

The Kentucky Agricultural Economic Outlook for 2003

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The Kentucky Ag Economy Larry Jones

2002 Review: Kentucky's farm product sales likely declined nearly 12% to \$3.1 billion during 2002 after registering more than \$3.5 billion sales during 2001. This level of sales is the lowest since 1995. In fact total farm cash receipts for 2002 was more than 10% below the average of the past ten years. Crop receipts during the past year were more than 26% below the past ten year average while livestock receipts in total were actually 2% above the past decade average. The 2002 decline was led by significant losses of revenue in the equine sector and in tobacco sales. Equine cash receipts declined by \$175 million in 2002. The effects of Mare Reproductive Loss Syndrome explains a significant portion of the decline. The Keeneland July (2002) yearling sales value, for example, was off approximately 33%. The decline in total equine sales was tempered, however, by rather stable values in stud fees and in the value of breeding stock sold. Tobacco farm product sales declined an estimated \$86 million due to challenging growing/curing conditions and lower effective quotas. Although equine and tobacco collectively represented 57% of the decline in farm cash receipts during 2002, other agricultural commodities also recorded major declines including cattle/calves, dairy,

hogs, grains, oilseeds and hay. These declines occurred for a variety of reasons including the fact that Kentucky suffered major weather problems. Poultry cash receipts, including broilers and eggs, continued to increase with 2002 sales estimated at \$617 million making this sector the second largest contributor to Kentucky farm cash receipts, just behind equine. But once the final numbers for 2002 are compiled it is possible that the poultry sector will be the largest contributor to Kentucky's farm cash receipts. Other sectors registering product sales increases included vegetables, fruits/nuts, floriculture and ornamental products. Collectively these commodities probably represented about \$80 million. Kentucky's agricultural exports increased nearly 28% during FY 2001, reversing a three year decline. Higher foreign sales of live animals, un-manufactured tobacco, soybeans, wheat and corn accounted for most of the increase. U.S. exports, in contrast, increased 3.9%.

2003 Outlook: Farm cash receipts are expected to rebound about 10% in 2003 and reach nearly \$3.4 billion. Interestingly this figure would just be the average of farm cash receipts for the past decade. Most of the increase will be led by the livestock sector, notably equine and cattle/calves. Equine sales are expected to rebound following the effects

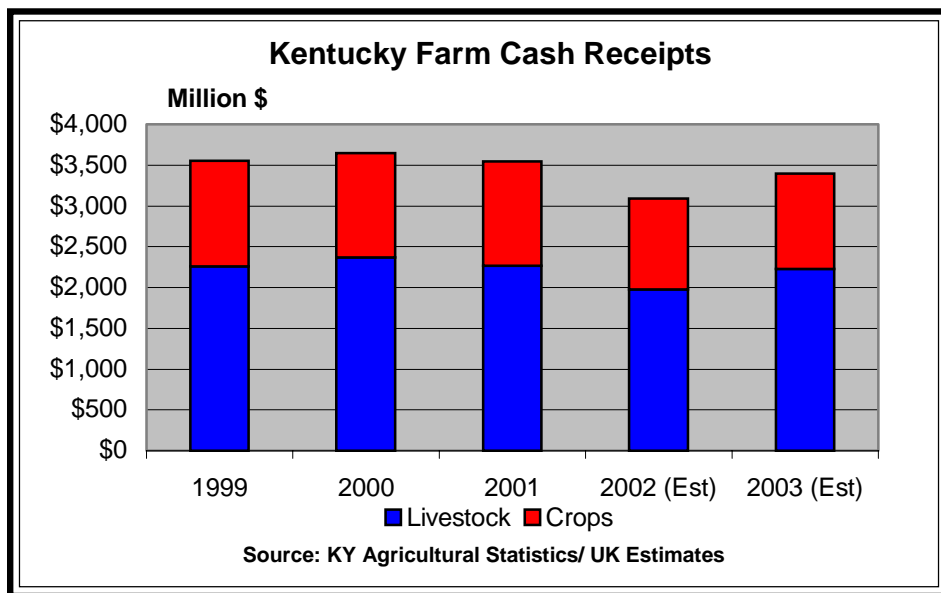
of MRLS while cattle/calves cash receipts will increase significantly. Poultry, hogs and dairy should record some increases. The crop sector will increase a more modest 4.5% and be primarily led by corn cash receipts. Tobacco, which has historically been the state's largest contributor to farm cash receipts, is expected to remain near \$500 million making it the fourth largest commodity grown in the state for the second consecutive year. Most other crop commodities are expected to show small gains in product sales. Farm exports for Kentucky during FY 2002 will likely soften due to expected declines in exports of live animals and meat and tobacco whereas U.S. exports expected to continue to increase into FY 2002.

