Agricultural Outlook 2008

Managing Great Times and Great Risks in 2008

Great financial times, but more uncertainty seems to be hallmarks for 2008. Agriculture is experiencing the best times since the 1970s. It's finally a boom for Indiana farmers and agribusinesses. Farm incomes are up. Equity is way up due to a 17% increase in land values. Farm families on average are on their strongest financial footing in 50 years.

These better times are being driven by a worldwide surge in the use of grains and oilseeds for biofuels that has eliminated grain surpluses. But two other factors are important as well. World economic growth has been robust and is spurring added food demand, and the value of the U.S. dollar is depressed making the U.S. a haven for the world's food buyers.

The implications continue to reverberate throughout the ag sector. Higher farm margins and incomes mean strong demand for inputs. Input prices will rise sharply in 2008 raising crop input costs by 17%. Cash rents are also expected to move sharply upward by maybe 15% or more. Both higher inputs and rents may compress potential margins. Added to those concerns, wildly volatile crop prices and virtually no government safety net mean that crop margins may both have high return potential, but will also expose producers margins to any downturns. That's the dynamic, but high risk business environment agriculture will experience in 2008.

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Economy Slowing, But Not Stalling

Larry DeBoer

The U.S. economy is completing its sixth straight year of expansion. But it experienced its slowest growth since 2003.

Output rose only 1.8% above inflation over the past year, and the unemployment rate fell slightly to 4.6%, though it is unchanged since September. The inflation rate fell to 2.4% after the drop in oil prices last fall, and the core rate of inflation—not counting food and energy—reversed course and began falling. It's now 2.2%. Both short and long term interest rates fell slightly, to 4.8% and 5.0% respectively, and the Federal Reserve left the federal funds rate unchanged at 5.25%.

The housing slump has not yet run its course. Building permits are still declining—down 10% in the past three months. Home price appreciation has slowed to a crawl. Mortgage defaults are up. The drop in residential construction is the principle drag on economic growth. The concern is whether the problems in housing will spread to other investments and to consumers as their decline in housing wealth could reduce consumer spending? On the other hand, the falling value of the dollar and strong growth in the world economy should increase export growth, reducing the trade deficit. All-in-all, expect GDP to rise 2.6% above inflation during the next year. That's more rapid than last year, but modest for an expansion year.

When GDP grows less than about three and a third percent above inflation, the unemployment rate tends to rise. That didn't happen this past year, but it probably will in 2007-08. Expect the unemployment rate to rise to 4.9% by next July. Core inflation may continue to moderate, but both oil prices and food prices are expected to rise. The inflation rate should remain near 2.5% over the next twelve months.

The Federal Reserve still regards inflation as the primary threat to the economy. It has declared, however, that it stands ready to supply funds in volatile financial markets. Perhaps we'll see a quarter-point interest rate cut in coming months and the short term Treasury interest rate will follow. Expect the interest rate on 3-month Treasury bills to fall to 4.6% by this time next year. Long term rates are more problematic. Investors might use Treasuries as a safe haven from risk. Chinese officials have threatened to sell some of their stock of Treasury bonds. The spread between short and long term rates is small by historic standards. The first of these would reduce long term rates; the other two would raise them. The 10-year Treasury bond interest rate should rise to 5.3% by this time next year.

Will there be a recession? The odds are perhaps one in five. The wild cards are financial shocks. Will there be a credit crunch? Will consumers reduce spending with declining home values? Will the Chinese dump bonds? Each is unlikely. The economy should grow slowly, but it's unlikely to stall.

2007 Agricultural Trade Reflects Strong World Demand

Philip Abbott

USDA's most recent trade forecast predicts another record year in fiscal 2007 for U.S. agricultural exports, at $79 billion. Agricultural imports continue their rapid growth as well, and a record at $70.5 billion is foreseen. While import growth is expected to exceed a 10% annual growth rate, higher prices for grains and oilseeds have led the even more rapid advance in exports, and will allow the agricultural trade balance to improve next year to an $8.5 billion surplus.

Poor weather in Europe and Canada account for the very recent increase in the export forecast, and have most dramatically affected wheat export value. Why such strong export values? That is because of higher prices due to biofuels demand around the globe, strong world economic growth, and the very weak dollar. Until recently, both export and import expansions were led by higher value product trade, such as meats, and horticultural products in the case of imports. However, over two-thirds of the current export expansion is from greater grains and oilseeds export values.

Quantities of grains and oilseeds exported have not fallen substantially in the face of these high prices, however. Feed grain export values increased 28% from 2005 to 2006, and another 40% is expected from 2006 to 2007. This reflects a 50% expected increase in prices, and only a 10% reduction in quantities exported. For 2008, both corn and wheat volumes are expected to increase with higher prices. In the case of soybeans, export value is expected to increase 7% in 2008, resulting from a 14% increase in price and a 7% decrease in quantity exported.

While meat export increases are not now leading trade growth, 2007 exports are nevertheless expected to be 13.6% higher for red meats and 14% higher for poultry than last year. For 2008 livestock products are expected to grow by another 4%, while poultry products are down 3%. Even in the face of higher meat prices, exports have not tended to fall. Reduced imports by Mexico appear to be the most important factor limiting meat export growth.

Expected strong economic growth worldwide is one factor contributing to strong export demand. In addition, the dollar has not only continued to depreciate against the euro, but has also depreciated more broadly than it had at this time last year, against currencies of competitors and key trading partners including China and Brazil. USDA's exchange rate index indicates the value of the dollar in May was down on average 11% since 2000, and 3% from last year. The extremely high U.S. trade deficit, at 6.25% of GDP continues to fuel expectations for a weak dollar in the longer term. This is good news for agriculture as a weak dollar has traditionally meant higher grain and oilseeds prices and strong export demand. One reason why exported quantity has not fallen more in response to high prices is that the weak dollar means prices don't seem so high elsewhere.

Trade Promotion Authority (Fast Track) for the Bush Administration expired in July, dimming prospects for the stalled WTO negotiations. An agreement between the Democratic Congress and the Administration enabled completion and signing of four pending bilateral trade agreements (with Korea, Peru, Panama, and Columbia) before expiration, but without fast track there will not be either a WTO agreement or new bilateral agreements unless Congress agrees. Agriculture remains a key sticking point in the WTO negotiations, and without a better deal from developing countries on industrial tariffs, it is unlikely that the current Administration will try to get Fast Track restored.

The new farm bill will not be guided by a new WTO agreement, or by ongoing negotiations, but recent WTO disputes lodged by Canada and Brazil call for modifications of existing farm legislation to come into compliance with our WTO commitments. Provisions of a USDA proposal for a new farm bill did little to respond to those disputes, and the bill that passed the House in August does even less. High grain and oilseed prices and record exports take the pressure off of reforms to come into compliance with WTO commitments now, as spending on farm programs is low, and well within commitments this year.

