SPECIAL REPORT
TD Economics

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CANADIAN AGRICULTURE SECTOR: PRICES DOWN, BUT LOONIE PROVIDING SOME OFFSET

Highlights

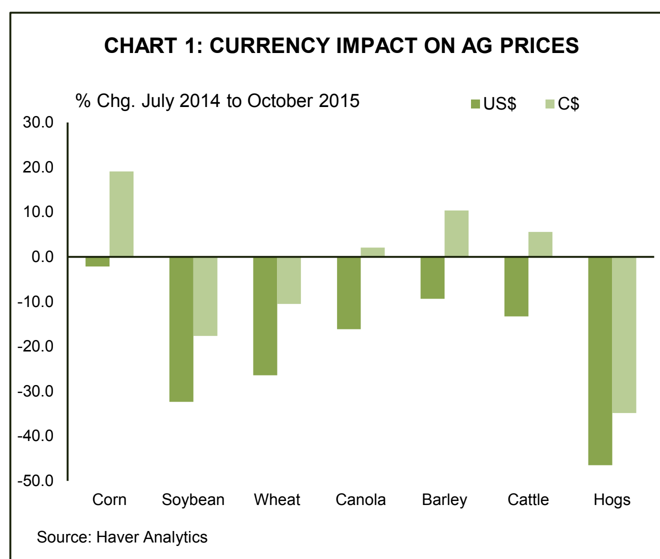
- Bloated stockpiles and concerns surrounding the Chinese economy have accelerated the three-year downtrend present in most major crop prices in recent months. Livestock prices have also been pressured lower, despite tighter market conditions.
- In Canada, however, adverse growing conditions in Alberta and Saskatchewan have led to lower yields and output levels of most crops, while Manitoba and central Canada recorded gains.
- A weaker Canadian dollar has helped to offset some of the decline in prices, with some agricultural commodities even recording a gain in Canadian dollar terms.
- The recently negotiated Trans-Pacific Partnership free trade agreement, if ratified, would prove to be quite beneficial for the Canadian agricultural sector, as it would provide greater access and lower tariffs on meat and crops in member countries.

It's been a wild ride for agricultural commodities in recent months, with most areas succumbing to the downward pressure felt elsewhere in the commodity complex. Growing concerns surrounding the Chinese economy – a key commodity consumer – have hit most major crop prices and accelerated a three-year downtrend that has been largely fueled by bloated world stockpiles. Livestock prices have also taken a hit despite tighter market conditions. Canadian farmers have benefited from the plunge in the loonie to around 75 US cents, as it has helped to cushion the blow from lower prices for agricultural products that are priced in U.S. dollars.

Going forward, we expect that ample supply will continue to keep a lid on crop prices in the near term, while growing herd sizes should limit the upside for livestock prices. That said, a likely further decline in the Canadian dollar would continue to mitigate the impact of lower price levels, along with prospects for minimal input cost pressures.

Further out, food demand and prices will continue to benefit from rising incomes and populations globally. It is up to Canada to capitalize on these opportunities. The recently negotiated Trans-Pacific Partnership (TPP) free trade agreement, if ratified, would prove to be quite beneficial for Canadian agricultural producers, by increasing access and lowering tariffs on meats and crops in member countries. While not included in the TPP, China will continue to present a significant opportunity for Canadian farmers given its size and scope for growth.

CHART 1: CURRENCY IMPACT ON AG PRICES



Source: Haver Analytics

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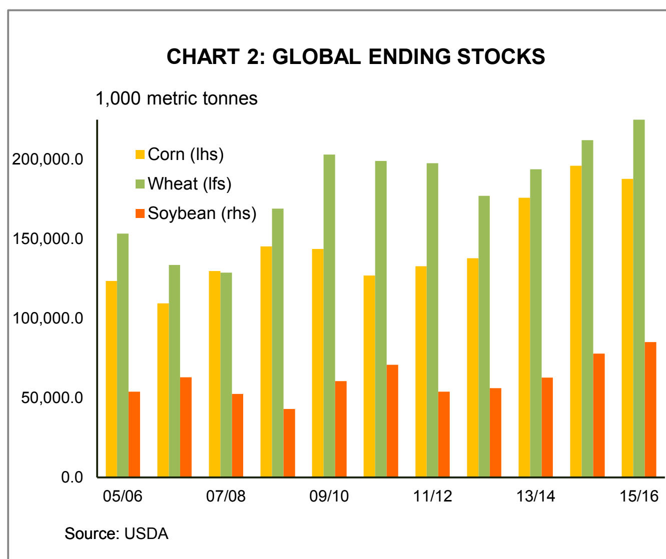


