many balance sheets.

So here's our best take on the pressing questions facing farmers this fall.

THE TASK AT HAND: 2012 SALES

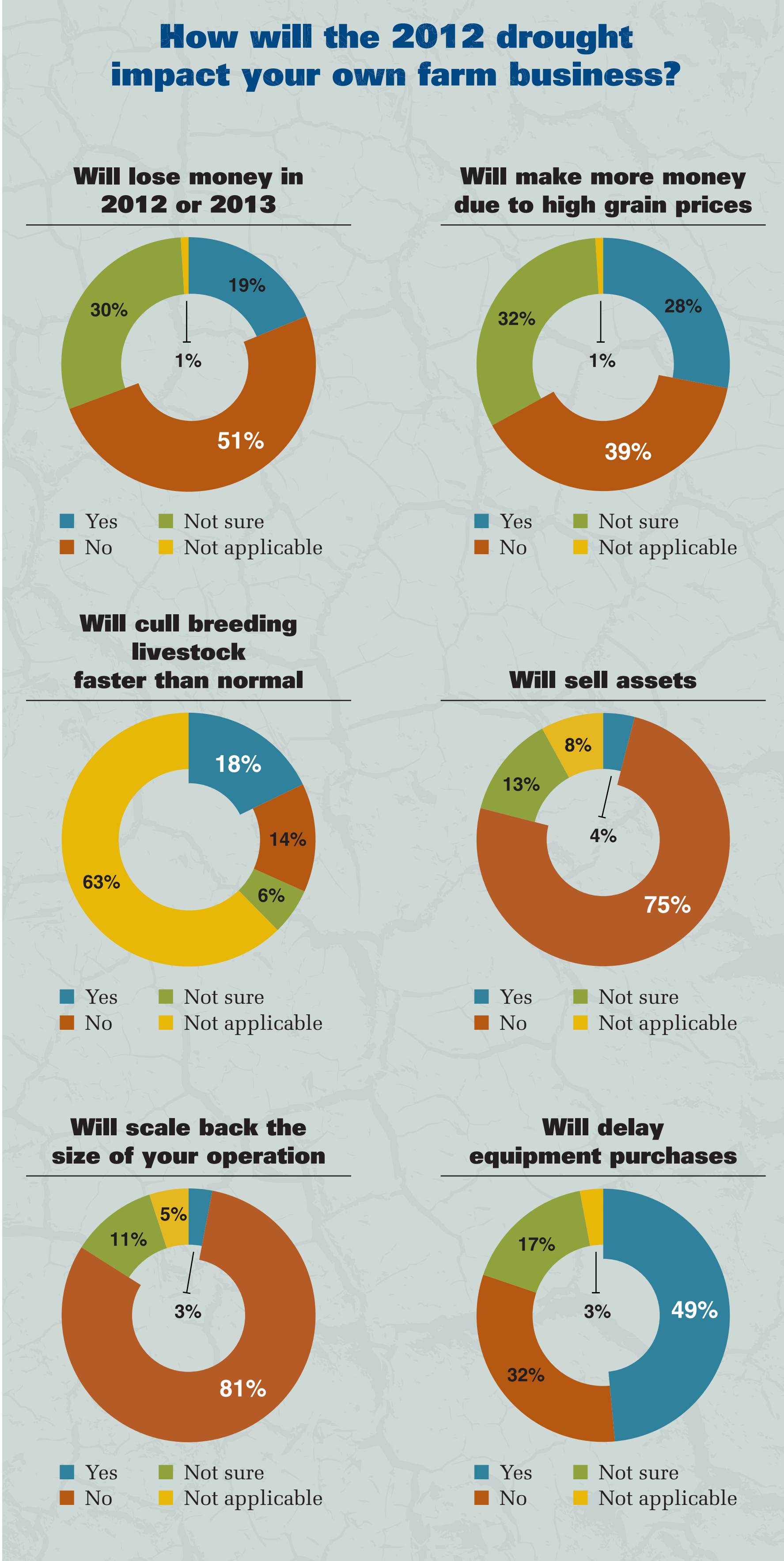
If history is a guide, the high could come soon — if it isn't in already. In the 12 years in the modern era of grain marketing since 1973 when corn yields fell 5% or more from normal, highs have come as early as June to as late as February the following winter. August is the most frequent month — three highs were recorded then, with two each in June and September.

