November 7, 2014

CANADIAN AGRICULTURE SECTOR: THE TALE OF TWO MARKETS SET TO CONTINUE

Highlights

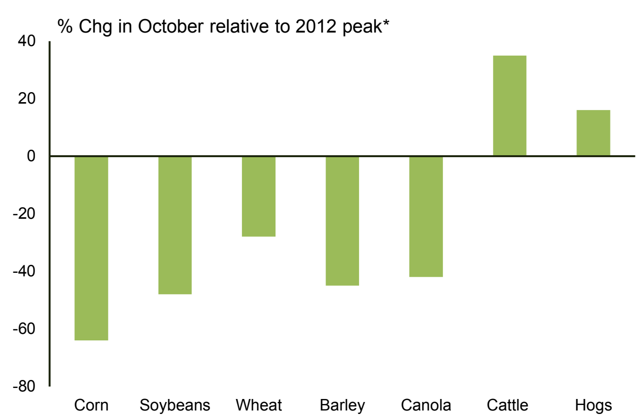
- A second consecutive year of a global bumper harvest led to a massive drop in crop prices across the board, with prices of most major crops now sitting at 4-year lows. Meanwhile, tight supplies have driven cattle and hog prices to record levels.
- In Canada, however, adverse growing conditions in the Prairies have not only led to lower than anticipated output levels, but also poor quality of some crops.
- The tale of two contrasting markets is set to continue, as the ample supply of crops will keep a lid on crop prices, while livestock prices will remain elevated until supplies begin to be replenished.
- A weaker Canadian dollar, combined with recently completed free trade agreements and the elimination of some bans on Canadian beef that were implemented after the BSE outbreak in 2003, should provide increased opportunities for Canadian agricultural producers to compete in foreign markets.

Another year, another global bumper crop. Favourable growing conditions around the world this year have led to record yields and expectations for ample carry-over stocks of most crops. As a result, prices have plunged 30-60% below their 2012 peaks and most are now sitting at 4-year lows. Meanwhile, the divergence between crop and livestock markets continues. Tight supplies have driven live cattle and hog prices to record levels this year – although hog prices have since come off from their peaks. Higher prices, combined with lower feed costs following the drop in crop prices have been a boon for livestock producers, who have endured a challenging market environment in recent years.

Going forward, the tale of two markets is set to continue. The abundant supply of crops will keep prices in check, although we do expect them to begin a gradual recovery by mid next year. On the other hand, livestock prices are likely to remain quite elevated for some time, as supplies are tight and will take time to rebuild.

For Canadian agricultural producers, the government has been working to increase access to foreign markets through free trade agreements, as well as removing bans on cattle and beef exports that were implemented after the BSE outbreak early in the last decade. These efforts, along with a more competitive currency, should provide significant opportunities for Canadian farmers.

CROP AND LIVESTOCK PRICES



*Livestock prices are relative to the 2012 annual average since no peak
Source: Haver Analytics

Abundant supply to keep a lid on crop prices

Last year, a bumper harvest led to a significant jump in year-end carry-over stocks, following historically low levels seen in 2012. Global crop output is set to rise again this year, bolstering

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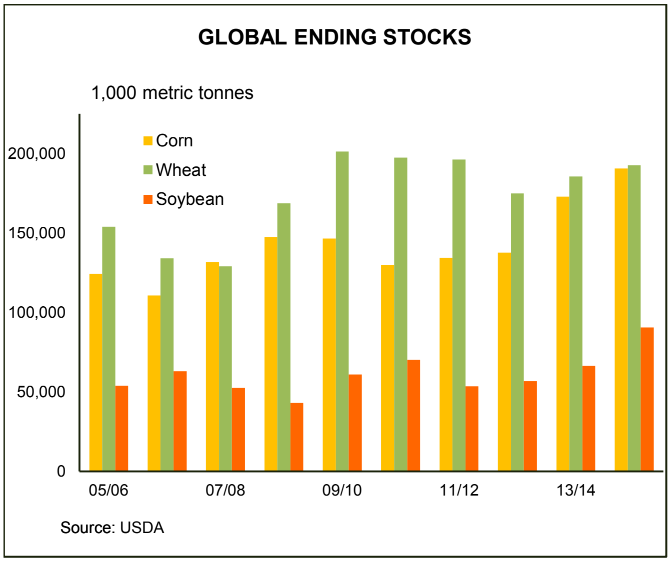


these already elevated stock levels. However, the difference between this year's bumper crop and last year's is the quality. Indeed, some regions – including Western Canada and Europe – have cited quality issues with the new crop which has led to premium pricing for higher quality grains and oilseeds. This has resulted in additional downward pressure on feed grain prices, as low quality crops are typically absorbed as feed. That said, lower feed prices lead to higher demand, putting a floor under how far prices will fall.