Kentucky Financial Outlook Gregg Ibendahl

2002 Review: Due to the summer drought, net farm income in Kentucky probably fell to a near 10-year low. Compounding low net farm income was a reduction in cash-flow. Reduced cash-flow was actually a more serious problem for Kentucky farmers than the reduction in net farm income. While the new farm bill will probably, in the long-run, be very beneficial to most farmers, it didn't provide much cash-flow in 2002. Farmers received a direct payment, but in many cases this payment was needed to offset the advance taken under the old farm bill. Government payments tied to the counter-cyclical and loan deficiency payments was limited. Even though grain prices were higher in the fall of 2002, farmers were financially worse off because of the reduction in yields and government payments.

Fortunately, most Kentucky producers had strong financial positions. However, there were many exceptions. Even though total debt continued to increase, the increase in farmer equity had been even faster. The result was that debt-to-asset ratios, which are a good indication of financial leverage, remained relatively low.

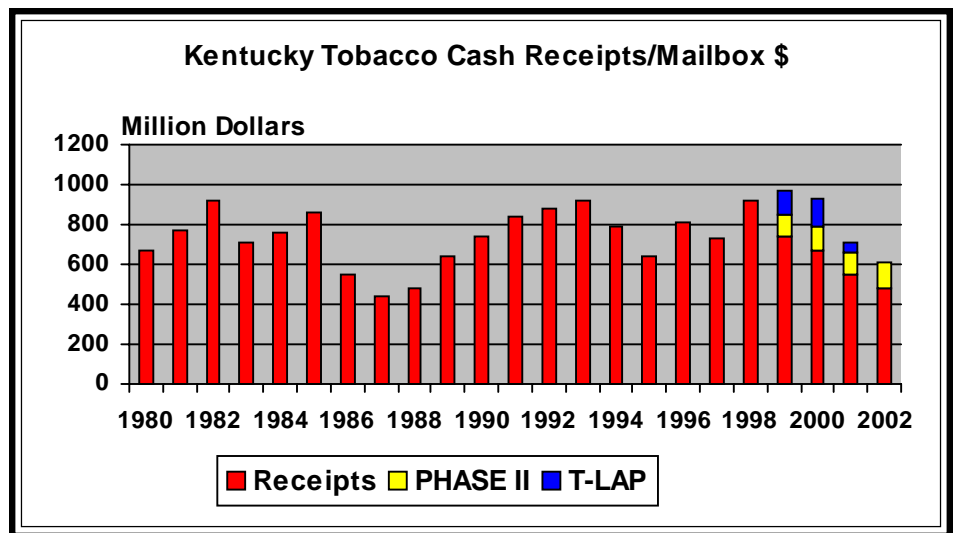
2003 Outlook: 2003 should be better provided Kentucky has more normal weather. More summer rain in the Midwest should increase yields while lowering prices. However, good yields, low prices, and larger government payments will make both grain and livestock producers better off than in 2002. The worst



thing to occur this year would be for Kentucky to experience a drought while the rest of the Midwest has normal rainfall. Balance sheets of Kentucky farmers should also remain in good shape as the 2002 farm bill will continue to support land prices.