Whether the persistent weak dollar and biofuels demands will bring a new era in international agricultural trade where WTO commitments and farm bills are much less relevant remains to be seen. Projections and recent trade performance suggest that foreign demand should remain strong, and agricultural exports have not reduced substantially in the face of higher prices yet. Export demand, at current prices and exchange rates, does not appear to be the cushion needed to absorb the projected increases in domestic use of corn for ethanol. If foreign markets are slow to reduce their purchases in the face of high prices, this may mean more adjustment in crop usage will have to occur in the U.S. or that crop prices will have to move even higher.

New Farm Bill on Deadline

Allan Gray

The 2002 Farm Bill is set to expire on September 30, 2007 and Congress has been working on the 2007 Farm Bill. On July 27th the House of Representative passed its version which in many ways resembles the 2002 Farm Bill particularly in the commodity title. The three-tiered system of support provided to commodity producers that includes direct payments, counter-cyclical payments, and marketing loans remains largely unchanged. There is an option for producers to choose between the counter-cyclical payment system used over the past five-years; with increases in target prices for wheat and soybeans; or a new counter-cyclical system that is based on changes in national revenue targets which incorporates changes in yields and prices to determine the amount of support the producer would receive. In addition, it would eliminate the three-entity rule used for determining payment limitations while making the operator and the spouse both eligible for a payment limit. There would no longer be a payment limit for marketing loan gains or loan deficiency payments and the payment limit for direct payments would be increased from $40,000 to $60,000 per person. In addition, anyone making more than $1,000,000 in adjusted gross income would no longer be eligible for government support payments; the limit would be $500,000 if less than 75% of the person's income comes from farming.

The House version of the Bill also makes some changes in the conservation title. It would maintain the Conservation Reserve Program (CRP) and Wetlands Reserve Program (WRP) while modestly increasing funding for the Grasslands Reserve Program (GRP). Funding for the Environmental Quality Incentive Program (EQIP) would see modest increases funding while reserving 60% of the funds for livestock operations. It also contains provisions to allow no new contracts under the CSP program and instructs USDA to devise a new CSP program that would be implemented in 2012; essentially eliminating this program from the 2007 Farm Bill. Finally, the House version contains provisions for increasing spending for Fruit, Nut, Vegetable and Vine Producers and biofuels. The Bill contains provision to increase funding for school lunch programs to purchase more fruits and vegetables, and provisions for increased spending on research and market promotion for fruits and vegetable. In addition, the House would provide funding for loan guarantees, grants, and feedstock subsidies for cellulosic ethanol and biodiesel.

The process for getting a final Farm Bill passed into law is still a long one. The already passed House version is just the first step. Now, the Senate must take up debate of its version of the Farm Bill.

> *"I wouldn't bet on a new Farm Bill being in place earlier than November."*

Once the Senate has passed its version of the Farm Bill the House and Senate versions must be reconciled in process known as the Conference Committee. The Conference Committee must find a compromise between the two versions and then go back to the floors of the House and Senate for final approval. Assuming that both the House and the Senate approve the final Conference Bill, the final bill would then be sent to the President for his signature or veto. If the President signs the bill it becomes law. If the President does not sign the Bill it goes back to the House and Senate where the veto can be overridden by a 2/3rd's majority vote in both chambers.

In September, the Senate will take up its debate of the 2007 Farm Bill. Senator Harkin is expected to release his "Chairman's Mark" of the Bill right after the August recess. This will be the first hint at what the Senate bill might look like. This "Chairman's Mark" is the starting point from which the Senate Agriculture Committee will debate and amend to come up with their final version. It is expected that this starting point will contain substantial differences from the House Bill in terms of spending for conservation programs; particularly the CSP program, Senator Harkin's signature program. It may also contain a more revamped counter-cyclical program that is revenue based without the option for producers to continue to use the price based system.

Finally, the Senate version may also contain language that makes payment limits considerably tighter than the language contained in the House version. Assuming the Senate Agriculture Committee can come up with a Farm Bill that can pass a vote by the full Senate, an intense Conference Committee looms. The Conference Committee will have to find suitable compromises and also stays within spending limits set forth by the budget processes in both the House and Senate. The Conference Committee will also have to be cognizant of the President's response to the final bill. The Administration (both the President and the Secretary of Agriculture) have voiced their displeasure with the House version of the Farm Bill. The Administration wants payment limits to be stricter than the House version. In addition, the Administration is not pleased with a provision in the House Bill to tax some foreign companies that have subsidiaries in the U.S. to help pay for some of the new spending they have proposed in their version of the Farm Bill.

So in conclusion, the 2007 Farm Bill is still a long ways from becoming law. The House has put the first "stake in the ground" to give us an indication of the shape the final bill. It seems that much of the bill will look very similar to the 2002 Farm Bill. But, there is plenty of politics and negotiating left to do. One thing seems certain. The deadline of September 30th will come and go without a new Farm Bill being in place. The crops being harvested this fall are covered by the 2002 Farm Bill anyway so the September 30th deadline is not that critical. I wouldn't bet on a new Farm Bill being in place earlier than November. Don't forget, if things get too contentious in the Senate and/or Conference debate on the bill Congress could just decide to extend the 2002 Farm Bill for one or two years and walk away simply wasting the last 4 months of effort.

Food Price Inflation Perks Up

Corinne Alexander

After several years of moderate food price inflation, food shoppers are seeing much higher food price increases. Food price increases so far in 2007 are almost double the levels in 2006 due in large part to tight supplies and strong demand for many food products as well as higher energy costs. Another reason for tight supplies is that egg, chicken, and beef producers have reduced their flocks and herds in reaction to higher feed costs.

World demand for food is strong as well. This is a result of several factors including the use of grains and oilseeds for biofuels which have reduced international supplies; the strong world economic growth, and the current weakness of the U.S. dollar which moderates prices of U.S. ag exports. Each of these factors is serving to stimulate U.S. demand and increase agricultural commodity prices. Another example of the implications of these factors is the reduction of surplus dairy products in Europe and the U.S. which is an important reason for sharp increases in milk product prices (see Dairy article).

Given tight supplies and strong demand, the outlook for food prices will also depend on weather. Favorable weather conditions and good yields worldwide will moderate food prices while unfavorable weather will result in greater food price inflation. Hurricanes and fall storms can affect fruit and vegetable supplies. The weather focus however will soon shift to the Southern hemisphere and to weather conditions there. In addition, food retailers continue to see higher transportation and energy costs that they are passing on to consumers.

