SPECIAL REPORT
TD Economics

November 1, 2013

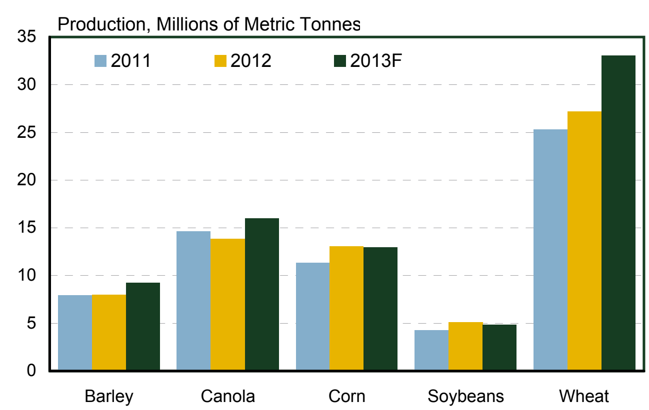
OUTLOOK FOR CANADA'S AGRICULTURE SECTOR
Bumper Crop, Lower Feed Prices Support Optimism

Highlights

- 2013 is shaping up to be a decent year for Canada's farm sector, with crop volumes on track to record strong increases on the back of co-operative weather.
- On the flip side, recent declines in grain prices have been taking some of the shine off financial performances, although livestock farmers stand to benefit from lower feed costs. High production volumes are also likely to lead to heightened logistical challenges related to transportation and storage of bumper crops.
- We expect to see prices in most areas holding close to their current levels over the next few years, while some areas of recent cost pressures subside. Therefore, the overall picture remains relatively positive.
- Looking further out, prospects for a sustained long-term expansion in Canada's food supply system are increasingly turning global, reflecting the tilting balance in world growth towards emerging markets and the major push by the federal government to enter into new free trade deals, such as the recently-announced pact between Canada and Europe. In this environment, the agriculture sector's productivity performance becomes even more vital to ensuring future success.

With a helping hand from Mother Nature, Canadian farmers are enjoying a bumper year in 2013, particularly in the western Grain Belt. Declines in grains and oilseeds prices – along with some heightened logistical challenges related to the transportation and storage of the bumper volumes – have taken some of the shine off this year's estimated crop performances. On the flip side, the drop in feed costs has helped boost margins for livestock producers from coast to coast, who on the whole, have faced more challenging market conditions compared to their counterparts in the crop sector in recent years.

CHART 1: PRODUCTION OF PRINCIPAL FIELD CROPS



Source: Statistics Canada

While growing conditions are never easy to predict, a period of relative calm appears to be in store for pricing and cost conditions over the next two years. Fundamentals suggest that prices for most major commodities will hold close to their current levels, with wheat and cattle prices looking to be among the best supported of the commodity areas from a near-term price perspective. In addition, while the last several years have witnessed sizeable increases in input costs, upward pressure for a number of key in-

Derek Burleton, VP & Deputy Chief Economist, 416-982-2514
Sonny Scarfone, Research Associate, 416-944-5069

TABLE 1: PRINCIPAL CROPS PRODUCTION (2012-13 % Chg.)						
	Canada	AB	SK	MB	ON	QC
Barley	15.4	9.3	41.7	10.9	-18.4	-7.1
Canola	15.1	2.3	24.2	24.5	-24.0	-10.6
Corn	-0.9	99.7	N/A	-0.3	-1.6	2.7
Soybeans	-5.3	N/A	N/A	18.0	-13.2	-1.2
Wheat	21.4	18.8	25.6	15.5	26.4	17.2

Source: Statistics Canada Projections as of September 2013.

puts – including borrowing costs, fertilizer and energy – is likely to be limited.

That being said, this relatively benign near-term outlook conceals a number of important structural shifts that will continue to work under the surface, which will have a major bearing on farm operations and finances going forward. The possibility of new free trade agreements, the increasing importance of emerging markets, an ageing population and increasingly volatile weather patterns are just a few of the important developments that will create both challenges and open doors to new opportunities for Canada's agriculture and broader food industry.