Ample stocks keep crop prices under pressure

Following two bumper crop years, global yields in 2015 still managed to surpass expectations, owing to favourable weather in several key growing regions. Global wheat, soybean and corn production is estimated to have reached record highs in the 2014/15 growing year, driving carryover stocks above their already elevated levels. What's more, all three major crops posted record yields last year – the first time this has occurred in the same season since the late-1990s. Meanwhile, the appreciation in the U.S. dollar – the currency in which most North American commodities are priced – has slowed U.S. export demand. The abundance of supply, along with lackluster demand, has certainly played a role in the downward trend seen in crop prices recently. Financial markets have also contributed to the decline in recent months, as volatility and uncertainty surrounding the global economy – particularly China – have led to a sharp reduction in non-commercial net long positions for most crops.

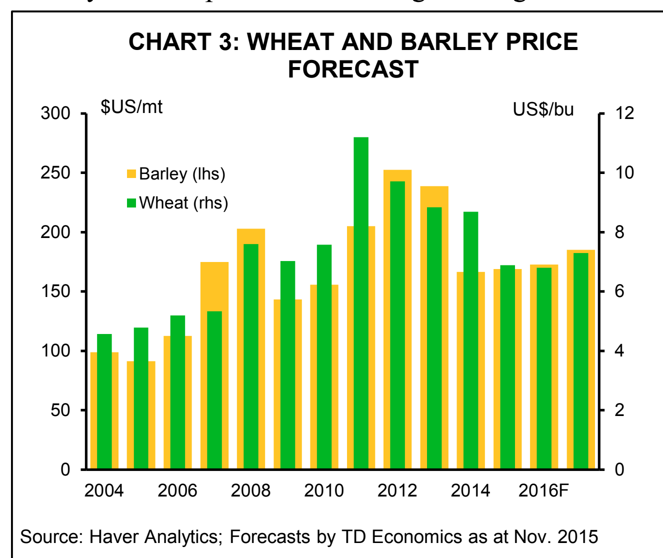
While many key producing regions experienced favourable growing conditions, Canada was an exception. Drought in the Prairie Provinces translated into the driest growing season since 2001. Rain late in the season across the Prairies managed to mitigate some of the losses. Still, yields fell, leading to sizable declines in production in Alberta and Saskatchewan. Wheat output was down by an estimated 15% and 18% last year, while canola production is projected to be down 25% and 9% in each province respectively. Alberta's outsized drop in canola was also due to late frost in May. While barley yields also fell, increased acreage led to higher output.

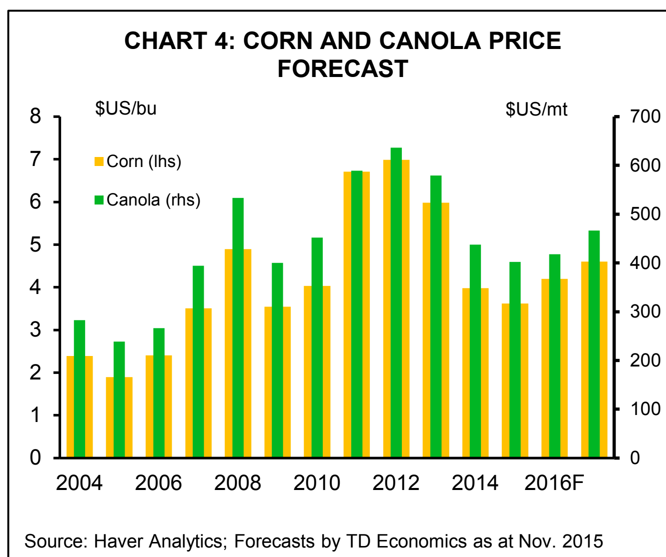
Manitoba was the lone bright spot, with the province seemingly having its own bumper crop year. Production of wheat was up by an estimated 26%, soybeans by 14%, and canola was relatively flat, with higher yields and acreage underpinning the gains. Corn was the only major crop in Manitoba that saw lower yields drive output down.

Outside the Prairies, farmers fared a little better. Corn production was up in Ontario and Quebec thanks to higher yields and acreage. Soybean output was also up in Quebec, but fell 9% in Ontario due to lower yields and harvested area.