Over the last 12 months, rising prices have been lead by eggs which are up 25%-30% and milk which is up 25%. Wheat products including bread, pasta and flour are up between 5% and 15% due to the tight world stocks of wheat as a result of poor wheat crops in Australia, Canada, U.S., Ukraine and other parts of the world. Chicken and beef prices are up between 5% and 10% due to a decrease in the chicken flock and cattle herd as a result of the higher feed prices this past year. On the other hand, prices for fresh fruits and vegetables have been moderating from high prices this past winter resulting from winter storms in Florida, California, and Mexico.

Grocery store prices rose 4.6% from July 2006 to July 2007, well above the 1997-2006 average annual food and beverage retail price increase of 2.5%. Restaurant prices are expected to increase at 3.6% for the rest of 2007 and 2008, above the typical 3% increase. Restaurant prices are not increasing as fast as grocery store prices because the restaurant bill includes labor to prepare the food and overhead in addition to the higher food costs.

For 2007 and 2008 food price increases for all food on average are expected to be in the 3.5% to 4.5% range. This compares with food inflation of about 2.5% per year for both 2005 and 2006.

Are biofuels to blame for higher U.S. food prices? The correct answer is that biofuels are just one of the contributing factors, and that strong world economic growth, the weak dollar, and adverse weather must also be added.

Milk Prices Soaring, For Now

Mike Schutz

. Milk prices hit record levels this summer and continue near those levels. The US All Milk price reached an all-time record of $21.70 for July. Clearly, these prices won't last forever, as the milk supply responds to increased profits; but strong demand seems poised to prevent a dramatic drop in prices well into 2008. An important question is how much will retail sales be hampered by such historically high prices in the dairy case

As prices rose in early 2007, several articles in the popular press singled out increasing ethanol production and accompanying feed price jumps as the reason for the escalating milk prices. While feed costs may have had some impact in holding back production per cow, its contribution to higher milk prices paled in comparison to the effects of increasing domestic and global demand for dairy products, especially dry products like whey powder and nonfat dry milk. Global demand for U.S. dairy proteins has been especially strong in 2006 and 2007 reflecting reduced supplies of milk and whey powder from Europe and Australia combined with better exchange rates against a weaker US dollar.

To be sure, a number of factors have merged to create the unprecedented strength in dairy production. The expansion of the U.S. herd size from recent years slowed in 2007 driven by the 54,000 cows removed from the US herd by the Cooperatives Working Together program and likely the effects of higher feed costs. As mentioned, global demand played a role; and, while demand for milk and whey powder appears to be slowing, the U.S. is becoming an exporter of butter. Not all of the exceptional demand for dairy products has been in the global markets as U.S. consumption of butter and cheese (especially Mozzarella) were up 4.5% and 4.8% in early 2007 versus early 2006.

The U.S. supply of milk is expected to respond to the increased milk prices, and probably in a big way. July 2007 milk production ran 3.9% higher than for the same month in 2006. So, while milk production would seem ready to explode because of favorable milk prices, forage availability especially in the Eastern Corn Belt and Upper-Midwest, evolving milk handler and retailer attitudes about use of Posilac™ in their patrons herds', and extreme summer heat over a wide swath of the US held back the accelerating production.

Pennsylvania State University forecasts a 2.1% increase in milk production for 2008. Consumer response to higher fluid milk prices in the store is also

Milk Prices Soaring, For Now Cont.

Mike Schutz

expected to diminish sales; but it is also expected that increased demand and fairly small stocks of butter and cheese will allow the industry to easily divert lost fluid milk sales to manufactured products. Some evidence suggests that markets for dry whey and non-fat dry milk, namely the animal feed industry, are cutting back on purchases in response to the high prices.

It's quite likely that current milk prices are not sustainable in the long term; but demand appears to be strong enough to avert a crash in milk prices. Both the futures markets and the USDA Economic Research Service are anticipating very strong milk prices well into 2008. Anything that affects demand and exports could quickly erode milk prices. But for now, expect prices to remain over $18.10 for the rest of 2007 and above $15.50 through the first half of 2008, which reflects a very strong price, historically. Furthermore, in recent months the strength of butter and powder sales have led to still higher Class IV prices and those are expected to run $.50 to $1.00 above Class III into 2008. Since the market order reform in 2000, it is quite unusual for Class IV prices to exceed Class III. But it is the higher of Class III or Class IV component prices that dictate the Class I price, so this is great news for strong fluid milk markets like the Mideast Market Order, which includes most of Indiana. The U.S. All Milk price is expected to average over $21.00 for the rest of 2007, leading to a phenomenal annual average price of around $19.25. Average annual All Milk price for 2008 is expected to fall back; but only to around $18.75 according to the recent USDA Economic Research Service Outlook. The Chicago Mercantile Exchange and milk cooperatives provide some opportunities for price risk management, especially with some risk that product demand and prices could decline.

In Indiana, construction continues for Conagra's ReddiWip™ production in Indianapolis and the Nestlé's plant in Anderson. Both should modestly increase demand for milk and cream locally, possibly providing small increments for regional dairy producers. On the other hand, forage supplies will be extremely tight in Indiana, and producers will need to seek alternatives to hay crops, such as increased corn silage or combinations of dry distiller's grains with straw or lower quality hay.

Beef Cattle Industry Seeing the Green $

Chris Hurt

Reduced beef supplies mean cattle producers should expect a record price year in 2007 and again in 2008. The size of the nation's breeding herd dropped slightly in the mid-year update to 32.9 million head. Cow-calf producers have shown little interest in expansion and brood cow numbers have remained near their cycle lows since 2004. Beef heifer retention was also down 6% at mid-year which also indicates females are headed to town rather than back to the breeding herds.

The reasons for the slow willingness to expand brood cows is related to a number of traumas the industry has been through in recent years including, BSE, restricted exports, drought in the western plains, fear of very high corn prices, and drought in the Southeast in 2007.

Beef exports are recovering from their near elimination after the late-2003 BSE announcement. In 2007, annual beef exports are expected to increase by 20% and by an additional 23% in 2008. Next year, exports are expected to have recovered back to 1.7 billion pounds compared to the record 2.5 billion pounds in 2003.

Nearly stable beef production in combination with growing exports and growing U.S. population mean that the supplies of beef available per person will decline in 2007 and 2008. Per capita supplies will drop by 1% in 2007 and are expected to drop by an additional 2% in 2008.

Smaller available supplies per person mean strong prices for finished cattle. Choice Nebraska steers averaged $85.40 in 2006, but are expected to reach a record $91 this year. For next year prices should set a new record, perhaps around $93 per hundredweight.