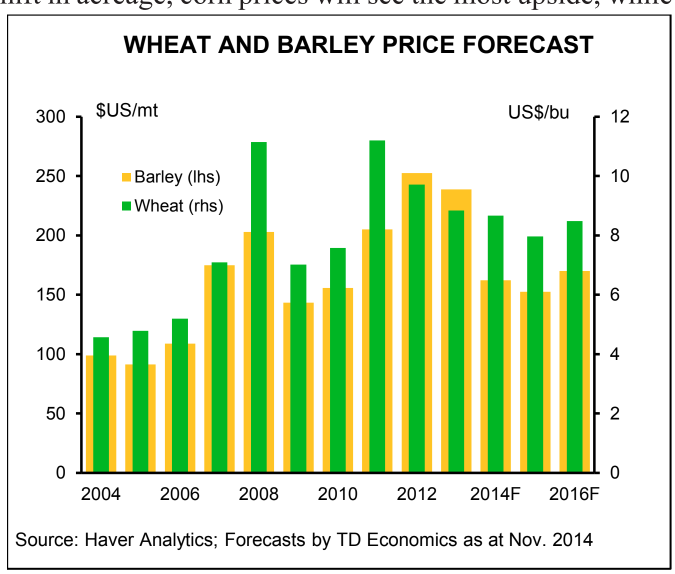
In Canada, output is expected to be much lower than originally forecast, largely due to challenging weather conditions in the Prairies. While wheat and canola output in Canada is expected to decline from last year's record highs by 27% and 22% respectively, it could still be the third largest harvest seen over the last decade. A decline in seeded area will lead to a 30% drop in barley production, but prices are still under pressure considering that prices of other feed grains are quite competitive. Corn production is also expected to be down 20% over last year's levels, while soybean output is expected to be up 11%. As a result, only soybeans will see a rise in ending stocks this year.

Transportation issues have been a challenge for the industry as a whole in Canada, with a shortage of rail cars and locomotives and delays in unloading grain at the port terminals limiting grain shipments. Barley producers noted additional logistical constraints, as handling companies earn higher margins with wheat and canola, which limited barley exports. Part of the problem stems from the 30% surge in output last year to record a high, but rail companies are also dealing with increased demand from other commodities, such as oil. In March, the federal government stepped in, requiring the nation's two largest rail companies to each move a minimum of 500,000 tonnes of grain per week or face a hefty fine. The legislation, which was for 90 days, was extended in August and is set to expire at the end of November.

While the mandate helped to increase grain shipments, there was still a significant backlog of crops sitting in elevators and on farms when the new crop year began in August. The crammed elevators in Canada prompted an increase in exports to the U.S., where elevators had space and were offering more attractive prices. Wheat exports sent south of the border were up by about 40% over the last year, while canola exports shot up by a massive 128%, resulting in the U.S. accounting for a larger share of these Canadian exports. A rise in the number of canola crushing plants in the U.S. also helped boost exports of the oilseed.

Going forward, price movements will depend on the final output numbers in the Northern hemisphere, as well as the outlook and growing conditions for crops in the Southern hemisphere. So far, conditions in South America look decent. However, massive global supplies and current low prices will likely impact planting decisions. Acreage devoted to soybeans is expected to increase at the expense of corn, as soybeans are generally cheaper to produce and require less fertilizer. The next growing season in the U.S. is also expected to result in the rotation of crops, likely favouring wheat and soybeans over corn.