Despite the struggles in some regions, Canadian producers across the country have benefited from the low Canadian dollar. Indeed, the drop in the value of the loonie since mid-2014 has helped to offset some of the decline in U.S.-dollar prices that has taken place over that time. In some cases, the depreciation has even led to gains in some crop prices. (See Chart 1) While any inputs imported from the U.S. (such as fertilizer) have become more expensive, the net impact for Canada's overall farm sector has been positive.

Going forward, the direction of prices – as always – will depend on weather. In the near term, the outlook for production in the Southern Hemisphere will be key, although so far, prospects are decent. The shift in acreage towards soybeans is likely to continue, given its recent trend of higher yields and cheaper cost of inputs relative to corn. Overall, assuming normal growing conditions, estimates for global production of wheat and soybeans suggest another record high in the 2015/16 growing year, while barley output is projected to be 7% above the 5-year average. The corn crop is expected to dip slightly from last year's record. This will add to already ample supplies, with ending stocks of wheat and soybeans in particular reaching new highs.





Barring any significant weather disruption, the upside for prices going forward is quite limited, as it will take time to work down the stockpiles. That said, a combination of modest demand growth and a gradual uptake in inventories is likely to sow the seeds for a steady but slow improvement in most major crop prices over the next two years. Given the increase in acreage devoted to it, soybean prices are likely to underperform over the forecast horizon, while corn has the potential to record stronger price gains. While canola prices typically move in line with soybeans, robust demand – particularly in Asia – should help canola trade at a premium.

Livestock prices to remain rangebound

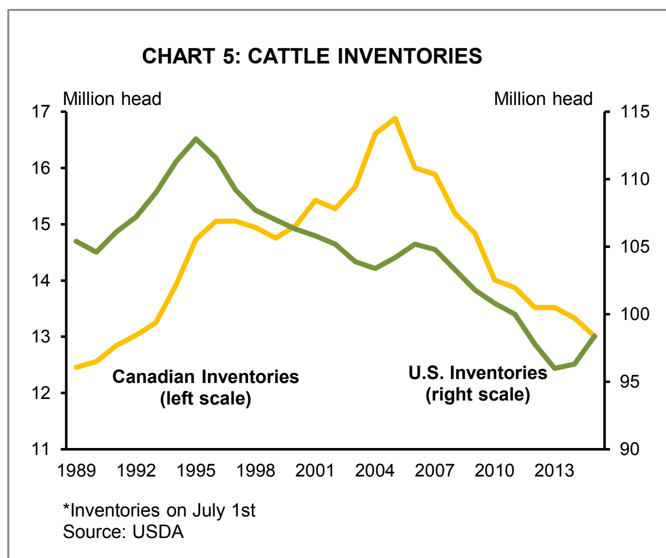
Livestock prices have also seen some fairly significant price declines over the last year. Hog prices have been seesawing since the PED virus outbreak in 2014, falling by over half between mid-2014 and March 2015, before rebounding in the second quarter. Some downward pressure has since resumed, due to rising supply. U.S. producers have begun to rebuild herds, with inventories as of September 1st up 4% versus year-ago levels. This is the highest level of inventory on record going back to 1988. Herd expansion in Canada has been much slower, with inventories up only 1% y/y in July. Canadian producers are being cautious on investing in higher production in light of the struggles they have encountered over the last decade and the fact that the U.S. herd size is expanding more rapidly.

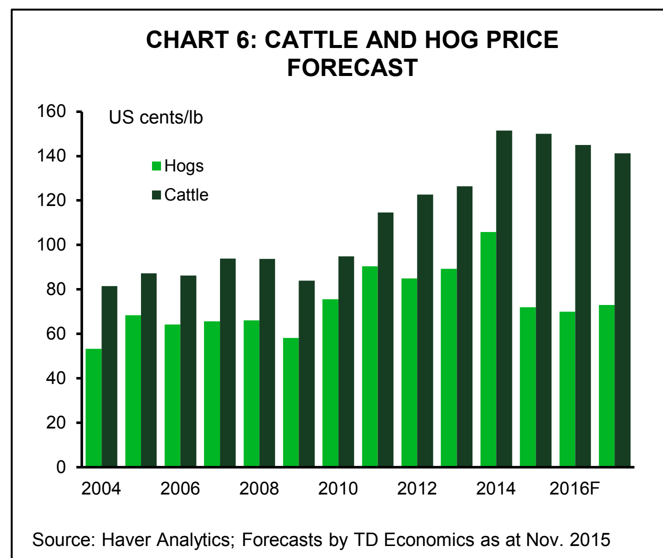
In the cattle market, prices have fallen from their record highs reached last November, due in part to higher live weights, which increases meat supply, and weaker export demand resulting from the appreciation in the U.S. dollar. As well, the U.S. cattle herd has started to increase, up 1% y/y as of July 1st, marking the first July increase since 2006. In Canada, inventories were down 2%, extending the decline in the herd size. Extreme dryness in Western Canada and high feed prices did nothing to incent farmers to try to expand their herds this year.