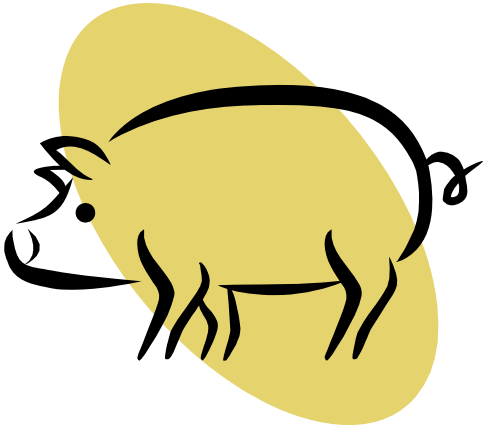
Record high finished cattle prices and a large corn crop are expected to contribute to very strong calf prices this fall as well. Kentucky steer calf prices are expected to average in the $110 to $125 range this fall. These prices are expected to be stronger than the fall of 2006 when 500-550 pound Kentucky steer calves averaged $106 per hundredweight in the final quarter of the year. Of course corn prices had already started moving sharply higher last fall reducing calf prices. The record high prices were in the fall of 2005 when the same Kentucky steer calves averaged $119 per hundredweight. Southern Indiana steer calf prices should be similar to these Kentucky prices.

Profit prospects for cow-calf producers looks bright. The industry is at the low point in the production cycle, there is little interest in expansion, exports are now growing, there is a large corn crop this fall, and massive increases in distiller's grains will increase feed supplies. On the downside forage crops and pastures have been ravished in some areas and an uneasy U.S. economy could loom as threats.

Hog Margins Get Squeezed by Feed Costs

Chris Hurt

Hog producers have continued to modestly increase the size of the breeding herd in 2007 and 2008. This means that pork production is moving upward by 3% in 2007 and about 2% in 2008. Thus, per capita supplies are expected to increase by 2% in 2007 and again by about 1% in 2008. As a result of higher available supplies per person, hog prices are expected to ease modestly in 2008.



Pork exports have been an important demand stimulate. From 1990 to 2006, pork exports set new record highs for 16 consecutive years. That string of records will likely be broken in 2007 as pork exports are expected to drop as result of sharp reductions to Mexico, our second largest pork customer. Current estimates are for 2008 exports to return to the trend of new record highs.

Barrow and gilt yearly average prices have been surprisingly stable since 2005 ranging between $47 and $50 on a liveweight basis. For 2007, prices are expected to average about $49. With higher per capita supplies in 2008, they may drop to about $48.

While yearly average hog prices have been in a narrow range, costs of production have been more volatile with unstable feed prices. Hog costs of production was near $40 per live hundredweight in 2006, but rose to near $47 in 2007 and are expected to rise further to near $49 in 2008. Thus, higher feed prices have largely eliminated the profit margins the hog production industry was enjoying prior to surging corn and soybean meal prices late 2006.

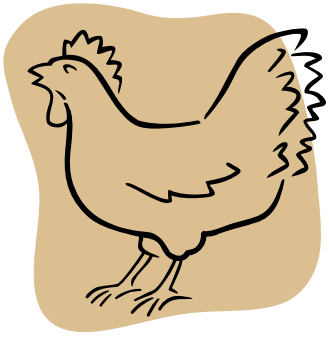
Hog prices this fall and winter are expected to average in the $46 to $48 range then move back toward the $50 to $52 level for averages next spring and summer. With costs of production moving upward to the very high $40s this means the industry may operate at small losses this fall and winter, and at slight profits next spring and summer. Overall the next 12 months appear to be near a breakeven situation. Breakeven is not a tragedy since our definition of breakeven means that all costs of production are covered including full depreciation, return on equity, and hired and family labor are provided a fair wage.

Some have argued that the hog industry has not had to adjust supplies to the realities of higher feed prices due to biofuels and other world events. It is true that pork production has not dropped. However, since the pork industry was operating with strong profit margins when feed prices began to move higher, producers absorbed the higher costs by sharply reducing margins. Thus the impact of higher feed has compressed hog producer margins rather than force a cut back in production as was evident in the beef, broiler, and egg sectors.

Poultry Industry Ready to Expand With Large Corn Crop

USDA

The broiler and egg production industries reacted quickly to higher feed prices in the fall of 2006 and early 2007 by cutting production. As a result chicken and egg prices moved up rapidly. In the first three quarters of 2007, wholesale broiler prices were 23% higher compared to the same period one year earlier and egg prices rose by 50%. The expected percentage changes in 2007 annual prices compared to 2006 are broilers up 21%, turkey up 6%, and eggs up 43%.



Looking forward to 2008, poultry production is expected to rise with broilers up 2%, turkey up 1%, and egg production up 2%. Prices are expected to moderate somewhat with broiler prices falling from 78 to 76 cents per pound, turkey falling from 82 to 78 cents per pound and eggs dropping from 103 to 94 cents per dozen.

Big National Corn Crop, But Not for All

Chris Hurt

The market needed more corn in 2007, and producers responded. In September, USDA estimated the nation's corn crop at 156 bushels per acre and a record total crop of 13.3 billion bushels. Yields were about 3 bushels above trend with a total crop that is 2.8 billion above last year. For Indiana, statewide yields were estimated at 160 bushels per acre but there were wide ranges from as low as 132 bushel in east central Indiana to 176 bushels in the west central part of the state.

Record usage due to the huge growth in ethanol production is expected in the 2007/08 marketing year. Total usage will grow to 12.8 billion bushels with ethanol use expanding to 3.3 billion, or 27% of total usage. Ending stocks of corn are expected to increase to 1.7 billion bushels with average U.S. prices received by farmers averaging $3.10 per bushel. World stocks will remain very tight, with ending stocks levels near the record lows of the mid-1970s. Tight stocks and the low value of the U.S. dollar mean foreign export demand will remain strong and compete heavily with livestock producers and processors for inventory.

The ethanol industry is expected to experience some growing pains this fall and into 2008. Ethanol producer margins are expected to narrow and reach breakevens or even losses. This will likely slow down some plant construction and may result in fewer bushels moving into ethanol use. The question of how much ethanol plants can pay for corn appears to be a factor that may limit corn's upside price potential. Breakeven levels are currently about $3.00 to $3.50 per bushel, and prices above $3.50 may begin to result in some ethanol plants running at less than capacity.