Tobacco *Will Snell*

2002 Review: Burley tobacco quotas were reduced 2% in 2002 resulting in the third straight year of relatively low, yet stable quotas. Dark tobacco acreage allotments were cut by more than 20% last year primarily in response to several years of over-production. Tight quota supplies, coupled with Phase II payments and buyout speculation boosted lease prices to record high levels. Production of the 2002 burley crop was certainly challenging given periods of unfavorable growing and curing conditions. Consequently, marketings of the 2002 burley crop fell short of the quota, which encouraged tobacco companies to purchase nearly 50 million pounds of pre-2002 burley pool stocks. Contracting expanded to approximately 3/4 of the crop vs. 2/3 of the 2001 crop being sold via contracts. In addition to a larger percentage of the crop being delivered directly to receiving stations, contract prices continued to exceed auction prices, leading to much uncertainty over the future of the auction marketing system. Snuff consumption rose for the 15th straight year, while domestic cigarette production, consumption, and exports continued their downward spiral, albeit at a much slower decline than in recent years. Excise taxes on tobacco products were increased in more than 20 states. Imports of burley leaf and cigarettes expanded, while leaf exports remained sluggish. Consequently U.S. burley use may have declined below 400 million pounds, with Kentucky tobacco cash receipts perhaps falling below \$500 million for the first time since 1988. Despite a lot of production and economic issues confronting the sector, the majority of discussion across the tobacco belt in 2002 focused on the potential of a tobacco quota buyout.



2003 Outlook: World burley production is expected to increase in 2003, however U.S. burley growers may not be in a competitive position to capitalize from this burley expansion. Examining the quota formula reveals that burley quotas may, at best, remain near recent levels. Despite adequate inventories, dark tobacco acreage allotments could rebound marginally in 2003. U.S. cigarette consumption is expected to revert back to its traditional annual decline of 2-3%, but price competition in the domestic cigarette market may result in discount and imported cigarettes continuing to expand at the expense of traditional premium domestic brands. This could easily force domestic manufacturers to further increase their utilization of lower-priced imported tobacco, causing additional erosion in purchase intentions and quotas. Consequently, lease prices are destined to remain at relatively high levels again in 2003. Snuff consumption is expected to grow in response to higher cigarette prices, smoking restrictions and the perceived lower health risks relative to cigarette consumption. Finally, while some modest volumes of U.S. burley may eventually be sold in non-traditional markets (e.g., China), U.S. burley exports will struggle to exhibit much, if any improvement.

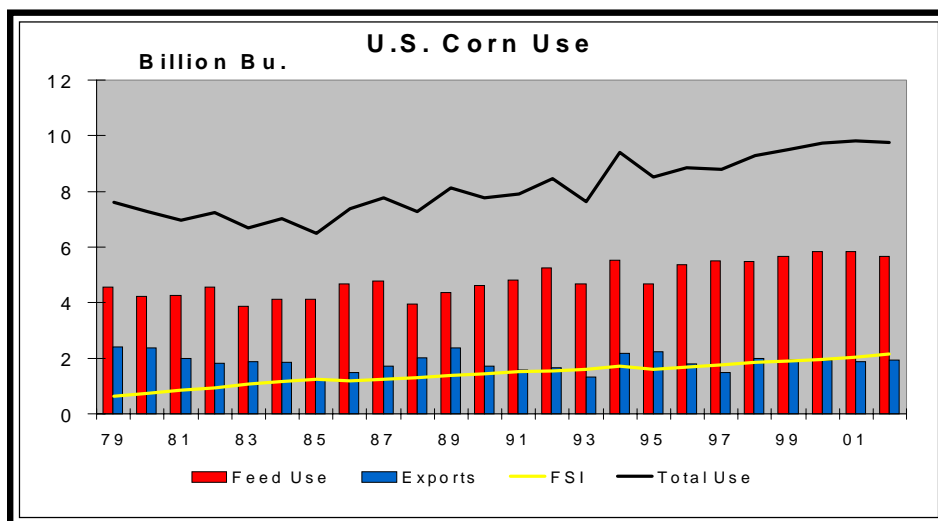
All these adverse market conditions will put even more pressure on farm group leaders and policymakers to successfully legislate a buyout. Farm group leaders will have to strengthen consensus among themselves, tobacco companies, and health groups to move the process forward. This will not be easy given differences among the groups in terms of the four main issues: 1) structure of the buyout, 2) post-buyout tobacco policy, 3) funding, and 4) FDA regulation. However consensus must evolve or the industry will continue to experience declining tobacco quotas and income, escalating rental rates, and possible future elimination of the program with limited or no compensation. Consequently, 2003 could go down in history as the beginning of a major transition period in the Kentucky tobacco economy and culture.

