

James Butterfill

Executive Director – Head of Research & Investment Strategist

Aneeka Gupta, CFA

Associate – Equity & Commodities Strategist

research@etfsecurities.com



22 March 2016

ETF Securities Equity Research

Agriculture stocks on the cusp of recovery

Summary

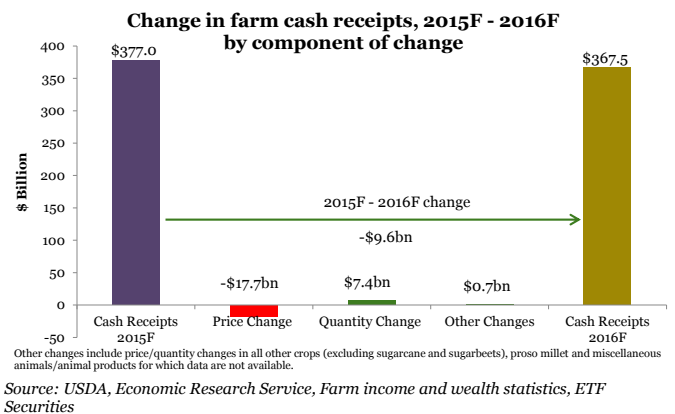
- Decline in overall production expenses (-2%) to cushion the fall in cash receipts
- The expected increase in direct US government farm program payments in 2016 will benefit producers
- The weaker US dollar will benefit US agricultural exports providing a strong catalyst for US farm income
- The uptick in profitability coupled with the rising sentiment indicator appears favourable for agricultural producers

Farm income outlook less bearish

A sustained period of high crop prices from 2008 to 2012 led to a bout of investment by agricultural producers, since then falling soft commodity prices have revealed high debt loads and narrowing margins. However the drop in input expenses coupled with a turnaround in sentiment is painting a more optimistic picture for agricultural producers heading into 2016. Our analysis focusses on the S-net ITG agriculture index, which is diversified across Seeds Chemicals & Fertilizers (53%), Commodity Agricultural Products (30%), Equipment (13%) and Livestock (3%) with 70% of the constituents from the United States.

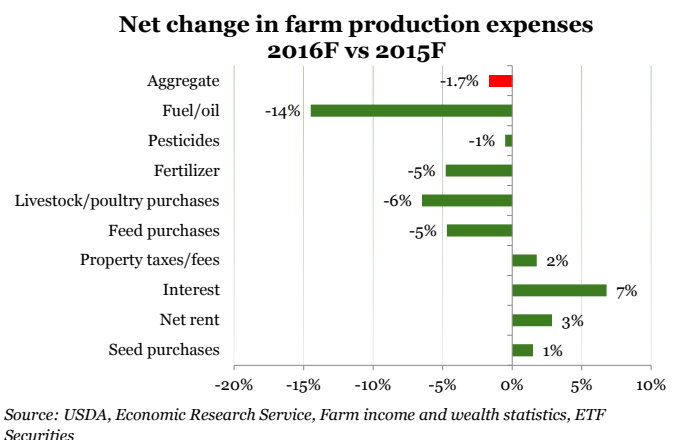
In the latest farm income outlook released by the United States Department of Agriculture (USDA), US net farm income, a key indicator of U.S. farm well-being, is forecast to decline by 3% in 2016. While this will be the third consecutive year in decline, it is not as severe as the declines of -27% and -38% witnessed in the prior years 2014 and 2015 respectively. Cash receipts are forecast to fall 2.5%, falling prices being the key contributor to this price fall as highlighted in the accompanying chart.

Global nitrogen fertilizer supply is poised to grow as cheap energy prices fuel production increases, providing a boost to their bottom line. Although it is worth noting that the recent squeeze on farmers margins does not eliminate the risk of farmers skipping application of fertiliser or shifting acreage from chemical intensive corn to other crops. We believe the fall in fertiliser costs is likely to benefit both fertiliser producers and farmers.



Lower expenses buffer slide in cash receipts

Overall farm production expenses are forecast (USDA) to decline for the second consecutive year. Occurrences of multi-year reductions in farm production expenses are rare, the last time being 1984-86. This drop in expenses for inputs such as feed, livestock/ poultry purchases and fuel are forecast to outweigh the increase in interest expenses and hired labour costs thereby alleviating falling cash receipts. More importantly input costs (currently in 2nd year of decline) tend to lag behind commodity price swings (that have been in decline for 4 years).



In addition, US farmers are poised to benefit from a 31.4% (\$13.9bn) increase in direct government farm payments in 2016. The 2014 farm bill eliminated direct payments worth

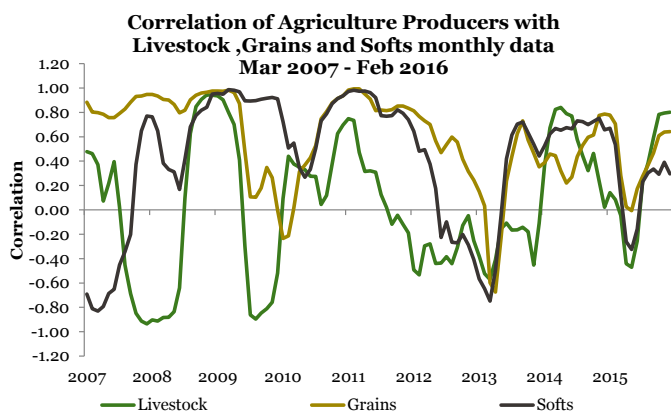
\$5bn annually and replaced them with a net suite of safety net programs that will be triggered in 2016 if farm prices continue to fall.