The Canadian dollar has been a key story for the livestock sector this year as well, mitigating the drop in US dollar denominated prices. Looking ahead, we suspect that the downside for livestock prices is limited, with rising demand poised to offset any increase in supply. We expect prices to be fairly range-bound over the next few years, averaging slightly higher than current levels.

Despite lower prices, profitability to remain elevated

Last year, increased sales volumes offset lower crop





prices, and helped drive net farm cash income to a record high of nearly $14 billion. This year, net income is likely to fall short of last year's record due to lower output and prices – of both crops and livestock. That said, minimal cost pressures should allow it to remain in the $12-13 billion range, which would be well-above the 5-year average of $10.6 billion. Indeed, there are several factors that will help to offset the lower level of commodity prices:

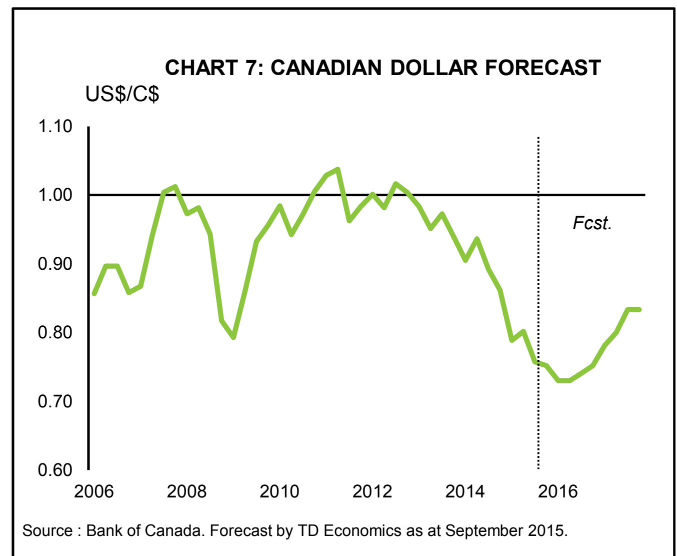
Canadian dollar – The loonie has lost a lot of ground over the past year, which – as previously noted – has helped to cushion the blow from lower agricultural prices, although it makes any imported inputs more expensive. The Canadian dollar is likely to lose further ground in the coming months, bottoming at 73 US cents in the first half of next year, which should ultimately help farmers' bottom lines.

Energy prices – The crude oil market remains severely oversupplied, with production continuing to far outpace demand and global inventories sitting at record levels. We expect prices to remain below US$50 per barrel over the next 3-6 months before gradually rising as the market begins to move to a more balanced position. We forecast the WTI benchmark to remain suppressed, only reaching US$70 per barrel by the end of 2017. The natural gas market is also well-supplied, keeping prices subdued. This trend is expected to continue, with prices likely to remain below US$4 per MMBtu through 2017.

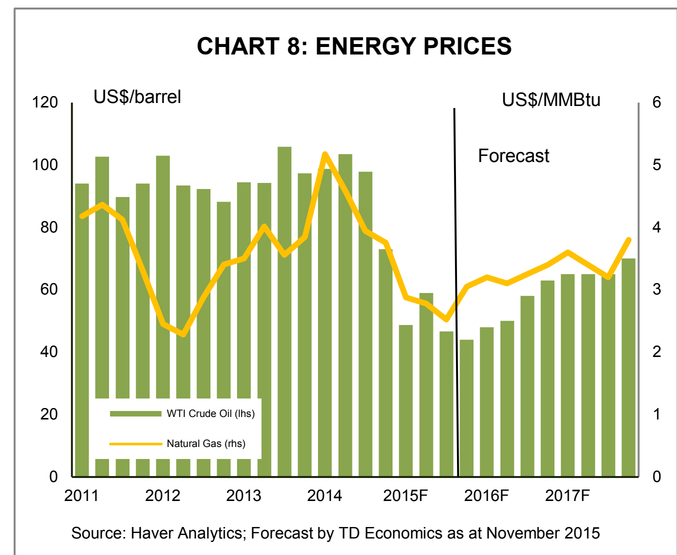
Fertilizer – Demand for fertilizer so far this year has been down in Brazil and the U.S., partially offset by increases in China and India. Lower overall demand globally, combined with growing mine capacity has weighed on potash prices, and is likely to continue to pressure prices down through 2016. Other fertilizer prices have followed suit, although most are expected to hold relatively steady next year.