Grains *Steve Riggins*

2002 Review: U.S. corn production for the 2002 crop now looks to total about 9.003 billion bushels, roughly 500 million bushels below last year's harvest and 900 million bushels smaller than the harvest from the 2000 crop marketing year. USDA has forecast 2002 U.S. corn yield to average 127.6 bu/acre (November Crop Report) that is nearly 12 bushels below the trend yield of the past 40 years. As recently as September, market participants were expecting a crop size of only 8.85 billion bushels based on an average yield of 125.4 bushels/acre.

Early spring weather was ideal in the western corn-belt and extremely wet in the eastern corn-belt. It appears that 1-2 million acres of land in the eastern belt never got planted to any crop. The areas in the east that were too wet in the spring (and some States in the western belt) also experienced some degree of drought during the critical pollination phase.

The key question in the corn market is whether USDA's projection of total use of 9.77 billion bushels of disappearance in the current



marketing year is achievable (see graph). With use projected to be the second largest in history and exceed production by 770 million bushels, carryover stocks are expected to continue their decline from 1.9 billion bushels at the end of the 2000 season to 1.6 billion bushels for the recently concluded 2001-2002 marketing year to only 850 million bushels by next August 31. A projected stocks/use ratio of 8.7 percent is small by historical standards and is a reduction of more than 7 percent from last season's level.

The situation for soybeans is one of large production (5th largest in history) but less than had been expected with yield nearly 2 bushels/acre below trend. Reduced supplies are expected to curtail use compared to both last season's record level and the near record disappearance recorded for the 2000 marketing season. Robust demand of U.S. soybeans by China and the projected very tight stocks/use ratio has provided some price strength for U.S. soybeans. However, prospects of increased plantings and projected new record large production of soybeans from South America, for the crop they will harvest this coming March and April, have served to curtail price strength. USDA, in November, projected record large crops of 32.5 million metric tons (mmt), or 1.19 billion bushels for Argentina and 49 mmt — 1.8 billion bushels, for Brazil. If realized, their combined production of 2.995 billion bushels would surpass U.S. soybean production from this year of 2.69 billion bushels. This would be a first for South American soybean producers.

The situation in wheat has been one of sharply reduced acres for the past six years and very poor yields in many States this marketing year. Acreage reduction and the poor yields this year, U.S. average of only 35.3 bu/acre, have produced the smallest U.S. wheat crop since 1972. The gradually shrinking supply of U.S. wheat has more than offset the reduction in demand for U.S. wheat in the export market and the wheat stocks/use ratio has tightened

to only 17 percent compared to 36 percent one year earlier.

Outlook for 2003: The price outlook for U.S. corn and soybeans over the next several months will be heavily dependent on production prospects for corn and especially soybeans in the Southern Hemisphere, weekly export sales and shipments of U.S. grains/products and livestock feed demand in the U.S. By early spring, the driving force behind price outlook will be expectations about acres planted to principal crops in the U.S. Production prospects will then dominant the market news until mid summer.

Current forecast by USDA call for a small increase in U.S. corn exports while wheat exports are expected to be reduced slightly below last year's low level. Soybean exports are projected to be strong, but well below last year's record level; you can't sell what you don't have. These forecast assume that South American soybean production will be record large. A tight supply/demand balance for world vegetable oils is expected to provide more than normal support for whole soybean prices. Further it is assumed that China will be a major buyer of U.S. produced soybeans.