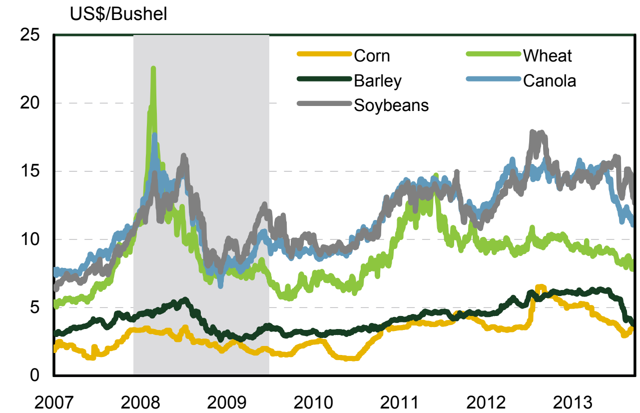
Expectations of a bumper crop in 2013

The October 2013 release of principal field crop production estimates by Statistics Canada revealed how weather and decent moisture have co-operated this year to generate a strong growing season. Canadian farmers anticipate higher output of most crops, led by a gain of 21% in wheat – to its best level in more than two decades. Other commodities – canola, barley and oats – are not too far behind. In fact, of the major crops, only soybeans appear to be headed for a significant decline relative to last year, while corn production is estimated to be flat.

Wheat production is expected to be up across the country, especially in western provinces. This regional strength holds true for others crops: for one, barley production is likely to increase by as much as 42% in Saskatchewan alone. And while soybean output is projected to decline at the national level, Manitoba farmers are expected to post an 18% gain in the segment this year. In Ontario, performance has been mixed. As wheat (+26%) recorded large gains, harvests of corn (-1.6%) and canola (-24%) will likely decline. A similar pattern was observed in Québec, where strength in wheat is being offset by reductions in other crops.

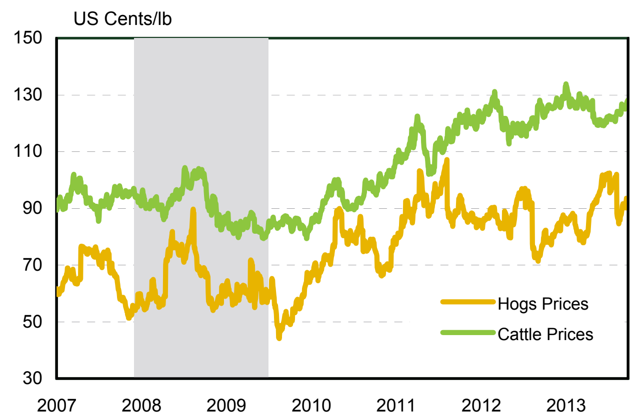
Notwithstanding the strong overall growing conditions, three developments have acted to dampen some of the enthusiasm in recent months. First and foremost, the good harvest is being partially offset this year by weaker pricing conditions. Led by the Black Sea region and Kazakhstan,

CHART 2: CROP PRICES



Note: Shaded region represents a period of economic recession
Source: WSJ

CHART 3: LIVESTOCK PRICES



Note: Shaded region represents a period of economic recession
Source: WSJ

world wheat output is on track to increase by a hefty 8% this year, placing significant downward pressure on global prices. Strong soybean yields in South America – along with a solid outlook for the Canadian canola crop – have led to a sharp decline in oilseeds prices, with downward momentum accelerating during the summer. However, it's barley and corn that have experienced the largest price declines so far this year. The slide in barley reflects strong supply gains, and the one in corn is a two-fold story of oversupply across North America and weakening expectations of ethanol demand. Crop prices, for the most part, had begun this calendar year on a relatively strong footing, but recent weakness has brought down prices toward the lower half of their 5-year range. For example, corn's 50% price plunge so far this year, follows a 75% increase in the prior two years.

Second, there have been some concerns about the quality of this year's crop. In particular, Canada's spring wheat crop appears to contain a lower-than-usual protein count. This will lower its attractiveness to a number of global buyers, resulting in lower prices fetched in international markets. Weaker wheat quality has also adversely affected barley and corn markets, as low-grade wheat is used as a substitute for feed.

Lastly, the growing volume of production and exports this year has been raising some logistical challenges for Canadian farmers. Many farmers appear to be scrambling to find adequate storage space, driving up costs and leading to crops piling up on their land. And with the recent move by the Canadian oil industry to transport more profitable crude oil via rail to key U.S. markets, a competition for railcar availability could boost transportation costs.