On the whole, global supplies are ample and will take time to work down. Hence, we suspect that crop prices have a little more room to fall. Barring any major weather disruptions, prices are likely to bottom by mid-2015, before beginning to recover thereafter. Given the expected shift in acreage, corn prices will see the most upside, while



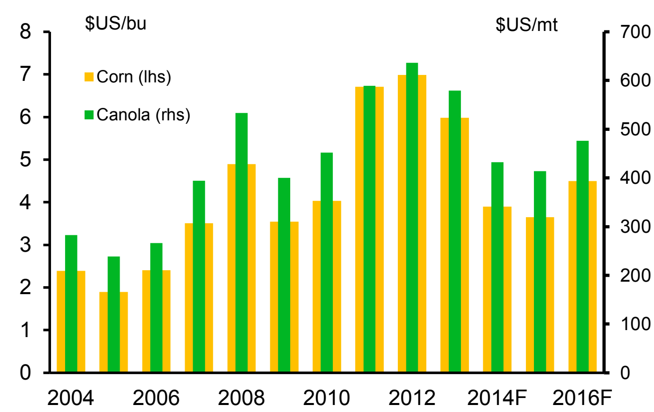
soybeans will see the least. The good news for Canada – which produces more canola than soybeans – is that canola prices should outperform soybeans, as the market is tighter. Barley acreage is expected to decline again next year, which should be supportive for prices, while higher demand for wheat should give prices of the grain a small boost. While we expect crop prices to begin rising again, they will likely not return to the levels seen over the last few years; however, on average, they will remain well above pre-2007 levels. Moreover, the recent slide in the Canadian dollar has provided some cushion for farmers who sell their crops in U.S. dollars, and should continue to do so in the near term.

Livestock prices flying high

Livestock producers probably don't remember the last time market conditions were this good. Prices of both cattle and hogs reached record highs this year thanks to strong demand and tight supplies. Meanwhile, the drop in grain prices have driven feed costs down, prompting producers to fatten up the animals, thereby increasing weight and production, and improving profit margins. In fact, profits in the livestock sector are the highest they have been in several years.

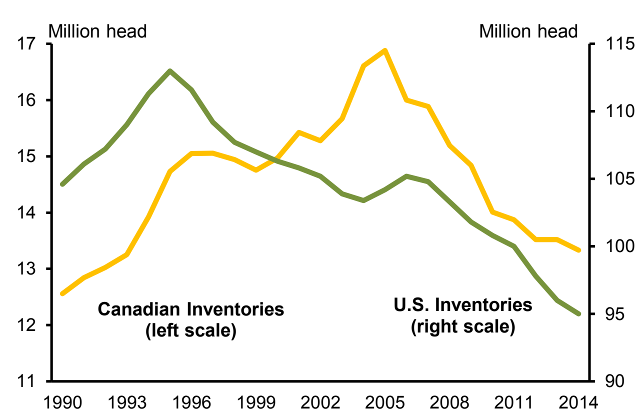
Cattle prices have been rising steadily since mid-2013, setting record after record, and are now more than double the 10-year average seen prior to the recession. The tightness in the market stems in large part from the decline in the American herd that took place during the 2011-12 drought, which caused grass feed shortages. Beef cattle numbers south of the border are at 63-year lows. This has led to increased demand for Canadian cattle, with export volumes to the U.S. up 12% this year following an increase of nearly 30% last year. As a result, Canadian cattle inventories have also tightened up, and as of July 1, were sitting at a 21-year low. While a tight market would typically prompt producers to grow their herds and increase supply, many farmers are taking advantage of the high prices and selling the animals rather than keeping them to breed. Given that it takes time to rebuild a herd, supplies of North American cattle are likely to remain quite tight over the next couple of years.