Tight supplies of soybeans, corn and wheat in the U.S. will keep a firm support under the market. This situation requires U.S. farmers to produce large crop supplies next year or prices will go much higher. Increasing production in South America and some countries from the former Soviet Union are somewhat moderating the effect of tight U.S. supplies. The key question is the strength/weakness of global and domestic demand. The very large supplies and consequent low prices of the past few years have spurred increases in consumption. There seems to be ample evidence that the general economy is now less than robust after the longest economic expansion in the history of the U.S. Is it still possible that USDA's forecast of near record disappearance of corn can actually

occur? Export sales and shipment data, to-date, have been very disappointing for corn and wheat. The weekly data for soybeans are somewhat more hopeful with export sales at a very strong level relative to USDA's projection of total annual exports and with weekly export inspections improving dramatically since early October. Weekly sales and shipments of corn and wheat need to improve (the sooner the better), the soybean numbers need to remain strong, and the USDA's numbers on domestic use of grains and soybeans (due for release in January 2003) need to show that domestic disappearance has remained robust.

Livestock and Meats

Lee Meyer

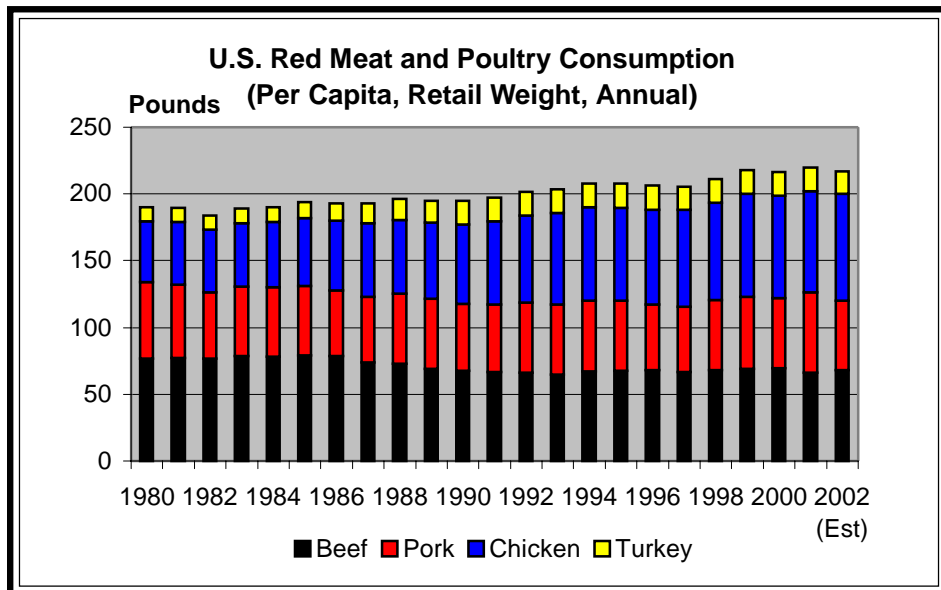
2002 Review: Livestock producers started 2002 with prices near the profitable levels of 2001. Hogs were selling in the upper \$30s and feeder steer calves were mostly in the \$90s. Given the negative impacts carrying over from the fall of 2001, attitudes were positive. Low feed prices were keeping costs down and profits up.

As the year progressed, meat supplies increased dramatically. The amount of both beef and pork rose by over five percent from the year earlier. To compound the problem, the Russian poultry embargo diverted poultry back to the domestic market. These factors put downward pressure on prices. Hog prices dropped by 30%, broiler prices dropped by 10%, as did the prices of both slaughter and feeder cattle.

As the year progressed, it became apparent that corn prices were going to increase. While this was a negative factor, it was partially offset as cattle supplies tightened. The number of cattle on feed late in 2002 was down almost 10 percent. As a result, slaughter cattle prices increased, pulling feeder cattle prices up with them. By the end of the year, feeder cattle prices were only slightly lower than the 2001 level. Hog prices, however, were still down because of very high production, ending the year in the middle \$20s, about \$10 per hundred lower than prices of late 2001.