In the 11 subpar years for soybeans, sometimes highs don't come until the following spring. But in all but three of the years, the highs have been in by the end of October, with that month along with June and July sharing honors.

Farm Futures' annual storage strategies study followed both crops since the 1985 crop marketing year. (See "Boiling point," page 14.) During that period, storing soybeans on farm until the following summer paid off in five of the six short crop years. For corn, the results were less encouraging: The sit-and-hold strategy returned a profit over costs just three of seven years.

This year your tactics have another wrinkle: RP crop insurance coverage ends in October, when average futures prices for the month will determine final payments. After that, producers have no safety net should the market head south, say, on better-than-expected yields, sluggish demand, or a financial crisis that spills over into commodities.

As a result, producers should take a close, hard look to make sure the risk of storage, either on paper or in the bin,



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is worth it. "While fundamentals and seasonal trends indicate prices should rally off harvest lows into the end of the year, 2012 may not be the time to put that tendency to the test if harvest sales plus crop insurance payments generate enough revenues to meet your financial goals," says *Farm Futures* Market Analyst Arlan Suderman. Weak cash corn prices at harvest compared to futures could allow selling deferred hedge-to-arrive contracts to store for basis gains, traditionally the safest strategy. "But the big discount of spring and summer futures to November caused by active Brazilian hedging makes that strategy difficult, if not impossible in soybeans," he says.

FALL FIELDWORK: BATTLE FOR ACRES?

Analysts widely expect farmers to plant a lot of corn in 2013 due to the need to rebuild drought-depleted inventories. A 2013-crop soybean-to-corn ratio of around 2 to 1 is also at levels that historically favor corn.

Trouble is, farmers we surveyed in July and August haven't gotten the memo yet. While they told us they plan to put in a lot of corn next spring — 93 million acres — that's short of the 96 million seeded this spring.

Instead, initial plans call for producers to bump up soybean acres again, perhaps to as many as 78 million.

Initial *Farm Futures* projections show corn could return $180 to $280 an acre for 2013, compared to $45 to $80 for soybeans on a nationwide basis. The ranges are based on whether costs increase a modest 3%, like they did in 2012, or 10% to 20%, like they did in 2008.

Why would growers balk at planting profitable corn?

Crop rotations may be one reason. After pushing corn for many years, farmers continue to believe they should rotate — perhaps until they see the bottom-line implications.

Both corn and soybeans could have a competitor this fall: winter wheat. Thanks to good yields and a strong crop insurance price, farmers enjoyed favorable returns for the crop in 2012. Our survey showed growers ready to increase winter wheat seedings 3% this fall to 43.8 million acres, with farmers in the eastern Midwest especially enthusiastic about soft red winter wheat.

And why not? Profits could top those in soybeans, according to our projections.

What would this mean for prices? Assuming a good crop allows usage to rebound to normal levels next year, corn prices should avoid a big collapse — if outside investors stay in the market. Even figuring some exit, the average cash price could be $5.75 a bushel for the crop. That suggests average futures prices at $6.50 to $7, not far from where deferred 2013 crop futures traded in August.

A record soybean crop in 2013 — 3.3 billion bushels — might still leave ending stocks below 200 million bushels, if China continues its voracious appetite for protein. Futures might drop to $11 if investors bail. Otherwise, futures in the range of $12.50 to $14.50 seem possible.