CORN AND CANOLA PRICE FORECAST



Source: Haver Analytics; Forecasts by TD Economics as at Nov. 2014

CATTLE INVENTORIES*

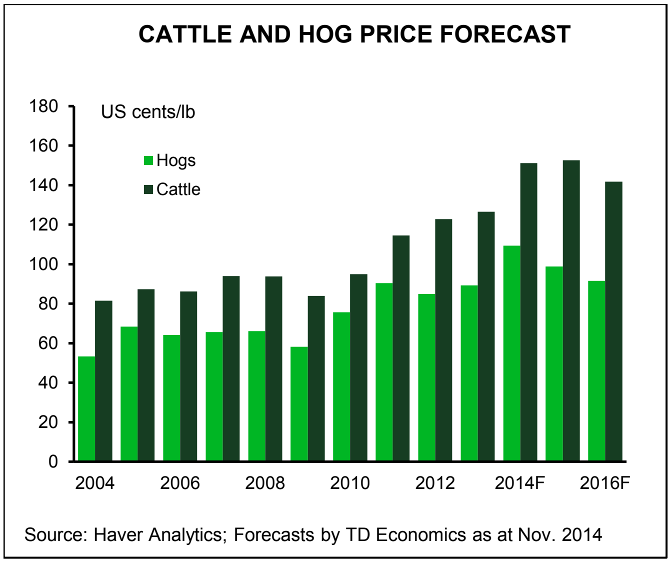


*Inventories on July 1st
Source: USDA

Hog prices shot up early in the year, as the porcine epidemic diarrhea (PED) virus spread across North America, killing millions of young pigs. After peaking at a record high in July, prices eased as the disease began to dissipate, but still remain quite elevated – about 60% above the 10-year pre-crisis average – given the drop in supply. While higher prices over the last 3-4 years have triggered herd rebuilding efforts, inventories in the U.S. as of July 1st were 5% lower than year ago levels, although in Canada they were actually up 1%.

The Canadian hog industry has been facing some challenges. Implemented in 2011, strict environmental regulations imposed by the provincial government have constrained herd expansions in Manitoba. Meanwhile, meat packing plants are having difficulties finding workers due in large part to new federally imposed restrictions on foreign temporary workers that were implemented in June of this year. The legislation includes a cap on the number of foreign temporary workers at each site, a significantly higher fee for each application and a shorter length of stay for workers. The result has been lower operational capacity at some plants and questions about future investment.

The country of origin labelling (COOL) legislation



that the U.S. implemented back in 2008 continues to be a headwind for Canadian livestock producers, as it weighs on their competitiveness in the U.S. market. For a third time, the World Trade Organization (WTO) ruled in favour of Canada in October, implying that the U.S. must take corrective action. However, the U.S. has one more chance to appeal the ruling, suggesting that this dispute could be dragged on until the middle of next year. If the WTO ruling is upheld, it would likely result in increased Canadian exports of livestock and meat south of the border.

Despite some challenges, the outlook for livestock producers is still fairly bright. Given the time it takes to rebuild a herd, supplies are likely to remain on the tight side over the next couple of years. For hogs, production is set to increase next year as the PED virus is no longer wiping out supply, which should weigh on prices somewhat. That said, while lower than this year, prices are expected to remain elevated relative to both pre and post-recession averages. A moderation in pork prices will filter through to the cattle market in terms of competition for meat. As a result, cattle prices are expected to ease from current levels; however, they will remain quite lofty until supplies begin to be replenished.

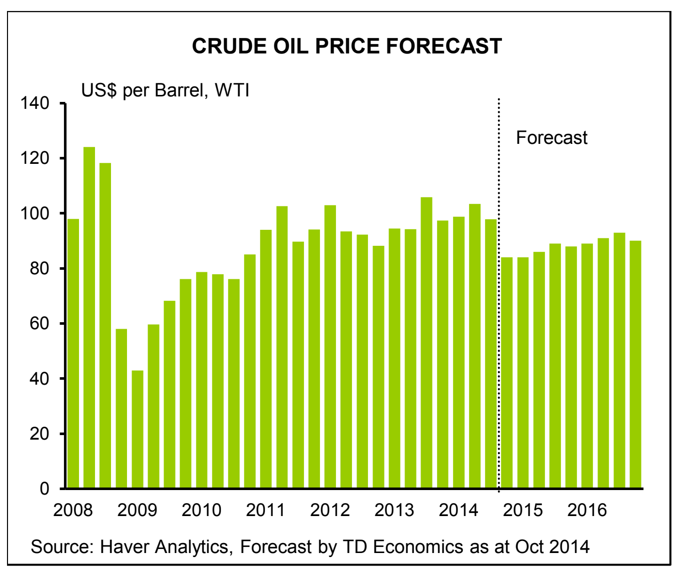
Farm profitability may hold steady in 2014

Despite the significant slide seen in crop prices this year, net farm income in Canada will not necessarily take such a big hit. Roughly half of last year's bumper harvest was available for sale during the 2014 calendar year. So while crop prices may be lower, the quantity sold will likely be higher this year, which would generate higher incomes in aggregate[1]. Moreover, with livestock prices reaching record levels this year, and feed grain costs falling, net income in the sector is expected to be significantly higher than last year. Add to that the cushioning from a weaker loonie, and net farm incomes may come in close to last year's levels. In 2015, however, lower average prices nearly across the board, along with less output – some of which is lower quality – are likely to put a dent in farm cash receipts.