Interest rates – with the Canadian economy evolving roughly in line with the Bank of Canada's forecast and little inflation pressures, we expect the central bank to remain comfortably on the sidelines until the second half of 2017. This will provide farmers with low borrowing rates throughout the forecast horizon.

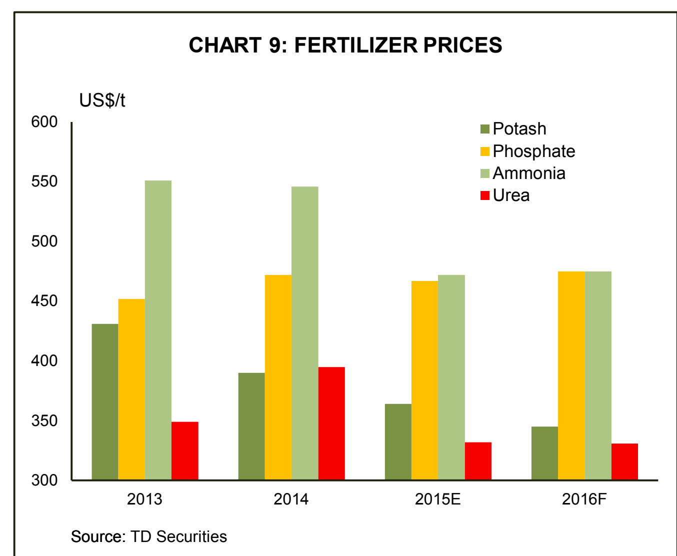
Farmland values – the value of farmland in Canada has been on the rise since 1993, with growth accelerating to an average pace of 19% per year between 2011 and 2013. In 2014, while land values continued to appreciate, they did so at a slower pace of 14%, suggesting that lower agricultural prices have taken some of the steam out of land price growth. Gains have been broad-based across regions,



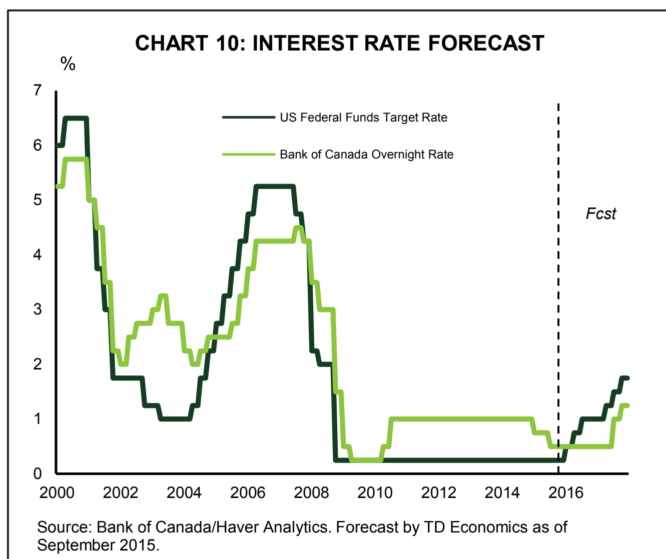
Source : Bank of Canada. Forecast by TD Economics as at September 2015.



Source: Haver Analytics; Forecast by TD Economics as at November 2015



Source: TD Securities



Source: Bank of Canada/Haver Analytics. Forecast by TD Economics as of September 2015.

with Saskatchewan at the top of the leaderboard. Given the outlook for crop prices going forward, farmland values are likely to cool further, although outright declines are unlikely in the near term.

Ag sector poised to gain from proposed TPP deal

Longer term, the outlook for the agricultural sector remains reasonably bright. As world population grows, so too will demand for food. Much of this growth will come from the emerging world, so agricultural producers in Canada should work to attain better access to these markets. The Canadian government has been working to expand trade with markets outside the U.S., and participating in the recently negotiated Trans-Pacific Partnership agreement was just another step in that direction. The deal has yet to be ratified, and given the change in political power following October's election, Canada's ratification is not certain. The newly elected Liberal government is generally in favour of free trade, but will not sign off on the deal until reviewing the details of the agreement.