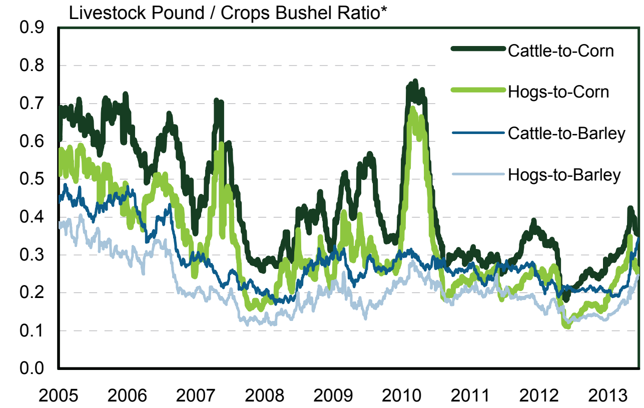
Despite some of these challenges, we believe that the benefits from increased production will outweigh the impact of lower prices, making 2013 a bright year for crop farmers. First-quarter 2013 data on farm cash receipts also suggest that the year began on a strong footing for crops (+13% Y/Y). Farm cash receipts in the crop sector could be hard pressed to sustain this double-digit pace throughout the year. Nonetheless, we still anticipate a solid year for growth and above-average incomes.

Livestock producers enjoying higher prices

In contrast to the crop sector, cash receipts for livestock producers are more likely to gain momentum as the year unfolds. First quarter livestock cash receipts rose by a modest 2% compared to year-ago levels, led by the gains in cattle and supply-managed sectors. After about 5-6 years of shrinking herds, the number of hogs and cattle on farms in Canada has managed to stabilize, with both up slightly on a year-over-year basis. Perhaps more importantly, cattle and hog prices have bucked the trend observed across the agricultural sector, by strengthening in recent months. A shrinking supply of cattle and, to a lesser extent, hogs, in the United States has provided support to North American prices. Meanwhile, a growing emerging market appetite for livestock, particularly beef, has contributed to the improved price backdrop. Canadian farmers have responded to this rise in demand by nearly doubling cattle exports (in value terms) to Asian markets so far this year.

As their top lines have been helped by improved pricing and exports, livestock producers have benefitted from this year's decline in grain prices. Feed costs are the number one expense of livestock farmers, absorbing about 36 cents of each revenue dollar according to the Western Beef Development Centre. As evidence of growing margins, the ratios of cattle and hogs prices to those of corn have been on an improving trend since early 2012, while the cattle-to-barley ratio has jumped to a 7-year high.

CHART 4: MORE FAVOURABLE FEED COSTS IN 2013



* Series measured in USD
Source: Bloomberg

One major risk surrounding the outlook for the livestock sector is U.S. country-of-origin labeling (COOL) – a burdensome rule that discriminates against Canadian and Mexican livestock in the U.S. market. It has been estimated that COOL law inflicts financial damages of some $500 million annually to the Canadian hog industry, and as much as $650 million annually to the cattle sector. The World Trade Organization (WTO) judged against COOL in 2011, requiring U.S. officials to modify the law. However, the U.S. has responded with changes that threaten to impose even higher costs on Canadian imported products – as much as $45-50 per head of cattle on top of the $25-$40 estimated under the previous rule. The Canadian federal government is now considering $7 billion in retaliatory measures against U.S. imports, which include 100% surtaxes on a number of targeted items. Out of sheer necessity, the burden of COOL has been a major impetus of Canadian livestock farmers pursuing other export opportunities in regions such as emerging Asia.

Most agriculture prices to remain in their recent trading range

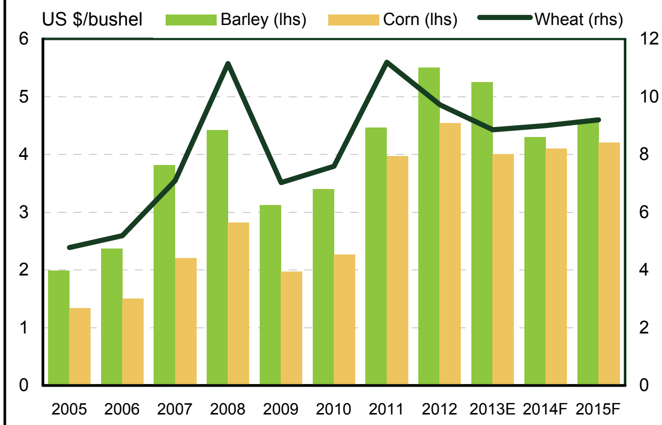
There are two financial variables that are almost impossible to forecast with precision: commodities and currencies, especially in the current period of elevated global economic risk and financial volatility. That said, we do our best to weigh key fundamentals to generate a view on where prices are headed over the next couple of years.

