COMMENTARY

GLOBAL ALPHA

September 28, 2018

Dear clients and colleagues,

As you may have read in recent headlines, tariffs discussions between the US and other countries continue to escalate. Caught in the crossfire, the US farmer could be significantly affected by these trade wars, especially the one with China. To make matters worse, US farm profits are at their lowest levels in more than a decade, according to the US Department of Agriculture.

As US tariffs on Chinese goods are put into effect, retaliatory tariffs from China will impact a wide variety of American agricultural products, including pork, soybeans and wheat, as well as US automobiles. China is the largest export market for US agriculture products, and soybeans are the largest exported agricultural commodity. The US exports $14.2 billion worth of soybeans to China each year, outstripping exports of any other US agricultural commodity, all of which are below $1 billion. China imports $50 billion worth of soybeans annually.

China's alternate source of soybeans is Brazil. Brazilian soybean spot prices have risen from $0.60 a bushel to $2.40 a bushel over the last three months, making them more expensive than US soybeans even after taking into account the 25% duty China recently imposed on US imports. So it's likely China will continue to source soybeans from the United States. Although it's still unclear how 2018 exports of US soybeans to China will be affected by these tariffs, there is one things we know for sure: tariffs have set inflation accelerators in motion, and the US farmer will be directly affected. Illinois and Iowa are the largest soybean producing states.

Are these tariffs an indicator of an upcoming increase in inflation?

Net farm income, a broad measure of profits, is forecast to fall to $65.7 billion in 2018, a decrease of $9.8 billion (or 13.0%) from its 2017 level. This follows an increase of $13.9 billion (or 22.5%) in 2017. Net cash farm income is forecast to fall to $91.5 billion, a $12.4 billion (or 12.0%) decrease. In inflation-adjusted 2018 dollars, net farm income is forecast to decline $11.4 billion (or 14.8%) from its 2017 level after increasing $13.0 billion (or 20.3%) in 2017. If realized, 2018 inflation-adjusted net farm income will come in just slightly above its 2016 level, and 2016 was the lowest level since 2002.

The supply of agricultural goods remains healthy, so volumes are high and overall prices are weak. In early September, the USDA updated its global supply and demand estimates for 2017/18 and 2018/19, increasing yield estimates for US corn (181.3 bushel/acre versus 177.6 bushels/acre consensus) and soybeans (52.8 bushels/acre versus 52.3 bushels/acre consensus). These estimates are negative for US farmers given the above-consensus supply of corn and soybeans in both the US and globally. However, ample global supplies of major crops are generally positive for agricultural processors as they benefit from volume.

If we look at the impact on the economy, we can see that goods coming from agricultural sources should have a muted impact on inflation, even if prices in general start moving upward. At 1% of GDP, the agricultural sector is smaller than the "10% plus" sectors such as financials, government and business services. However, its impact is more widely felt as it represents 11% of employment and 14% of household expenditures.

If we look in broader terms, long-term themes, such as innovation and demographics, continue to favour a muted inflationary environment. Productivity continues to grow, impacted by technology and a continued shift to on-line activity. Millennials are still not buying single-family homes, as signified by the drop in single-family home starts to 1 million in 2018 from 1.7 million in 2016. Also, indicators such as wage and salary growth remain in the 10-year 4.5% growth median.

The agricultural industry remains key for Global Alpha as agricultural companies appear in several different sectors of our investment universe such as Capital Goods, Consumer Products and Real Estate. The industry also benefits from investment themes such as demographics, outsourcing, the environment and innovation.

Global Alpha is invested in the agricultural industry through various companies including Limoneira (LMNR:US; Market cap, $476 million). Based in Santa Paula, California, Limoneira is the largest lemon grower in the United States. Lemons are a specialty crop that grow in moderate climates typically found in California and Arizona, and to a lesser extent in more tropical climates such as in Mexico. Importing lemons from Mexico when a US shortage occurs is therefore difficult, resulting in inelastic lemon pricing. Consequently, when the 2018 heatwave caused supply shortages, lemon prices rose sharply from $23 to $35 per carton. This is not the case for avocados, the crop most commonly cultivated alongside lemons, which can be easily replaced by Mexican imports and therefore have more elastic pricing.

We believe Limoneira is at a point in its global development where it can truly expand and optimize its packaging facilities and benefit from its international footprint which enables it to better withstand weather-related incidents often experienced by agribusinesses. For example, the company recently acquired 210 acres of lemon and orange orchards as well as interest in a packing facility near La Serena, Chile. The Chilean crops will help offset the shortfall from its US facilities into the 2019 US selling cycle.

Limoneira is following the geographic diversification path of Rayonier (RYN:US; Market cap, $4,390 million), another agricultural company held in the Global Alpha portfolios. Structured as a real estate investment trust, Rayonier is the largest timberland owner in the US. The company holds 2.6 million acres of timber assets in the US Southeast, US Northwest and New Zealand. This diversification allows the company to navigate the difficult market conditions that occur at different times in different geography regions. For example, in the last few years, Rayonier benefitted from strong exports to China from its New Zealand and US Northwest operations while its US Southeast operations stagnated. Going forward, Rayonier expects better volumes in the US Southeast as some of its major clients are opening new sawmills within the next 12 months.

We recently attended the 2018 Credit Suisse Materials Conference in New York. The conference had a low attendance so we were able to spend a great deal of time with companies in the Materials, Chemical and Agriculture sectors. Conferences such as this are currently out of favour, but are often the best place to uncover hidden gems. We look forward to discussing these companies with you in the near future.

Have a good weekend.

The Global Alpha Team