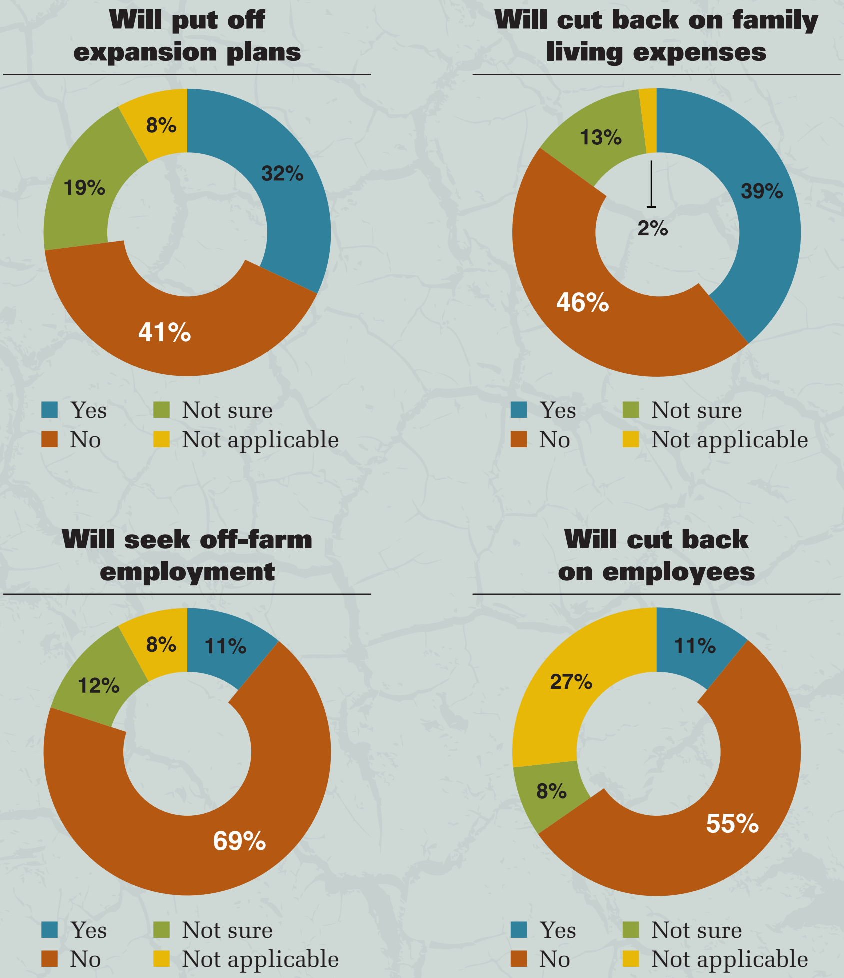
Wheat could have the most intriguing possibilities, even if U.S. acreage increases for 2013. Other farmers around the world may divert wheat ground into more profitable oilseeds and feed grains, shrinking the number of days of supply globally and supporting average U.S. cash prices. Chicago futures could average $8.20, with rallies to $10 possible.

FACING THE FUTURE: SALES FOR 2013 — AND BEYOND

Our survey showed growers excited about using the 2012 rally to price crops for next year and beyond. Three-quarters said they would use the rally to price 2013 crops, and a third plan sales of 2014 production.

Count Sasse, the Illinois farmer, as

How will the 2012 drought impact your own farm business?



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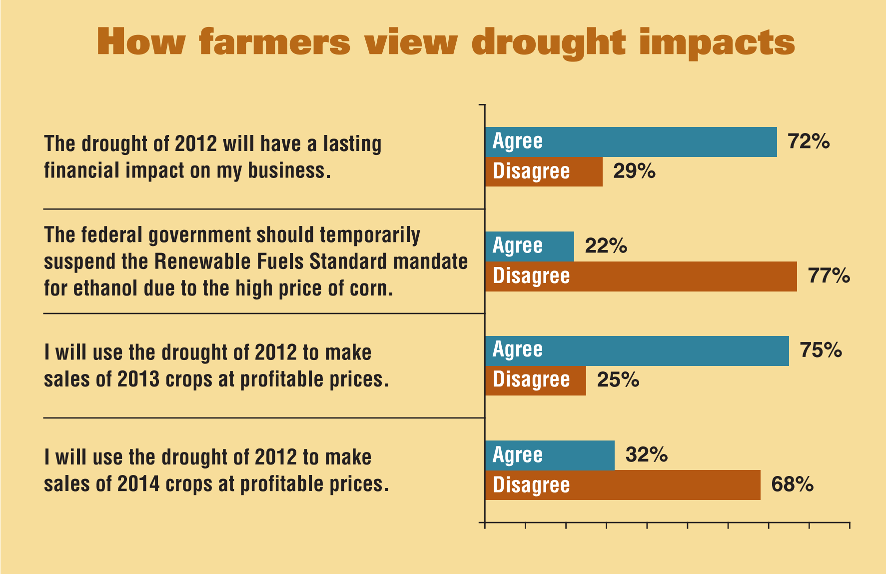

one of them. He's worried that rationing by end users could eventually turn into "demand destruction" — a permanent loss of a market for his crops. And he's studied the price patterns from past bull markets, which show a "short crop, long tail" pattern when prices slog lower for years after a major top.