While there will be a number of uncertainties regarding the impact of the TPP on the Canadian economy until the full text is made public, it appears as though the agricultural sector stands to be a key winner in the deal. The removal of tariffs on key agricultural products would give Canadian farmers easier access and increased competitiveness in TPP member countries. More specifically, Canada currently faces high tariffs and no preferential treatment in Japan, Malaysia and Vietnam, all of which would eliminate or greatly reduce duties or grant preferential access under the TPP within 15-20 years if not on implementation.

The livestock sector could see substantial gains, as tariffs on pork and beef of around 30% in Vietnam and Malaysia would be eliminated in 9 years or less and the 38.5% tariff on beef in Japan would be reduced to 9% within 15 years. Japan has a much lower tariff on pork (4.3%) which would be removed within 10 years. Japan is a key market for Canada, as it was Canada's third largest export market for beef over the last three years, accounting for 6% of the total.

While the TPP would certainly allow Canadian producers to gain an advantage over Europe, Russia and Argentina – particularly for wheat and barley – it would still be competing with the U.S. and Australia, who would also see these tariffs reduced. That said, Malaysia and Vietnam present significant opportunities for Canadian canola producers, as not much is currently produced in other TPP member countries.

One big point of contention during the TPP negotiations related to Canada's supply-managed sectors – including dairy, poultry and egg producers – which other participants wanted to see open up. Details of the agreement suggest that the supply-managed structure will remain largely intact, with a small share of imports allowed for each commodity. Foreign import allotment will rise to 3.25% of Canadian dairy production over the first five years, and less for eggs and poultry. Thereafter, foreign allotment volumes will rise by 1% per year for the following 13 years. For example, the duty-free export quota for TPP member countries will rise from 8,333 MT of milk in the first year, to 50,000 MT within 5 years, and to a final level of 56,905 MT after another 13 years. In the case of milk, 85% of imports will be sent to Canadian processing facilities for further food processing, while the remainder can be directed for retail sale. There was mixed reaction from the sector following news of the deal. Some were thrilled with the implication that the supply-managed framework will remain intact for years to come, while others were disappointed with the concessions made. That said, the phase-in period will give those impacted some time to adjust to the changes, while possibly also being compensated for any associated losses. The Harper government had announced compensation of about $4.3 billion over 10 years for those producers who will be impacted; however it is unclear whether the newly-elected Liberals would stick with this program or how they would alter it should they ratify the agreement.

While concessions had to be made in order to be included in the deal, Canada could not afford to be excluded from

the TPP, as the cost of exclusion would be much higher. For example, if the U.S. and Australia gained preferential access and lower tariffs to the Japanese, Malaysian and Vietnamese markets, Canadian exports to these regions would be much less competitive and producers would have great difficulty gaining market share. From an agriculture sector perspective, despite the partial opening up of the supply-managed industries, the sector as a whole is poised to be a key beneficiary of the deal.

Interestingly, China is not currently a TPP member. However, it remains a key market for Canadian farmers given its rising population and incomes. Even with the recent slowdown in economic growth, the country will be a key market for agricultural products for years to come. Indeed, evidence suggests that as a country develops, consumption of some commodities – metals, energy – declines. However, consumption of softer commodities – grains and meat – still rises on a per capita basis, before flattening out at an elevated level. China still has room to go before that plateau hits, suggesting that it will continue to present a significant opportunity for Canadian agricultural producers over the longer term.

Bottom line

Record levels of crop production and yields in 2015, and expectations for another great year in 2016 suggest that there isn't much impetus for higher crop prices over the near term. Meanwhile, the gradual build of hog and cattle herds will keep a lid on livestock prices. That said, farm profitability is likely to remain historically elevated, thanks to a weaker Canadian dollar and minimal input price pressures.

Longer term, many growth opportunities remain for the sector, particularly as emerging markets continue to consume more high quality meat and grains. The federal government's latest attempt to expand market access through the TPP could prove to be beneficial for Canada's agricultural sector if and when it is implemented. Still, farmers will be presented with their share of challenges in the coming years, particularly those related to weather variability and global uncertainties. But, these issues have become the norm in recent years and agricultural producers are becoming better prepared for any occurrence that should pop up.

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