Corn prices for Indiana producers are expected to average about $3.30 per bushel in the coming year. Harvest prices are expected to be around $3.00 per bushel. Strong seasonal price increases are anticipated with prospects for corn prices to reach $3.50 to $3.70 late in the storage season. This means that gross storage returns may be around 60 to 70 cents per bushel. Returns to on-farm storage space after deducting interest costs are expected to be 45 to 55 cents per bushel for storage into late-spring or early-summer of 2008.

Basis levels will be very weak around harvest due to record corn production and an early harvest compounding logistic difficulties. In addition, Ohio River markets in Southern Indiana are experiencing the highest barge freight costs since Hurricane Katrina in 2005, this widens the river basis. The wide harvest basis and growing internal ethanol demand in Indiana means that basis should appreciate more than normal. This will help contribute to stronger than normal gross returns to storage.

The decision to use commercial storage may not be as easy. That decision will need to be made according to local storage charges and an individual's willingness to speculate for higher prices. It is not unreasonable to expect commercial storage charges to move higher this fall. This will especially be true for those areas with high corn yields. In some instances those charges and interest costs are similar to the 60 to 70 cent gross returns to storage.

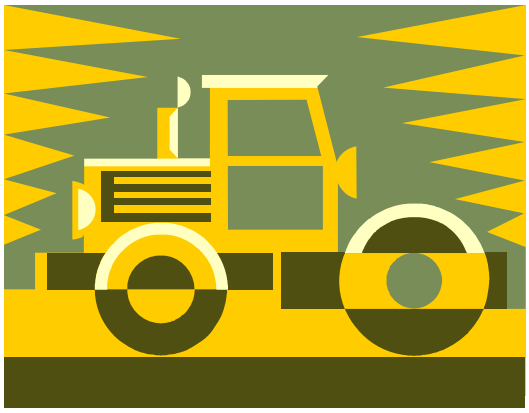
Given the concerns over narrowing ethanol margins, large price increases, as occurred last year during the storage season, are not expected. This means that forward pricing corn in storage but for delivery next summer should be considered. That forward pricing can be achieved in either the cash or the futures markets. In the cash market "forward cash contracts" or "hedge-to-arrive" contracts can be used. In the futures market that will mean futures hedging. In general, it probably is best to not set the basis this fall.

For 2008, corn acreage is expected to decline somewhat as the focus may shift to soybeans and to wheat. However, you will want to stay flexible until the winter as market events continue to develop. Since the world has tight supplies of most crops, those that are in the greatest need of acres will provide large price incentives for their production in 2008.

Soybeans Supplies Shift From Surplus to Short

Chris Hurt

The 15% drop in national soybean acreage and slightly above average yields of 41.4 bushels per acre will result in a crop of 2.62 billion bushels or 18% below last year. The large reduction in production means that soybeans will move from record surplus inventories of 555 million bushels as of September 1, 2007 to tight supplies by next spring and summer. Expected ending stocks for the 2007/08 marketing year are only 215 million bushels, the tightest since the 2003/04 marketing year.



For Indiana, USDA crop reporting district yields range from 48 bushels per acre on average for the northwest Indiana district, to a low of 36 bushels for east central Indiana. Similar to corn, there are wide variations across districts and even within neighborhoods depending on rain patterns.

In the year ahead, domestic crush is expected to remain high as the use of soy meal remains strong and the use of soy oil for biodiesel continues to grow. U.S. exports will have to be reduced by about 13% due to lack of availability (or rationing). The world market thus must rely more heavily on South America where soybean acreage is expected to rise by 4% with production up by 2%.

Basis levels are terribly depressed this fall with large soybean inventories still in store from the 2006 crop and a record amount if 2007 crop corn coming in an early harvest. While corn can be stored in temporary storage outside, soybeans require permanent storage facilities. Basis bids are 50 to 75 cents under the November futures at elevators. But, basis should improve by 40 to 50 cents as surplus soybeans this fall become short soybean inventories by next spring and summer. In addition, the addition of the new Louis Dreyfus crushing facility in Kosciusko County of Northern Indiana means that bean demand will be increasing and provide additional basis gains for the central and northern sections of the state.

Indiana soybean prices are expected to average about $8.40 to $8.80 this marketing year. If so, this means that harvest prices may be in the $8.00 to $8.50 range and then move upward to provide pricing opportunities that are around $1.00 higher. On-farm storage returns after interest is deducted may provide about 55 to 65 cents of return per bushel for the grain bin and the producer's time. Positive returns are also expected for commercial storage after deducting both interest and storage charges. Storage charges do vary and some may be high enough to sharply reduce the odds of earning a positive storage return.

Planting progress in South America will be watched closely this fall. Market prices will likely be very sensitive to any adverse weather there. Another important variable this year will be export sales. Given the weak U.S. dollar and the strong appetite for soybeans, foreign buyers may be slow to reduce purchases as forecast by USDA. Strong export sales could mean soybeans would follow a pattern similar to wheat where foreign buyers have not slowed purchases even in the face of record high wheat prices. If the same "buy at any price" attitude were to develop in soybeans, or if South American weather becomes threatening to their crop, then soybeans could be in for a more bullish upward pattern.

As an overall statement, soybeans provide higher returns to storage and probably have greater upside price potential for those who store and speculate. Thus, producers with limited storage space may want to store soybeans first and then allocate their residual space to corn.

Expect futures markets to provide price incentives for more bean acres in 2008.

Wheat: Record Prices Mean Wheat/Double Crop Beans

Chris Hurt

U.S and world wheat inventories will be low this year primarily due to poor yields in some growing areas including Australia, Canada, portions of Europe, and below normal yields in the U.S. Tight stocks mean record high wheat prices. Wheat supplies have tightened such that wheat is no longer a partial feed grain, but priced only as a human food grain. For this reason, wheat prices have moved sharply above corn prices.

Prospects for exports have been propelling wheat to record high prices in recent weeks. Strong world economic growth rates and the weak value of the U.S. dollar keep wheat buyers coming back to the U.S. This is reflected in export sales which as of late August were twice the level of sales at this time last year.

Wheat prices in Indiana were $5.00 to $5.50 around harvest, but have moved upward since to well over $7.00 per bushels. Most Indiana producers sell wheat around harvest or somewhat after. As a result most of the Indiana wheat has already been priced. For those still with wheat in store, seasonal prices tend to increase into December which histori-

Wheat: Record Prices Mean Wheat/Double Crop Beans Cont.

Chris Hurt

cally has been a strong pricing time period.

U.S. average prices of wheat for 2007/08 are expected to reach a record $5.80 per bushel. Worldwide acreage is expected to increase for next year's crop and assuming normal yields, wheat prices are expected to move lower and average closer to $5.50 per bushel. These are still very strong wheat prices and will encourage more wheat acres.