We expect a firming in world economic growth over the next few years to provide support to the consumption of food and other commodities. In particular, Europe is emerging from its six-quarter recession and the U.S. economy appears to be entering a more entrenched recovery. Combined, these developments are likely to spill over into improved exports and economic growth rates of key trading partners, including Canada. China and other emerging market economies have slowed over the past few years, but most continue to expand at a robust rate. Emerging market household incomes will likely continue to converge gradually on advanced nations over the next several years, setting the stage for more meat-intensive and less rice-intensive diets in regions such as Asia.

Global agriculture commodities are priced in U.S. dollars, so changes in the value of the greenback can have an influence on the effective prices received by Canadian farmers. There is a strong likelihood that the U.S. Federal Reserve will begin to reduce the current amount of monetary accommodation in early 2014, which is likely to drive up the value of the U.S. dollar in international markets. All things equal, this move can weigh on U.S.-dollar benchmark prices. On the plus side, the Canadian dollar is expected to trade lower – to around 90-95 US cents – over the next few years, cushioning the impact on Canada's agriculture sector.

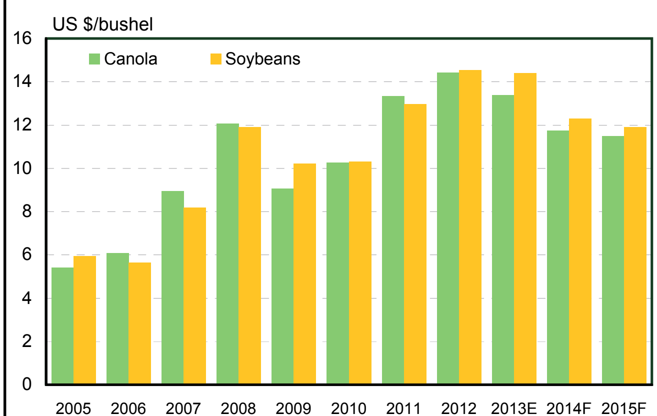
Based on these cross-currents, we anticipate that prices for most key commodities will hold close to their current levels. Overall, estimated year-end stocks of most crops are expected to be neither historically high nor low. Among the crop areas, tightness is somewhat more pronounced in the global wheat market, despite this year's strong estimated output gain. As such, we expect wheat prices to remain at the high end of their recent 10-year average and should outperform the average crop benchmark. Prices in other areas could see a further gradual downdraft, reflecting a combination of this year's strong harvest and ample supplies. Two exceptions could be corn and barley prices, which could make up some of this year's lost ground in 2014 as planted acreage shifts towards other areas, thus helping to reduce the current supply glut. The spread between barley and corn prices has compressed to unsustainably low levels recently, pointing to a likely outperformance of barley prices over the near term. Still, a downside risk to corn prices surrounds rumours that the mandatory ethanol blend for next year in the U.S. could be reduced by close to 16%, which could

CHART 5: CROPS FORECAST



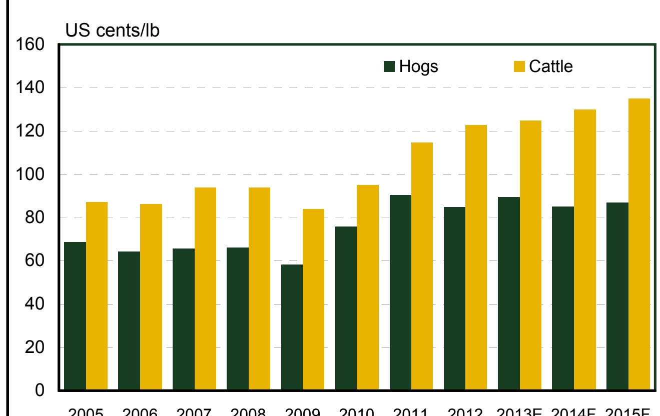
Source: WSJ; Forecast by TD Economics as of October 2013

CHART 6: OILSEEDS PRICE FORECAST



Source: WSJ; Forecast by TD Economics as of October 2013

CHART 7: LIVESTOCK PRICE FORECAST



Source: WSJ; Forecast by TD Economics as of October 2013 also hurt barley prices as well.