2003 Outlook: The broiler industry is adjusting to the low prices of 2002. Trade levels in late 2002 were disappointing, but decreasing production in 2003 will help prices recover. The key question still revolves around trade. If domestic supplies decline, prices should recover back to the \$.60 price level of 2001.

The hog industry is beginning to react to the double hit on profits (from both higher feed costs and lower prices) by cutting back on production. Slaughter is likely to stay high enough during the winter to keep prices in the mid \$30s. Cuts in production should hit the market in the spring, moving prices up into the \$40s (live weight basis). Prices for the year should average in the low \$40s, about \$10 per cwt. over last year's level and at profitable levels.



An overall decline in the number of cattle in the U.S. means less beef and higher prices for 2003. While there could be short periods of time when production is only modestly lower, there will probably be about three percent less beef on the market for the year. Slaughter cattle prices should average in the low \$70s, about \$4 - \$7 per cwt. higher than last year's. Prices are likely to peak in the spring, perhaps hitting \$80/cwt. with seasonal declines later in the year.

Kentucky feeder cattle prices will recover on the strength of the slaughter cattle market (demand) and due to lower U.S. supplies of feeders. With the U.S. cow herd down and the large slaughter in 2002 (up 3%), feedlots will have to be aggressive to keep their pens full. Sellers can expect prices to increase \$4 to \$10 per cwt.

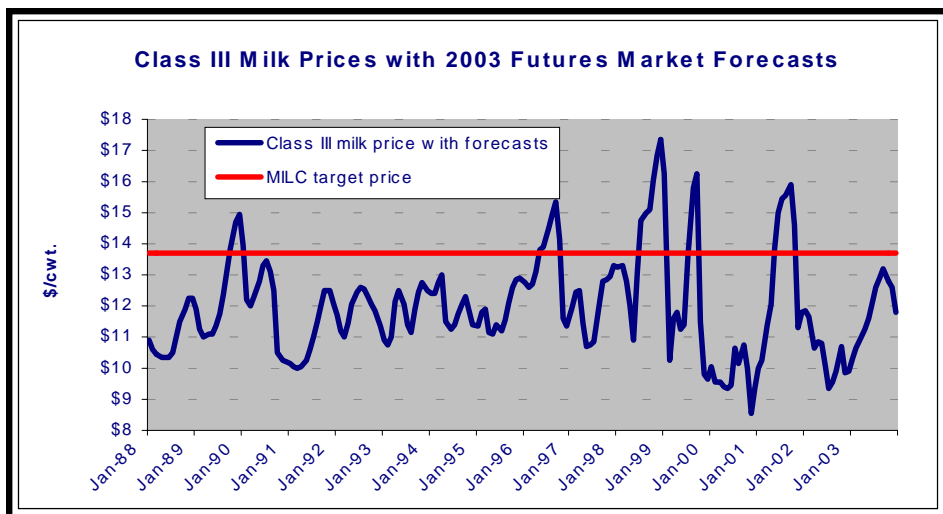
With little change in the size of the U.S. cattle herd, the longer run cattle price outlook is positive. Drought in the West has been a key factor in holding back an expansion. As managers begin to add heifers, overall prices will increase. From the supply side, the cattle cycle suggests two to four years of profitable feeder cattle prices. Demand continues to be a risk factor.

Dairy

Leigh Maynard

2002 Review: Appalachian mailbox prices fell from a 2001 average of \$15.68 to a 2002 average through July of \$12.75, and falling autumn Class III and IV prices will drag the 2002 average even lower by the end of the year. The milk-feed price ratio has been below 3.0 all year, one sign of unprofitable conditions. With Kentucky Farm Business Management results showing average cost of production exceeding \$14/cwt., 2002 was not a profitable year for many producers. Growth in supply simply outpaced growth in demand. Cheese stocks were 15-20 percent higher than the five-year average, and butter stocks were 60-70 percent higher than average. Cow numbers grew during 2002, in addition to the expected growth in milk per cow. Milk production continued to shift West, with growth in California, Idaho, Arizona, and New Mexico. Northeastern and Upper Midwestern states showed mixed growth and decline, while Kentucky and much of the Southeast continued to lose market share.

