October WASDE Offers Mixed Optimism and Pessimism for 2018-19 Grain Prices

In the May Economic and Policy Update, my column suggested that prices for corn, soybeans, and wheat could improve if the U.S. growing season produced crops closer to trend yields and if use remained strong. The market fundamentals in May seem like the distant past given forecasts of record corn and soybean yields signaling another year with large crops. Trade uncertainty with China is providing a double-whammy for the already stressed soybean market. The current market fundamentals offer a mixed bag of optimism and pessimism. Let’s look at the price potential for corn, soybeans, and wheat for the 2018-19 marketing-year.

USDA projects corn planted and harvested area to be down by 1.1 and 0.9 million acres, respectively, from the 2017 crop. The surprise in the corn market is the projected record yield of 180.7 bushels/acre. If realized, the U.S. corn crop of 14.78 billion bushels could be 174 million bushels larger than last year’s crop. The smaller carry-in for corn mostly offsets this increased production; however, the 2018-19 corn supply is currently projected to be a record 16.97 billion bushels (Table 1).

USDA projects total corn use to increase by 362 million bushels over 2017 with feed and industrial use leading the demand increase. Corn exports remain strong at 2.48 billion bushels and may increase further due to production problems in Europe. USDA projects corn stocks to decline by 327 million bushels to 1.8 billion bushels. This reduction in stocks is projected to increase the U.S. marketing-year average farm price to $3.50 per bushel (Table 1).

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USDA’s projections also provide a more optimistic story for wheat than in recent memory. Wheat planted and harvested area increased by 1.8 and 2.1 million acres, respectively, from 2017. Still, the wheat seeded area is still down 7.2 million acres from the 2015 crop. This reduction in the planted area the last three years has allowed wheat stocks to decline gradually and to support higher prices. The 2018 wheat crop is projected to be 144 million bushels larger than last year’s crop, but total wheat supply is only 45 million bushels larger due to the smaller carry-in and reduced imports.

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USDA also projects wheat use to increase from last year with exports leading the demand growth. Global production problems are providing an exporting opportunity for the U.S. in 2018. USDA projects wheat stocks to fall to the tightest relative surplus since 2014. Tightening stocks will support higher prices with the U.S. marketing-year average farm price projected at $5.10/bushel (Table 1).

The pessimism resides in the soybean market. Planted and harvested area declined by 1 and 1.2 million acres from 2017. USDA is surprising farmers and analysts with a projected yield of 53.1 bushels/acre. If realized, the 2018 soybean yield and production would be a record. USDA projects the soybean supply to be 5.15 billion bushels, which is a 419 million bushel increase over 2017-18.

USDA projects soybean use to be 28 million bushels less than last year with exports driving the reduced demand. Exports are currently projected to be 69 million bushels less than last year. However, the tariff war with China has caused new supply chains to form, which creates greater uncertainty about this projection as new trading relationships are forming.

USDA projects soybean ending stocks to grow to a record 885 million bushels. If realized, soybean stocks-to-use ratio will be the largest since the 1986-87 marketing-year. The U.S. marketing-year average farm price is projected at $8.60/bushel, which is down $0.73/bushel from last year.

The corn and wheat fundamentals have an optimistic story to tell of the potential for even larger exports that will reduce stocks further than projected. The soybean market fundamentals will be improved with a resolution of the trade dispute with China. Any production problem in South America will also help a beleaguered U.S. soybean market.

**Feeder Cattle Market Continues to Hold Steady**

Sometimes it’s necessary to step back and access where the market is, without getting distracted with the constant changes that are happening on a daily basis. If you had asked me this time last year, how I thought fall 2018 cattle prices would compare to fall 2017, I would have very quickly told you that I thought price levels would be lower in 2018. The primary reason for this expectation was supply. Those increased supply expectations have come to fruition, but prices have largely held near last year’s levels.

While production forecasts have evolved throughout the year, production levels of all major meats have been moderately higher for 2018. Beef, pork, and broiler production is forecast by USDA to be up by 2.9%, 3.3%, and 2.2%, respectively, for 2018. Holding everything else constant, this is typically a recipe for lower prices. But, the market has largely absorbed these production increases. Part of the reason has been strong export levels. Despite some trade barriers that have been in place since summer, beef exports have been above 2017 levels all year. This, coupled with a relatively strong US economy, has largely supported beef prices, and in turn cattle prices.

Figure 1 depicts state average price levels for Medium and Large Frame 550 lb feeder steers in Kentucky auction markets. In addition to what was mentioned previously, calf markets have also benefited from good fall forage growth, which has spread fall calf runs out more than usual. When this article was written, I just had three weeks of October prices to include, but I did go ahead and include October in the chart. You will notice about a $3 per cwt drop in prices from September to October, which puts October 2018 prices within $0.50 per cwt of October 2017.

**Figure 1. 550# Medium & Large Frame #1-2 Steers KY Auction Prices ($ per cwt)**

Source: USDA-AMS, Livestock Marketing Information Center, Author Calculations

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In many ways, I have actually been more surprised by how high heavy feeder cattle prices have been. A lot of large groups of 800-900 lb steers are still moving in the $150’s and I would make an important point that applies very often in the fall. Heavy feeders moving now, are still being sold based on spring CME® Live Cattle futures prices. At the time this was written (October 23, 2018), April CME® Live Cattle futures were trading at about an $8 premium over the June contract. As we move towards the end of the year, June will become the driver of our heavy feeder cattle market, rather than April. And, unless something else fundamentally changes in the market, the current prices levels are likely to be unsustainable for heavy feeders as they expected sale price when they come off feed will be much lower.