In the livestock sector, a mix of declining U.S. herd sizes as well as prospects for more rapidly growing global incomes point to some further upside in cattle prices. While these factors are likely to be supportive to the hog market as well, growing supplies of hogs in South America ought to be a constraining factor on swine prices in the near term. Unfortunately, as we noted previously, changes to the COOL legislation in the U.S. threaten to shut out more Canadian-sourced shipments of non-processed meat and poultry products from the U.S. marketplace. Hopefully, a resolution that addresses Canadian concerns can be found in the coming months.

Not much in the way of bubbling cost pressures

On the plus side, input costs across a number of areas could simmer down in lockstep with prices:

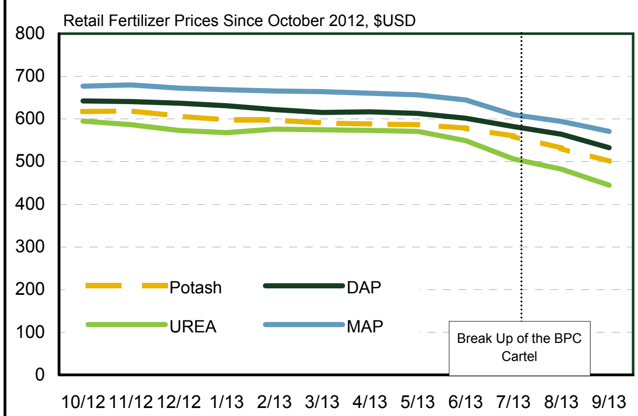
- *Fertilizer* – fertilizer prices have been on the decline in recent months (see chart 8), reflecting recent developments in the potash sector. The break-up of the Belarusian cartel and the decision by Uralkali to begin selling on a volume (as opposed to price) basis has sent potash prices downward, with reverberations felt across the entire fertilizer market. Relative to 2013, we expect fertilizer prices to fall in 2014 on an average annual basis.

- *Wage pressures* – average hourly wages in the Canadian agriculture sector this year have shown negligible growth. Strong harvests this autumn could lead to a near-term boost in wages, particularly in Western Canada where labour markets are relatively tight. Still, even in the most rapidly-growing areas of the Prairie job market, gains in hourly wages remain under wraps.

- *Energy* – continued significant increases in U.S. crude oil and natural gas production are likely to place a ceiling on energy prices over the medium term. At the same time, we expect to see crude oil prices retreat from current levels – partly on the back of a rising U.S. dollar – but then gain some traction in 2015. Overall, energy prices should hold reasonably steady.

- *Interest rates* – central banks around the world are keeping short-term interest rates extraordinarily low in order to ensure economic recoveries remain on track. We believe that interest rates along the maturity spectrum have likely bottomed, but only a gradual normalization in borrowing costs is anticipated over the medium term.

CHART 8: FERTILIZER PRICES TRENDING DOWN



Source: DTN/The Progressive Farmer

Land costs continue to simmer

One area where costs have continued to percolate is real estate. As chart 9 reveals, land values have been rising for several years. Since 2011, however, price gains have accelerated rapidly, providing a major boost to farmers' net worth. In 2012 (the latest data available) net worth jumped by 8% – to $341 billion – as a $28.5 billion increase in assets more than offset a $4 billion advance in liabilities. Some 90% of the increase in net worth reflected increased land prices.

Where farmland real estate prices head from their current levels is open to considerable debate. On the one hand, with borrowing costs likely to remain low and farm financial performances reasonably strong, conditions appear ripe for a further increase in prices over the next few years. On the other hand, in light of the huge erosion in land affordability, there is a growing number of forecasters predicting a flattening in real estate price trends in both Canada and the United States beginning in 2014. While much of the gains in recent years are underpinned by improving fundamentals, prices may have gone too far, too fast. Thus, some cooling in the market would be desirable, since it would mitigate the risk of a major correction down the road.

Long-term picture full of challenges and opportunities

The emphasis in this analysis has been on some of the short-term influences on Canada's agriculture sector. Yet there is no shortage of longer-term challenges and opportunities. How effectively the sector confronts these shifts will in no small part determine its future success.