That said, cost pressures will be minimal:

Energy – There will be some relief on the energy front, with both crude oil and natural gas prices expected to be, on average, lower next year relative to this year. Concerns surrounding slower global economic growth, coupled with plenty of supply, led to a sharp drop in crude oil prices during the third quarter of this year. While prices are likely to stabilize over the next 3-4 months before gaining some ground thereafter, increased crude oil production in the U.S. will likely keep a lid on prices. We expect WTI prices to hover in the US$85-90 per barrel range next year, following an estimated average of about US$96 per barrel this year. After jumping 20% this year, natural gas prices are expected to pull back next year, as demand is projected to be weaker thanks to forecasts for a milder winter, leading to higher storage levels.

Fertilizer – Following two years of bumper harvests and lower crop prices, it is unclear whether farmers will reduce fertilizer usage or replenish the soil. Overall, we suspect that potash demand will be down slightly in the U.S. and Brazil, offset by higher demand in China and India. As a result, global demand should be relatively flat next year. Producers within the industry are expected to be fairly disciplined in matching output with demand, which should prevent prices from swinging too much in either direction.



We expect fertilizer prices in general to be flat or slightly down next year.

Interest rates – moderate economic growth prospects in both Canada and the U.S. are likely to prompt the respective central banks to move off the sidelines next year. However, interest rates are only expected to begin creeping up in the fall of 2015, and the increase will be gradual, leaving rates at very accommodative levels.

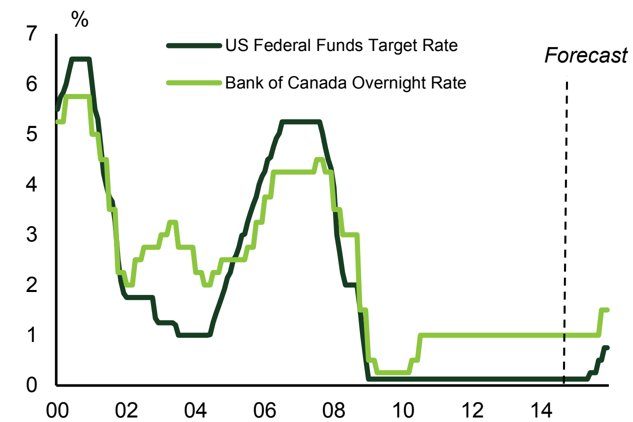
Canadian dollar – the loonie has lost quite a bit of ground this year, hitting a 5-year low of 87 US cents this week. The upside is likely limited over the forecast horizon, given the relative strength expected in the U.S. economy versus the rest of the world. We expect the loonie to hover in the 87-90 US cent range over the next couple of years. As mentioned, this is great news for farmers who sell their products in U.S. dollars. However, for those that rely on imported inputs, costs will be slightly higher.

Farmland values – in 2013, farmland values shot up by a stellar 22%, led by Saskatchewan, Quebec and Manitoba, which each recorded gains of 25% or more. Preliminary estimates suggest that Canadian farmland values on average are either flat or higher this year. Demand in Saskatchewan and Manitoba has been softer, thanks to difficult growing conditions and lower crop prices. However, limited supply has helped boost prices in Alberta. In Ontario, prices overall appear to be levelling off, although there are some areas within the province that are still rising. Going forward, while sharp declines are unlikely, lack of upward momentum in crop and livestock prices, and a stabilization and slight cooling off in the broader housing market should limit growth in farmland values.