"I'm more concerned about this market's long tail for next year because of demand destruction I see going on," he adds. "Livestock producers are liquidating; ethanol plants are shutting down. Those are all things you can't just walk out to the farrowing house and turn back on."

In the past, selling multiple years of crops was the gold standard for marketing. Falling prices insulated long-term hedges with futures from margin calls. But *Farm Futures'* Suderman believes times have changed.

Weather patterns, for one, appear to be turning drier, he notes. And today's global demand has a much stronger growth rate even as global stocks overall are much tighter.

"As a result, record-high prices in 2008 were followed by new record highs in 2011, and again in 2012," Suderman notes. "The tails are much shorter following the bull markets."

Instead of destroying demand, fears of shortages could cause importing nations to start building reserves, a strategy already embraced by China and Saudi Arabia.

Using futures also has become more difficult due to the threat of wild price swings amplified by the movement of vast sums in and out of the market by big speculators and investors.

"This environment of massive outside fund investment can create explosive price moves, with painful margin calls on otherwise profitable positions," Suderman warns. "Input costs are subject to the same volatility, which could quickly put you in a loss position if you lock in the revenue side of your income statement without also taking steps to limit your exposure on the expense side," he says.

Farmers we surveyed appear to be well aware of that risk. They said input prices were their greatest concern for 2013, with fertilizer the No. 1 question mark on the expense side of the ledger.

Still, Suderman believes in pricing at least 10% to 20% of future production — more for more nimble marketers using advanced futures and options strategies.

"However, I still expect additional pricing opportunities in the deferred contracts over the next year as the world tries to rebuild stocks of critical feed grains and proteins."

CROP INSURANCE TAX IMPACT

Chances are your original budgets for 2012 are in tatters. As a result, tax planning will be even more important than normal, with crop insurance causing some twists to consider.

For example, it's possible in some cases to shift insurance income from 2012 to 2013, according to Darrell Dunteman, Bushnell, Ill., accountant and *Farm Futures* Management Coach columnist.

If your records show that you normally sell 50% or more of your crop in the year after it is produced, then crop insurance received in 2012 for the 2012 crop may be deferred for tax purposes until 2013. But it's an all or nothing proposition, says Dunteman. You cannot elect to defer a percentage of the crop insurance.

Another twist: You can defer only the portion of crop insurance that relates to yield loss and not to prices that fall below base guarantees. That's doesn't look like it will be a problem in 2012. But payments from policies that are not based on physical loss, such as Group Risk plans, are not deferrable.

Deferring crop insurance income to 2013 may create other tax planning issues. Fall input purchases may have to be put off, or other income accelerated, to hit your target income.

"Don't forget that you can also create income in 2012 by taking a CCC loan and counting that loan as income rather than a loan," says Dunteman.

Take the time to determine your year-to-date taxable income position now, and create a plan to hit the optimum taxable income for 2012 and 2013.

SHORE UP BALANCE SHEET

After tackling your marketing plan and income statement, take a close hard look at your balance sheet. In uncertain times, there's one financial ratio that's literally golden: liquidity.

Wells Fargo economist Michael Swanson says a working capital cushion of at least 40% of gross revenue gives you a bulwark against uncertainty — and there's plenty that could go awry in the years ahead.

Take record-low interest rates, for one. While the Federal Reserve has promised to keep interest rates low until late 2014, the market may ultimately have other ideas. Rising rates would also lure more capital back to the U.S., as investors seek out a higher safe return, strengthening the cheap dollar that's helped sustain farm exports. Higher rates would also hurt farmland prices, perhaps creating a perfect storm.

"Never confuse the unthinkable with the impossible," says Swanson. "Some people think it is unthinkable to have 7% interest rates three years from now. No, it's not. It needs to be in one of your scenarios." The drought is the poster boy for the many random forces influencing the market these days, he says, adding, "What the market gave you, it will take away."

Mike Wilson contributed to this report.