One key challenge surrounds succession. An ageing workforce is impacting most key sectors of Canada's economy, but in no other sector is this more apparent than in farming. The 2011 National Household Survey (NHS) data showed that the average age of farmers continued to increase over the past half decade, to a new high of 54 years old. In addition, 48% of all farm operators are 55 and over. This trend raises the question of how effectively farm operations and succession will be handled in the coming years.

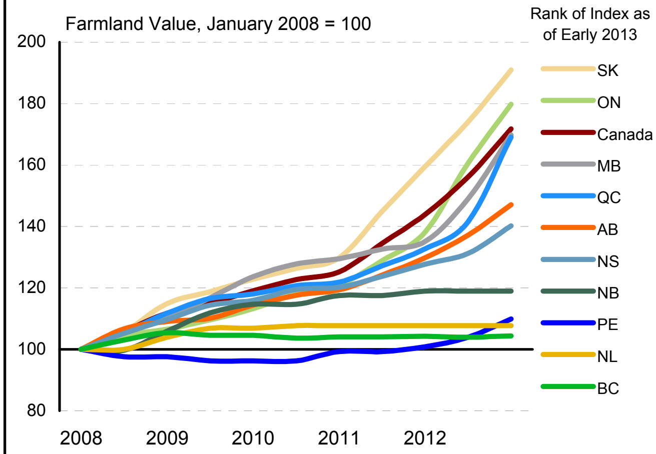
Free trade with Europe and others critical to boosting exports

Another challenge surrounds opportunities for increased trade and diversification away from the U.S. market. The Canadian federal government has just announced that it has completed a trade and investment deal in principle with Europe – the world's largest common market – with some estimates pointing to potential export gains to farmers in Canada of around $1 billion annually once the deal is fully implemented. In addition to targeting potential trade agreements with a host of other nations, Canada was accepted into the Trans Pacific Partnership (TPP) multi-lateral discussions, which would open the door to expanded exports to large countries in Oceania, Asia and South America. The 12 countries taking part of the negotiations represent 40% of the world economy.

Despite the potential for net overall gains in trade, some sectors will invariably lose in any trade agreement. There have been deep concerns within the Canadian agriculture sector that new trade arrangements will come at the expense of dismantling Canada's system of supply management. While details on the Canada-EU deal were just being made public at the time of writing, the two sides appear to have found an acceptable balance. The Canadian supply-managed industry would retain its protected status, but the tariff-free quota for European cheese entering into the Canadian market would be doubled – to 30,000 tonnes. While no doubt a significant adjustment for domestic cheese producers, the quota would still represent well under 10% of the Canadian cheese market. What's more, there is talk that the federal government may provide compensation to those affected.

On the other side of the coin, tariffs will be gradually reduced on a number of food commodities. Canadian beef and pork producers will get increased access to the European market, where onerous tariffs and regulations had previously closed the door on exports. Some estimates have pegged the annual potential benefits to the cattle and hog industries at about $600 million and $400 million, respectively. For an area attempting to diversify away from the U.S. market, this agreement provides a dose of good news.

CHART 9: SOARING VALUES SINCE 2011



Source: Government of Canada

In order to fully reap the benefits of trade agreements, Canada's agriculture industry needs to continue to focus on productivity. The good news is that overall investment and capital outlays in machinery and equipment continue to rise, although this spending has been concentrated in the crop sector. At the same time, the most recent NHS data show that farm sizes in Canada continue to get larger, delivering greater economies of scale. Moreover, farms continue to diversify across crops and livestock, which helps protect against large annual income swings.

Lastly, there are significant opportunities for Canada's overall food sector to record increased value-add. While upstream agriculture activities have been a long time Canadian strength, the industry has been increasingly flexing its muscles in food processing and manufacturing over the past decade (see textbox on page 7). More recently, however, growth in food manufacturing has tapered off, as the Canadian dollar has stayed elevated and competition from producers in the U.S. and around the world has increased. The benefits to broad-based economic activity across upstream and downstream activities cannot be over-stated.