Canadian access to external markets is widening

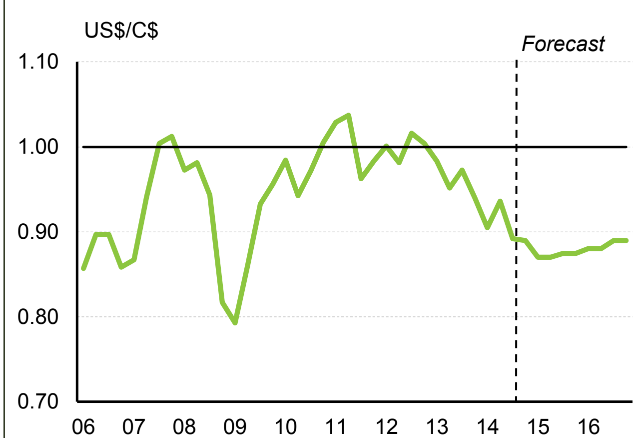
One of the benefits of producing food products is that no matter what, the need to eat will always be there, and hence demand will be there. It is true, consumption will vary depending on price and the availability of substitutes, but there is only so far that demand can fall. One of the major concerns in markets right now is a slower growing Chinese economy. However, even with growth of around 7% – which is still a healthy pace – a growing population and rising incomes will continue to boost demand for higher quality food in the country. Ditto for other emerging markets. Hence, Canada should continue to promote its agricultural sector in international markets so that producers can take advantage of the rising demand, and also help to diversify away from the United States.

INTEREST RATE OUTLOOK



Source: Bank of Canada/Haver Analytics.
Forecast by TD Economics as of September 2014.

CANADIAN DOLLAR



Source: Bank of Canada. Forecast by TD Economics as at Oct.2014.

Some positive developments have been announced on the trade front recently. In September, Canada signed a free trade agreement with Korea, its first in the Asia-Pacific region. Once fully implemented, the Canada-Korea Free Trade Agreement will benefit Canada's agricultural sector, as the tariff on 97% of agricultural exports will be removed, including the 40% tariff on fresh and frozen beef. This will put Canada on a more level playing field with the U.S. – who already has a free trade agreement with Korea – and help restore the trading relationship with a country that was the fourth largest destination market for Canadian beef prior to the bovine spongiform encephalopathy (BSE) outbreak in 2003.

The Canadian government also recently announced that Honduras has lifted the BSE-induced ban on Canadian live cattle that has been in place since 2003, and that Qatar has approved all beef imports from Canada, increasing Canadian export opportunities.

Perhaps the most anticipated free trade deal is the Canada-European Union agreement (CETA) which has been in the works for years. While it has yet to be ratified, the two regions formally concluded negotiations in September. According to the government, the elimination of agricultural tariffs should benefit the Prairie and Central provinces the most. Duty-free access will be granted for wheat and oils – which is great considering they are among Canada's top agricultural exports to the EU – and for 50,000 tonnes of additional beef exports and 80,000 tonnes of pork exports. That said, all meat products will have to meet strict European phytosanitary requirements (use of hormones and antibiotics). While a special committee will be set up to mitigate the impact of these non-tariff issues on trade, there has been some criticism from the industry that this will limit exports of these products. Perhaps the most controversial part of the deal is that which is related to the dairy sector. Although Canadian dairy producers will have full access to the European market, the increased access for European cheese in Canada has triggered concerns for Canada's dairy producers due to the increased competition. The Canadian government has said that compensation will be offered, however, details have yet to be released. Overall, it appears as though the agricultural sector as a whole will benefit from this trade agreement.

While opportunities will definitely arise, agricultural producers will also be faced with some challenges. Chief among them is weather volatility, which has been higher in recent years, as the frequency of severe weather conditions has increased. This isn't something that is generally talked about when growing conditions are ideal. However, it wasn't long ago that adverse weather conditions in North America led to lower yields and production of crops and shrank the cattle herds. The resulting higher prices can only go so far, as farmers can't sell what they don't harvest. Weather is always going to be an unpredictable factor, however, experience and innovation in the sector may help to provide some offset. Similarly, while potential outbreaks of disease in livestock will also prove challenging, implementing livestock traceability programs and disease control measures should help to mitigate the overall impact.

Bottom line

Another year of rising global crop production will be felt throughout the industry in terms of high inventories and lower prices for some time still, while livestock producers will continue to enjoy higher prices for the foreseeable future. Hence, the recent pullback in crop prices will weigh on farm incomes this year and next, but elevated livestock prices and limited cost pressures will provide some offset.

Longer-term prospects for the farming sector remain bright, as the Canadian government has worked hard to open external markets for agricultural products, and demand from emerging markets should continue to grow. As always, the future won't be without challenges. Increased weather volatility is likely to be the most difficult to navigate through, given its unpredictability. However, given the significant swings seen in recent years, farmers are likely becoming better at preparing for and battling through any such occurrences.

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ENDNOTES

1 “Crop prices and 2014 farm cash income”. Agriweek, October 20, 2014.