Since most Indiana wheat has already been sold, the focus now is on the decision to seed 2008 crop wheat this fall. Purdue budgets for 2008 suggest that those who are in the southern one-third of the state and can effectively produce wheat and then double crop soybeans next year should strongly consider this crop mix. Projected returns are currently $30 to $60 higher than single crop corn or soybeans for that part of the state. However, further north, single crop wheat does not appear to be competitive with single crop corn or single crop soybeans given current 2008 futures prices. Both single crop corn and soybeans appear to beat single crop wheat by a wide margin. But also keep in mind that Purdue's returns for wheat do not add any return for wheat straw which is an important revenue source for some wheat producers.

Crop Input Costs Swell for 2008

Alan Miller

Prices of several important crop inputs are expected to increase in 2008. Demand for corn for ethanol in the U.S. has increased corn acres and is certainly a factor contributing to increased demand for corn production inputs. Higher crop prices, changes in cropping patterns in favor of more corn, and changes in cultural practices also influence farmers' decisions about the optimal amount of input to use and are likely to add to demand for inputs in the U.S. Higher corn and soybean prices worldwide are also likely to increase demand for crop production inputs worldwide leading to increasingly tight supplies and higher prices.

The perception that farmers will have more money to purchase inputs and widespread optimism about the farm economy at the current time are undoubtedly influencing expectations about the direction of crop input prices for the 2008. However, U.S. producers and producers worldwide may attempt to counter relatively high price levels for key inputs through becoming more efficient with their input use. Forecasters expect a lot of uncertainty about to what extent optimism will translate into additional product sales and higher prices for the whole range of inputs, particularly for those that are discretionary such as purchases of new farm equipment. With uncertainty comes price volatility, so farmers who are purchasing inputs will really have to stay on top of their purchasing management for 2008.

The cost of producing corn and soybeans in Indiana has risen every year since 2002. The 2008 growing season clearly promises to continue that trend. Purdue's cost and returns forecast for 2008 currently indicates that the variable costs of growing average yield rotation corn will increase approximately $37 per acre or almost 16 percent relative to the forecast cost for 2007. The per acre variable costs of growing average yield rotation soybeans are forecast to increase $19 per acre or approximately 16 percent. The variable costs of growing average yield wheat are expected to increase $25 per acre or 21 percent. Purdue's estimates indicate Indiana corn growers will sink an extra $129 per acre into average acre of 2008 crop rotation corn when compared to 2002. The corresponding amount for soybeans is $42 per acre. Clearly the grower's financial risk exposure increases as the dollars invested in an acre of crop increase.

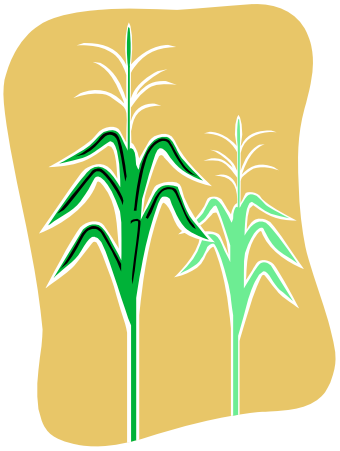
Fertilizer costs in the Purdue costs and returns forecast are based on the expectation that fertilizer prices will increase from 3 to 20 percent in the Corn Belt in 2008 relative to prices reported by the Agricultural Statistics Board, NASS, USDA, in April of 2007. Price increases will vary with the type of product. Factors contributing to the higher prices including growing demand worldwide for fertilizers and modest world supply growth in the capacity to supply fertilizers. The Fertilizer Institute recently reported that from the 2001 to 2006 fiscal years, world nitrogen demand grew by 14 percent, phosphate demand grew by 13 percent, and potash demand grew by 19 percent. The fastest growing markets were China, India, and Brazil. US consumption of N, P, and K appears to have increased significantly for the 2007 crop more than offsetting declines the previous two years.

According to the US Energy Information Administration's current short-term outlook, natural gas prices are expected to average eight percent higher in 2008 than in 2007 which will tend to prop up ammonia prices and other N fertilizer prices. But, increased demand largely driven by more corn acres may push N fertilizer prices in the US above the level implied by natural gas prices, as was the case during the last half of 2006. Very strong demand for urea is expected to keep the international market for urea

Crop Input Costs Swell for 2008 Cont.

Alan Miller

particularly tight and prices for urea based products are likely to bring a larger price premium relative to anhydrous ammonia than usual.



Chemical prices are forecast to creep up in 2008. Price increases for chemicals as a group should be modest overall (in the 2 to 6 percent range), although they may be more pronounced for new formulations and for products in high demand. The high price of energy is one factor that likely is contributing to increased chemical prices.

Seed is expected to be available in adequate quantities and quality to meet producers needs despite the drought conditions in some of the seed growing areas in Indiana and the U.S. Prices for many seed varieties are expected to increase significantly. This is particularly true for corn varieties carrying biotech traits. The rapid adoption of biotech corn in Indiana continued in 2007. USDA numbers indicated that 59 percent of the 2007 corn acreage in Indiana was planted to biotech varieties. This is an increase of 19 percent over the year earlier. Stacked trait corn varieties accounted for roughly ninety-five percent of that increase with the rest attributable to herbicide-tolerant-only varieties.

Soybean acres planted with biotech seed rose two percent in 2007 to 94 percent of the total planted acres in Indiana.

News from the seed industry suggests that seed prices will increase from 15 to 25 percent overall for 2008. Increased technology fees, higher crop production costs, and the high cost of research and development are among the factors contributing to higher seed costs. Wheat seed prices appear to be up around 30 to 35 percent this fall. High wheat commodity prices are to be a major factor contributing to higher wheat seed prices.

The US Energy Information Administration's current short-term outlook indicates that diesel fuel prices are likely to average around six percent higher in 2008 than in 2007. The supply of diesel fuel in the US has been tightening up this year and the price of crude oil is expected to average a little over five percent higher in 2008. U.S. supplies of propane have been below the normal range since the end of last winter's heating season. Inventory of propane nationwide is down almost 10 percent relative to stocks on hand one year ago at this time. Midwest supplies, although rebuilding, remained a little over 14 percent below the previous year as of mid-August. Rising oil prices and tighter propane supplies suggest that propane prices may be up as much as 5 to 10 percent this fall relative to last fall's prices.