Lower US dollar to benefit exports

Agricultural exports have been a major catalyst for the strong U.S. farm income in prior years, accounting for more than 30% of gross cash farm income. As majority of commodities are priced in US dollars, the appreciation of the dollar against the local currency of non-US growers has made the commodities more expensive for the foreign based buyer. Although its difficult to quantify just how much buyers have been sourcing lower cost soft commodities we have seen anecdotal evidence of this behaviour. For example, Brazil's soya bean exports surpassing US soya bean exports in 2015 are likely due to the Brazilian Real's depreciation. We expect a continuation of US Dollar weakness in 2016 benefitting farm income which has been squeezed by recent USD strength.

Outlook for Agricultural commodities

The correlation of agricultural producers with livestock, grains and softs has depicted a cyclical relation over time. Current correlation with livestock remains high at 80%, followed by grains at 64% and lower for softs at 30%.



Livestock related commodities account for approximately half of the farmer's cash receipts while the other half comes from crops (namely corn), so farm income would benefit if these specific commodities rise.

- **Livestock sector** ended 2015 as the worst performer among agricultural commodities despite the impact of avian influenza, market prices are expected lower in 2016 according to USDA.
- The price outlook for **grains** – namely corn, wheat and soya bean prices remain subdued since their inventory levels remain at record highs.
- **Sugar** prices are expected higher owing to the reduced sugar supply from Brazil and India driving expectations for a larger world market deficit in 2015/16.
- Dry conditions emanating from the El Nino coupled with a rebound in the real is lending buoyancy to

Arabica coffee prices in 2016.

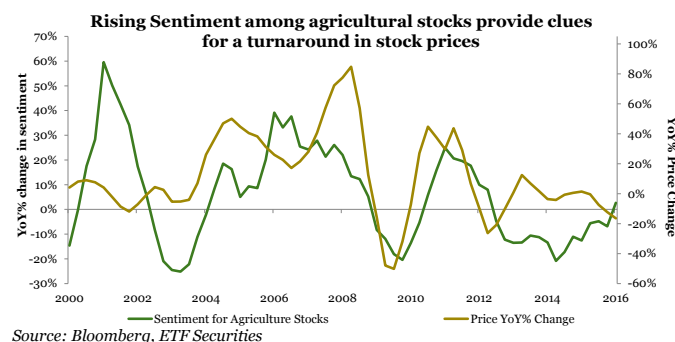
- **Cocoa** is forecasted to be in a supply deficit in 2016.
- While **cotton** has been negatively impacted from lower import demand into China, the crop is expected to remain in a deficit this year.

Shift in sentiment signals an opportunity

Despite the pessimism surrounding the agriculture industry, agricultural producers are currently trading at 20x earnings and 3x book value, in line with their respective 10-year average. Profitability of these companies has been volatile given their exposure to the vagaries of the weather. We are currently in one of the most extreme El Niño events on record, dating back to 1950. According to the Australian Bureau of Meteorology, out of the past 26 El Niño events since 1900 approximately 40% have been followed by a La Niña. If this came to pass, wheat, corn, soybeans, coffee and cocoa will benefit from favourable weather thereby negatively impacting prices while sugar prices will benefit on the upside.

Net profit margins have been in a downward trend since the slump in commodity prices ensued in 2011 but the last quarter in 2015 has seen an uptick of 3.1% over the prior year. Net debt to assets remains high at 31x. USDA has reported growth in farm real estate loan volumes throughout 2015, commercial banks and the farm credit system has remained cooperative and credit to the sector has not been curtailed until now.

Our sentiment indicator (based on consensus data) has been rising since 2014, highlighting a renewed sign of optimism in holding agriculture producer stocks.



In summary we believe agricultural producers are modestly valued, with profitability starting to turn the corner in-line with shifting positive sentiment. Despite the pessimism that permeates through the farming industry, farm income credit has not been curtailed. While net farm income is forecast to decline for the third consecutive year, the lag in declining expenses is expected to catch up and help alleviate the decline. 2016 has seen a positive turnaround for majority of commodities and is lending support for the price outlook of agricultural commodities.

Important Information

General

This communication has been issued and approved for the purpose of section 21 of the Financial Services and Markets Act 2000 by ETF Securities (UK) Limited (“**ETFS UK**”) which is authorised and regulated by the United Kingdom Financial Conduct Authority (the “**FCA**”).

The information contained in this communication is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities. This communication should not be used as the basis for any investment decision. Historical performance is not an indication of future performance and any investments may go down in value.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

This communication may contain independent market commentary prepared by ETFS UK based on publicly available information. Although ETFS UK endeavours to ensure the accuracy of the content in this communication, ETFS UK does not warrant or guarantee its accuracy or correctness. Any third party data providers used to source the information in this communication make no warranties or representation of any kind relating to such data. Where ETFS UK has expressed its own opinions related to product or market activity, these views may change. Neither ETFS UK, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this publication or its contents.

ETFS UK is required by the FCA to clarify that it is not acting for you in any way in relation to the investment or investment activity to which this communication relates. In particular, ETFS UK will not provide any investment services to you and or advise you on the merits of, or make any recommendation to you in relation to, the terms of any transaction. No representative of ETFS UK is authorised to behave in any way which would lead you to believe otherwise. ETFS UK is not, therefore, responsible for providing you with the protections afforded to its clients and you should seek your own independent legal, investment and tax or other advice as you see fit. 442



The
intelligent
alternative

ETF Securities (UK) Limited
3 Lombard Street
London
EC3V 9AA
United Kingdom

t +44 (0)207 448 4330
f +44 (0)207 448 4366
e info@etfsecurities.com
w etfsecurities.com