Regarding policy developments, USDA lowered the support price for nonfat dry milk by 10 cents/lb. in November and will make huge donations to reduce the burdensome surplus of powder. The butter support price was raised by almost 20 cents/lb. The fourth and final round of the Dairy Options Pilot Program was offered in 2002, but the heavily subsidized effort to promote market-oriented "price insurance" attracted light producer participation. The 2002 Farm Bill retained the



\$9.90 overall support price level and added the Milk Income Loss Contract (MILC) deficiency payment program, which pays all producers 45 percent of the difference between \$16.94 and the Boston Class I price, on up to 2.4 million pounds per farm per year. Payments were retroactive to January, 2002. The \$16.94 Boston Class I target price translates into a \$13.69 Class III price. The attached chart shows how high the target price is relative to market prices over the last 15 years.

2003 Outlook: Prices are expected to improve slightly in 2003, but USDA's forecasted all milk price is still below \$13/cwt. Class III (cheese) milk will likely be the Class I price mover during almost all of 2003, and shows potential for modest improvement, unlike Class IV prices that will be burdened by high butter stocks. Recent changes in Class III and IV pricing formulas will raise Class III prices and reduce Class IV prices, other things equal. The impact on Kentucky mailbox prices should be modest. Nationwide cow numbers will likely resume their downward trend, while milk per cow will continue trending up, reaching a 2003 forecast average of just under 19,000 lb/cow/year. The combined impact should lead to only slightly higher total production in 2003. The biggest boost to Kentucky producer revenues should come from MILC payments, which producers will probably receive every month during 2003. The downside of the high target price is that oversupply will likely persist for the duration of the program, preventing market prices from rising to the levels seen in 1998/99 and 2001.

Horticulture

Tim Woods

2002 Review: The fruit and vegetable sector delivered around \$15 million in cash receipts to farmers in Kentucky in 2002. Vegetable production expanded in 2002 largely behind the initiatives of the four vegetable cooperatives. The coops focused on sweet corn, bell peppers, tomatoes, cantaloup, pumpkins, and cabbage. Prices for the most

part were very strong during the Kentucky growing season. Weather limited yields, but the newer cooperatives were better prepared for the marketing season with improved packing equipment. A pre-season survey of planting intentions indicated producers expected to expand acreage for sale into a variety of other marketing channels. Direct marketing, retailing through on-farm sales or through community farmers markets, continued as the most commonly identified market channel. A smaller number of producers have been selling through produce auctions and direct to stores or restaurants. A number of producers took advantage of the USDA Farm-to-school program. Fruit expanded at a lesser rate, but saw increases of 34% for grapes, 27% for blackberries, and other berries expanding by 53%. Many producers have taken advantage of state and county Phase I funds to expand their horticulture operations on-farm. State funds have helped put in place better packing, grading, and processing equipment for cantaloupe, sweet corn, peppers, and cider apples.

2003 Outlook: Some growers were discouraged by early production and marketing challenges in 2002, but more are looking to expand fruit and vegetable production on their farms. Produce fits in well with many small farms that have previously depended on larger tobacco bases for income. Nearly half of fruit and vegetable producers surveyed in 2002 also grew tobacco. As direct and wholesale markets become established and as producers work out the technical aspects of commercial production, this sector will continue to expand as an important farm enterprise alternative. Marketing alliances with producers outside of Kentucky will continue to be an important strategy to gain entry into competitive wholesale markets. Organic acres, though small in comparison to conventional production, expanded by 30% in 2002. Good opportunities for selling organic produce into direct markets will remain as the organic category continues impressive growth nationally.