Bottom Line

2013 is shaping up to be a good year for Canada's farm sector, with production volumes and farm cash receipts on track to record healthy increases. We expect to see prices holding close to current levels on balance over the next few years, while some areas of recent cost pressures subside. Even though U.S. COOL legislation and other ongoing

TABLE 2: FOOD MANUFACTURING	Value Added*			Sales			Domestic Exports**		
	2012 Level (Chained 2007 blns $)	Annual % Chg. 2003-12	Annual % Chg. 2010-12	2012 Level (blns $)	Annual % Chg. 2003-12	Annual % Chg. 2010-12	2012 Level (blns $)	Annual % Chg. 2003-12	Annual % Chg. 2010-12
Total Manufacturing	**168.6**	**-1.1**	**2.4**	**593.8**	**0.6**	**5.7**	**271.2**	**-0.1**	**5.7**
Food, Beverage and Tobacco	**27.6**	**0.7**	**0.3**	**98.9**	**2.5**	**3.1**	**24.3**	**3.4**	**8.8**
Meat Product	5.8	2.4	-4.3	23.4	2.1	-1.7	5.5	2.1	2.9
Dairy Product	2.9	2.4	2.5	14.7	3.6	1.9	0.4	-0.7	8.0
Grain and Oilseed Milling	2.1	4.4	10.2	10.1	5.8	17.7	6.2	13.7	22.0
Fruit and Vegetable Related	2.1	-1.1	0.9	7.4	2.4	2.0	2.3	3.5	7.1
Animal Food	1.3	0.1	3.7	7.2	2.9	11.9	0.7	3.1	10.6
Sugar Product	1.0	-3.7	-4.3	4.1	0.6	-1.9	1.8	0.5	5.6
Beverage	5.2	1.5	2.5	10.0	1.3	3.7	0.9	-4.0	7.6
Other (including tobacco)	7.2	-1.1	-0.9	21.9	1.8	2.4	6.5	1.1	5.3

* Due to data limitations for 2003-2006, real GDP expressed in chained 2007 dollars are used to generate a proxy for growth profile.
** Excludes re-exports.
Source: Industry Canada, Statistics Canada, Haver Analytics

Canada's Food Manufacturing Sector – No Small Potatoes

- Canada's Food and Beverage (including tobacco) manufacturing industry generated some $28 billion in output and $24 billion in domestic export earnings in 2012, along with $99 billion in shipments. Among major manufacturing industries, together they represent the most important sector at 16.4% (12.8% for food and 3.6% for beverage and tobacco), ahead of Transportation Equipment (15.5%), Machinery (8.2%) and Primary Metal (8.1%).
- The sector's footprint has continued to grow over the past decade. Bucking the trend of decline observed in the broad Canadian manufacturing sector, the food and beverage industry has expanded since the Canadian dollar began to appreciate in the early 2000s. Output, shipments and exports of Canadian food and beverage products have far outperformed the overall sector. The leading areas of growth in that regard since 2003 have been animal food production, dairy products, and grain and oilseed milling.
- The story over the past years has been more mixed. Growth in output and shipments has slowed, especially in the meat products sub-sector. This slowdown has reflected reduced domestic demand, as exports have grown at a solid clip across all areas.
- Import penetration in the Canadian market has increased since 2010. Thus, despite the growth in exports, Canada's international trade deficit in food manufacturing products has increased to more than $6 billion (as of 2012).
- Research by groups such as the George Morris Centre point out some growing challenges to future growth. In addition to the competitiveness hit from a rising currency, Canadian food manufacturing companies tend to be smaller compared to international competitors, which hurts productivity and raises costs. These lower economies of scale appear to partly reflect ongoing interprovincial trade barriers and market fragmentation across Canada. In addition, Canadian food manufacturers invest less in productivity-enhancing machinery on the whole: some 60% of U.S. levels.
- With tariffs and other barriers to trade poised to be gradually reduced beginning in 2015 under the recently-announced Canada-EU free trade pact, competitive pressures facing Canada's processing sector will become more intense. On the plus side, Canadian food manufacturers will have increased access to a market that is some 14 times larger than that of Canada.

challenges will continue to hold back performances across a number of pockets, the near-term picture remains relatively positive. Looking further out, prospects for sustained long-term expansion in Canada's food supply system are increasingly turning global, reflecting the tilting balance in world growth towards emerging markets and the major push by the federal government to enter into new free trade deals, such as the recently announced Canada-EU trade pact. In this environment, the agriculture sector's productivity performance becomes even more vital to ensuring future success.

Derek Burleton
Vice President and Deputy Chief Economist
416-982-2514

Sonny Scarfone
Research Associate
416-944-5069