Crop insurance premiums followed crop prices higher in the spring of 2007 and will likely remain at the relatively higher level in 2008 if crop prices stay up. The average net premium paid across all insured corn acres in Indiana and across all product types was $22.88 per acre according to information from the USDA Risk Management Agency. The average net premium paid for soybeans was $11.31 per acre across all product types. The Revenue Assurance (RA) and Crop Revenue Coverage (CRC) products insured about 58 percent of Indiana's 4.2 million insured corn acres. Group Risk Income Protection (GRIP) insured about 28 percent of the corn acreage. RA and CRC insured about 54 percent of the insured soybeans and GRIP insured about 24 percent. Current corn and soybean prices would likely indicate somewhat lower premiums for corn in 2008 and higher premiums for soybeans.

As per acre variable costs of production rise, they squeeze the amount farmer's can afford to pay to rent cropland. But farmers' must also consider their farm machinery and labor costs when determining their ability to pay rent. Demand for equipment is forecast to be up for 2007 relative to 2006 and that likely will be true again in 2008 if crop prices and optimism continue to be buoyant. As a result farm machinery prices are expected to rise. The USDA's index of prices paid for farm machinery has been marching steadily upward in recent years at an annual rate of roughly five percent. By July 2007 the index was already up 4.4 percent relative to December 2006. Similarly, the index of prices paid for farm wage rates has indicated an average annual rate of increase of around 4.6 percent. Compared to Purdue's forecast for 2007, as published in the 2007 Purdue Crop Guide, the current estimates would indicate that farmers' will not be able to afford to bid as much for rent in 2008 as in early 2007.

Rethinking 2008 Land Leases

Luc Valentin

Rising crop prices serve to enhance margins, but rising variable costs serve to squeeze them. Thus both affect the amount of rent that can be paid. Producers' also must also consider farm machinery and labor costs when determining their ability to pay rent.

With the price of land having gone up significantly over the last years and with corn and soybean prices reaching new levels there is little doubt that land leases will have to be renegotiated at a higher level. This process can be dreaded by both landlord and tenants as information of current market rate for land can be scarce and somewhat distorted depending on the source.

Not only have returns per acre increased but also the uncertainty of those returns. Thus in establishing returns both level of returns and the riskiness of those returns should be considered. In negotiating between landlord and tenant, it is important for both to understand the tradeoff between expected returns and risks with different rental arrangements. Simply stated, the higher the expected return, the higher the risks.

From a landlord perspective, a cash rent agreement may provide the lowest expected return, but also the lowest risk level. At the other extreme, a crop share lease may have the highest expected return and the highest risk. Between these two is a flexible lease where the landlord has some opportunity for higher (or lower) returns but also takes some additional price and yield risks.

For the tenant the situation is opposite. The less risky situation is the share rent agreement where the risks are split between tenant and landlord. It may also have the lowest potential income. With cash rent, the tenant bears all the risks, but may also have higher returns over a period of time.

Given the recent dramatic changes in higher crop prices and higher input costs, both landlords and tenants are rethinking these arrangements as well as just what level of return should go to the land. This can be a delicate process especially given the high level of uncertainty in crop prices and input costs expected in coming years. In 2007, landlords may feel that they have not received enough compensation when compared with a share lease. The answer to these concerns may be to consider a flexible lease.

Before signing an agreement it would be advisable to have local FSA office officials review the agreement to make sure it meets the objectives of both parties. Finally look for the web based tool that will be put online this fall on the Purdue agecon web site to weigh different lease alternatives.

Land Prices and Rents Expected to Move Higher

Craig Dobbins

The June 2007 Purdue Land Value and Cash Rent Survey found that Indiana farmland values and cash rents moved sharply upward. Cash rent for average quality farmland increased by 9.4% to a value of $139 per acre. Average farmland in Indiana increased 16.6% to a value of $3,688 per acre both compared to one-year earlier. These were the strongest increases since 1977 and continue the positive trend since 1986.

Higher grain prices are the most important key in the upward surge and current futures markets indicate that corn and soybean prices are expected to stay strong. Corn prices for December 2008, 2009, and 2010 are trading at $3.91, $4.08, and $4.05 per bushel, respectively. Soybean prices for November 2008 and 2009 are trading at $8.93 and $8.69 per bushel. These prices signal a significant increase in crop revenue.

While the higher prices are welcome, price volatility has multiplied as well. Markets continue to search for the price levels needed to encourage the "correct" quantities of corn, soybean, and wheat production. Thus market prices are making both significant and rapid adjustments. This means that margin risks are not much higher.

Increased revenue from crop production has relaxed some of the pressure that were holding down price increases for purchased inputs such as seed, fertilizer, chemicals, and machinery. The cost of nearly all crop production inputs are expected to be higher next year. These price increases push up per unit production costs.

The new environment has also created uncertainty about how to divide the net return that remains after paying for crop production inputs, the investment in machinery and facilities, and labor to produce the crop. One part of this net return represents the return to land. Another part of this return represents the return to risk taking. In today's production agriculture where fixed cash rent leases are common, these returns often go to two different people – the landlord receives the return to land and the tenant receives the risk taking return. The increased variability in the margin for land and risk makes picking one number for the "right" cash rent very difficult. In many situations, the increased variability of returns may make the use of a flexible cash lease attractive.

Enterprise budget estimates indicate that the margin representing the return to land and risk is larger than in years past. At $3.25 corn and total corn production costs excluding land and risk of $358 per acre and $7.80 soybeans and total soybean production costs excluding land and risk of $221 per acre, the return to land and risk for a corn-soybean rotation would be approximately $175 per acre.

Land Prices and Rents Expected to Move Higher Cont.

Craig Dobbins

In addition to indicating larger margins, projected enterprise budgets also indicate that the variability in this margin is also much greater. A University of Illinois study indicates that for the tenant to have the same chance of a return the tenant's risk premium in this new environment needs to be more than twice as large as the risk premium in the period from 2001 to 2005. If prices in the above example are 10% higher, corn at $3.58 and soybeans at $8.59, the margin representing the return to land and risk would be $220 per acre, an increase of 26%.

Cash rents are expected to move strongly higher in the year ahead. Budget projections indicate increases of 10% to 25% could occur. Last year, many rents were set before the sharp rise in crop prices occurred. These cash rents may need to do a little "catching up" and thus be toward the upper end of the range. For those cash rents that were adjusted last year, or for areas hit hard by dry weather this summer, the changes will be lower. In this environment, it is important to devote time to budgeting each individual situation and developing a sound risk management plan.

It is important to recognize that the current commodity program safety net provides little safety at the new price levels. Asking "what if" questions and developing plans to manage the margin risk is important this year. Loss of the government safety net and higher input costs and rents mean that price declines could turn "anticipated" positive returns into losses more quickly than in the past.

The expectation that improved returns to land from crop production will continue to push farmland values higher. Combining these expectations about future returns with the limited supply of farmland on the market, an increased demand from farmer and others wanting to invest in farmland, modest long-term interest rates, and the strong liquidity position of buyers indicates that farmland values are likely to continue their strong upward movement.

