Agriculture Markets Brace for La Niña
How Mother Nature May Push Father Time to Speed the Recovery in Crop Prices

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Agricultural commodities remain mired in low prices after years of ideal growing conditions and expanded acreage. But with shifting weather likely to disrupt global production in 2016, we believe a rebound in prices is on the horizon.

Where We Are and How We Got Here
In a market dominated by concerns of emerging-market growth, slowing Chinese manufacturing and declining oil prices, agricultural commodities have proven to be relatively defensive. This was evident in 2015, when agriculture commodities held up better than most others and exhibited lower volatility.

Agriculture commodities are now mired in a low-price environment, with spot prices for the four major U.S. crops (cotton, corn, soybeans and wheat) well below their average cost of production (Exhibit 1). Many U.S. farmers are operating at a loss, and farm incomes sank 38% in 2015 to their lowest level since 2002, according to the U.S. Department of Agriculture (USDA).

Highlights
- Valuations are attractive for many agricultural commodities, with prices significantly below the average cost of U.S. production.
- Mother Nature may be preparing for a reset: the El Niño–Southern Oscillation weather pattern looks likely to disrupt global crop growing patterns.
- If El Niño develops into La Niña, we can expect below-average crop yields, lower inventories and significantly higher prices for agricultural commodities.
Following the 2008 financial crisis, grain prices rebounded from extreme lows, supported by demand from emerging markets and consecutive years of subpar crop yields in the United States. In 2012, the U.S. suffered a historic drought that sent corn, soybean and wheat prices soaring. High prices presented U.S. farmers the chance to earn significant profit margins, prompting many to expand the amount of land under cultivation. Combined U.S. planted acreage for the three major crops increased by 11 million acres to 232 million (about 5%) from 2010 to 2012.

With help from Mother Nature in the form of ideal growing conditions, farmers produced bumper crops from 2013 to 2015. This led to above-normal inventories and a precipitous drop in prices. From the record highs set in 2012, corn and soybean prices have since fallen 55% and 50%, respectively, while wheat is down 50% from its 2012 peak.

Low prices have brought supply rationalization to the farming sector. Many farmers have responded to low prices by planting less acreage and reducing the use of pesticides, herbicides and higher-cost genetically modified (GMO) seeds. We believe these aggressive cuts to input costs will eventually negatively impact crop yields, translating to lower production, especially if growing conditions are less than ideal.

**If You Don’t Like the Weather, Wait a Few Minutes**

While a weather shock can wreak havoc across virtually all commodity sectors, it can have an immediate and pronounced impact on the agricultural sector. Production for most agriculture commodities is reset every year with each newly planted crop, making supply extremely sensitive to weather conditions throughout the growing season. We are currently in the midst of an extreme weather pattern that has already had a pronounced impact on crops around the globe. We believe the likely path of the current weather pattern in 2016 and 2017 may further expedite the rebalancing of supply and demand that is already taking place in agriculture—with particularly bullish ramifications for U.S. grain markets.

A lot has been written over the past year about El Niño, a weather pattern associated with rising surface temperatures of the Pacific Ocean. El Niño is actually just one part of a three-phase phenomenon called the El Niño–Southern Oscillation (ENSO).

**A Brief Overview of El Niño and La Niña**

ENSO is a climate phenomenon composed of three parts. It is helpful to view them as parts of a bell curve, with El Niño and La Niña as the opposing extremes.

**El Niño** refers to the large-scale climate interaction between ocean and atmosphere linked to warming sea surface temperatures across the central and east-central Equatorial Pacific.

**Neutral** episodes are at the center of the continuum, and represent average temperatures in the Pacific.

**La Niña** episodes are periods of below-average sea surface temperatures across the east-central Equatorial Pacific.
In 2015, a “Super El Niño” brought historic droughts to India, portions of Africa, Australia, central Brazil and many Southeast Asia countries, along with historic precipitation to portions of the U.S., parts of Argentina, southern Brazil, Paraguay, Uruguay and the U.K. According to the National Oceanic and Atmospheric Administration (NOAA) and NASA, 2015 was the Earth’s warmest year on record since record keeping began in 1880—a direct result of the El Niño event. The El Niño occurring now is the most powerful ever recorded, with the sea-surface temperature anomaly surpassing the previous record set during the 1997-1998 El Niño. It has impacted the production of many commodities, including cocoa, coffee, corn, cotton, palm oil, soybeans, sugarcane and wheat.

**El Niño’s Sister Packs a More Powerful Punch**

Of the three ENSO events, El Niño is not the most detrimental to agricultural commodities—La Niña has a much greater impact on grain production. La Niña tends to bring drier weather to the U.S. Southern Plains and Midwest and key cereal-growing regions of South America, and increased rainfall to Australia and Southeast Asia. Historically, the most significant impact on production has been to the grain sector in the U.S., Argentina and Brazil.

Of the 22 El Niño events recorded since 1950, about two-thirds were followed by La Niña conditions. Additionally, approximately two-thirds of La Niña episodes were followed by another year of La Niña conditions. From 2010 to 2012, back-to-back La Niña episodes contributed to the historic American drought of 2012 that covered approximately 81% of the contiguous United States at its peak, with a devastating impact on crop production in the grain belt.

Most weather forecasters now believe that El Niño has peaked and that we will transition into a La Niña phase. Australia’s Bureau of Meteorology said the probability of a La Niña event is 50% for the second half of 2016, while scientists at NOAA believe the chance of La Niña by August is 53%. Some industry experts are putting the likelihood of a transition to La Niña during 2016 as high as 85%.

The timing of La Niña is significant in determining the potential impact on crops. History illustrates that a switch from El Niño to La Niña can occur in as few as three months. If this happens before the summer of 2016, U.S. corn, soybean and wheat yields could be significantly impaired by hot and dry weather during their key growth stages. If La Niña conditions are not seen until the northern hemisphere winter of 2016/17, the greatest impact would be to grains in Argentina and Brazil during their summer growing season.

Looking at realized crop-yield data dating back to 1970 and comparing it to trend-line yield estimates during the three ENSO phases since 1970, La Niña episodes have resulted in below-trend yields for all major U.S. crops—corn, cotton, soybeans and wheat—to varying degrees.

If El Niño develops into La Niña this year, which is now a medium-to-high probability, we can expect below-trend yields for U.S. grains, resulting in a reduction to inventories and significantly higher prices. If instead we transition into an ENSO Neutral phase, we can expect yields that are close to trend, which even with the expected small increase to planted acres, still tightens U.S. grain inventories and could lead to modestly higher prices from current depressed levels. We believe the odds of a continuation of an El Niño pattern are close to zero.

If a La Niña forms this year, yields for U.S. grains could suffer, leading to lower stocks and potentially significantly higher prices.
Closing Perspective

While rebalancing supply and demand for any commodity can take years, a weather-related event can alter the supply-demand balance of an agricultural commodity in an instant. This differentiates agriculture from other commodities, because weather can significantly shorten the time it takes for price recovery. We believe the defensive nature of the agriculture sector and current valuations already make the sector interesting in the present macro environment. A weather-related supply disruption could make it even more compelling.

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