What do 10% to 25% higher cash rents imply for land values? A 10% increase would push rents to $153 per acre for 2008. At a 4% capitalization rate average farmland values might be in the neighborhood of $3,825 per acre, an increase of about 3.4%. If the land rent increases 25% to $174 per acre, farmland values might approach $4,325 per acre, an increase of 17%, assuming the capitalization rate stays the same.

On the negative side of the land market, there is currently some uneasiness in financial markets that could push long-term interest rates higher. The housing market may not be the only market that has been undervaluing risk. A rise in long-term interest rates because of the need for a larger risk premium would increase the capitalization rate and reduce the increase in farmland values. The higher prices for farmland may also convince more owners that it is time to sell, increasing the supply of farmland for sale. However, the current market still appears to be characterized by more buyers than sellers.

Finance and Agribusiness Outlook

Mike Boehlje and Chris Hurt

The financial performance of farm and agribusiness firms has been very strong in 2007. Expectations are that improved earnings, sales, equity growth, and stock prices should continue for 2008. For example, Deere recently reported a 23% increase in second quarter earnings compared to last year, and projected a 7% increase in sales for the upcoming year in spite of a slowdown in the construction industry. Other agribusiness companies in the fertilizer, seed, chemical, and grain storage industries as well as grain merchandising report similar strong financial performance this past year and very positive expectations for the remainder of 2007 and 2008.

The Indiana farm sector is in the midst of a boom in their financial wellbeing as well. Indiana farm income was $1.5 billion in 2006, about 25% higher than the average annual income for the previous ten years. Purdue estimates for 2007 are for farm income to reach $2.2 billion or an additional 45% above 2006. In addition, these strong farm incomes are not expected to fade in 2008 and to thus remain near $2.2 billion. Contributing to the high farm income are high prices for crops, milk, broilers, and eggs. Hog and turkey producers have not shared equally in the income improvements due to higher feed costs without major increases in the process of the products they sell.

Higher incomes are only one measure of the improving Indiana farm financial situation. Another is increasing levels of financial equity. In 2007, the equity position of Indiana farms improved by an estimated $8.3 billion. Thus, the equity increase in 2007 was the equivalent of about 7 years of average income ($8.3 billion divided by $1.2 billion average annual income for the previous ten years). The large increase in equity is mostly driven by 17% higher land values in 2007.

Equity per farm in Indiana is now estimated at approximately $1 million on average and has grown by an estimated $330,000 in the past four years as land values have risen 47%. The standard measure of solvency or risk bearing ability in the agricultural sector – the debt to asset ratio -- has declined to a 50 year low of 12.1% -- that ratio peaked in the mid-80s at 25%.

Finance and Agribusiness Outlook Cont.

Mike Boehlje and Chris Hurt

Can these good fortunes continue for Indianan's farms and agribusinesses? What are the risks? Clearly, the financial and capital markets have seen a resurgence of risk in the past few months. The rapid growth of subprime mortgage financing combined with the slowdown in the housing market and the recent reassessment of credit quality has created turmoil and a liquidity crunch in the financial/credit markets. This has resulted in an increased risk premium in interest rates. Generally higher interest rates put downward pressure on asset values and under-mine the financial feasibility of highly leveraged assets. The current turmoil in the financial markets is not expected to have a major impact on interest rates in agriculture – in fact, it may encourage the FED to lower interest rates to encourage financial stability. If so, the costs of short term operating funds might fall. However, a larger risk premium may be needed by capital markets in long-term mortgage financing. This may result in a .10 to .30 percentage point increase in long term mortgage financing for farmland purchases.

But the greater immediate risk in agriculture relates to margins – farmers are expected to face both margin compression and greater margin risk in 2008. As suggested in the outlook for inputs and land values/rents, farmers will encounter higher input costs and cash rents. Plus, prices for commodities are expected to be more volatile given the record low world stocks. Higher costs will likely result in margin compression for corn and soybean producers (more for corn than soybeans).

These cost increases in combination with commodity prices well above the government price safety net results in significant risk to margins. Just to illustrate, with a $3.00 price for corn and cash cost per bushel of approximately $2.30, margins per bushel would be approximately 70 cents. In this situation, the potential of a negative margin is almost zero since the government support price system of LDPs, counter cyclical payments, and direct payments provides a safety net price equivalent of almost $2.30 per bushel (assuming that the farmer gets normal yields or protects the yield risk with crop insurance). On the other hand, if cash cost increase by 20% to $2.75 this next year, average margins would decline to 25 cents per bushel assuming $3.00 corn, and the margin risk exposure increases as well because prices could decline below the cash cost of production of $2.75. In a worst case scenario, assuming no change in the government program, the government safety net of $2.30 per bushel results in the potential of up to a 45 cent loss if prices were to decline below the cost of production.

In general, the business climate and financial outlook for the farm and agribusiness sector is very favorable for the next 1-2 years at least. But that favorable outlook is not guaranteed, and one should be cautious as both cash costs and price variability increase in the future. Higher costs result in margin compression unless those cost increases are offset by higher prices. And remember that the real risk of concern is not price risk, but margin risk. And margin risk is expected to increase dramatically for grain farmers in particular during the next 1-2 years.

Producers are thus encouraged to focus on "managing margins" in the next several years. Managing margins implies consideration of costs and revenues at the same time. Rather than just pricing inputs one must also price inputs with a view to locking in and protecting margins. The same is true for pricing grain. Margin managers will want to attempt to both price grain and price inputs to establish margins. Crop insurance will be a critical tool in helping to protect margins. In addition, the concept of managing margins also implies that producers are constantly evaluating both the anticipated margin levels but also the risks that could jeopardize their margins. Then they should develop trigger points when margins are jeopardized and a plan to deal with the margin threats.

Conservatism and diversification are also advised. Conservatism means not taking major positions based on a "hoped for outcome." For example, someone might buy a large position in corn futures at $4.00 because they felt corn would go to $5.00. Or someone might buy a large amount of land at $5,000 because they felt it would go to $7,000 per acre. Another example would be a tenant that locks in above-market cash rents for the next three years based on the "hope" that cropping returns will continue to increase as more corn is used for ethanol.

Diversification is a clear concept to most. This new era is being influenced by many factors such as energy prices which can change quickly and adversely. Government energy policy in the U.S. and around the world could also quickly alter outcomes as well as many other factors. Diversification keeps producers and agribusiness managers from having too many financial eggs in one basket. The objective is to increase the odds of survival by managing downside risks while still leaving an acceptable amount of opportunity in place if outcomes move to the upside.

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