Trade continues to be a hot political (and economic) topic for U.S./Kentucky agriculture during fall harvest and the upcoming mid-term elections. Despite all the trade rhetoric this past year, coupled with a strengthening U.S. dollar, USDA is projecting U.S. agricultural export value to increase 3% in FY 2018 (+ $4.3 billion to $144.5 billion) on the heels of strong corn (+14%), and meat exports (beef +16%, poultry +8%, dairy +5% and pork (+3%) exports, offsetting lower soybeans exports (-7%). Trade accounts for approximately 1/3 of the value of U.S/Kentucky agricultural production so trade tensions/losses are a real concern, especially in a depressed farm income/price environment.

What about the U.S. Mexico, Canada Trade Agreement (USMCA)?

U.S. agriculture welcomed the news of the recent trade agreement between the United States, Mexico, and Canada. Mexico and Canada have consistently been among the top three foreign markets for U.S. agriculture. Under NAFTA, tariffs for most agricultural commodities/products were reduced to zero, which propelled U.S. ag exports to our southern and northern neighbors to increase from less than $9 billion prior to NAFTA’s passage in 1993 to nearly $40 billion in recent years. Collectively, Mexico and Canada represent the largest export market for U.S. corn, wheat, beef, poultry, and pork and accounts for nearly 30% of total U.S. agricultural exports.

In reality, the USMCA (if ratified) will not likely result in a significant boost in U.S/Kentucky ag exports to Mexico and Canada in the short-term, but the agreement may offset the fears of these neighboring markets seeking alternative suppliers amidst the trade dispute, and thus prevented an erosion of exports to this important trading region if the trade tensions had lingered. Under USMCA, most agricultural tariffs established under NAFTA will remain at zero, but the retaliatory Canadian tariffs placed on some U.S. beef products and the Mexican tariffs placed on U.S. pork (among other ag products) remain in effect. The latter is pretty significant as nearly one-third of US pork exports go to Mexico. Still USMCA may be a step towards removing these retaliatory tariffs on U.S. meats and other U.S. ag products. In general, pork markets are move heavily impacted by trade barriers as a much larger share of our domestic pork production is exported than our domestic beef production. In 2017, 22% of U.S. pork production was exported, while around 11% of U.S. beef production was exported.

The United States will see some additional access to Canadian dairy markets under USMCA, but Canada’s dairy supply management system largely remains. In addition to dairy, the USMCA will bring about additional access for U.S. poultry/eggs, and wines entering Canada. The USMCA should preserve important grains and oilseeds markets. USDA-FAS data ranks Mexico and Canada as the first and third largest importer of U.S. grains and feedstuffs, respectively. Similarly, Mexico and Canada are the second and third largest importer of oilseeds. The agreement should open the Canadian wheat market to the U.S. as the Canadian system graded U.S. milling quality wheat as feed grade in Canada. The agreement also provides science-based sanitary and phytosanitary (SPS) measures to address agricultural biotechnology and gene editing to reduce SPS imposed trade barriers, which U.S. trade officials hope is a model for future trade agreements.

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U.S. agriculture now awaits how retaliatory tariffs recently applied to U.S. ag goods in these markets will be handled, as well as the legislative approval of the agreement among the three nations. Presently, it appears the U.S. Congress will not vote upon USMCA until early 2019.

What about China and other Trading Regions?

The trade relationship with China remains tense with the United States currently applying tariffs on $250 billion of goods entering from China, roughly half the value of all Chinese goods sold to the United States last year. China has countered with tariffs on over $100 billion of U.S. goods (mainly ag products). Just two years ago, China had overtaken Canada and Mexico as the number one destination for U.S. ag exports, but will likely slip to fifth position in 2018, behind Canada, Mexico, Japan, and the European Union. Through August, U.S. ag exports to China were 21% lower compared to a year ago, primarily due to soybean exports being off 34% from 2017 levels. The White House indicates that President Trump will meet with Chinese President Xi next month at the G-20 summit in Buenos Aires, Argentina to discuss their trade differences.

In other trade news, it appears that the U.S. will be pursuing trade discussions with the EU, Japan, Philippines, and the United Kingdom. Improved access to the Japanese market was one of the biggest opportunities for U.S. agriculture lauded in the Trans Pacific Partnership (TPP), prior to the U.S. pulling out of the TPP in the early days of the Trump administration. Earlier this month, the Trump administration officially informed Congress that it intends to begin negotiations with Japan on a bilateral free trade agreement, which could be a boost for U.S. meat, dairy, and grain exports. Japan has historically been a top five export market for U.S. agriculture. Despite relatively high tariffs, Japan is the largest export market for U.S. beef. Under TPP, tariffs on U.S. beef would have been reduced to 9% over time compared to the current level of 38.5%. Current tariff levels provide a competitive advantage for Australian beef, which under a recent free trade agreement enjoys a much lower tariff structure entering Japan than U.S. beef.

Tax Law Changes for Traded Items

In the past, personal property that was used as a trade-in on a purchased item was treated as a “like kind” exchange. The Tax Cuts and Jobs Act changed the wording to accommodate only real property as eligible for like kind exchanges. Starting in 2018, personal property (i.e., equipment and livestock) will be treated as being sold when a trade occurs. This could potentially have both good and bad consequences.

For example, let’s say you have Tractor A that you plan on purchasing. The full cost of Tractor A is $150,000. You are going to trade Tractor Z in and the trade allowance is $70,000. Under the old law you would not report the sale of Tractor Z, it would continue to depreciate out and be marked as a traded item on your asset schedule. Meanwhile, Tractor A would be put on your depreciation schedule with a cost (basis) of $80,000 ($150,000-70,000.)

Under the new law, Tractor Z will be sold for $70,000. If there is any cost left to deprecate then that will reduce the amount of gain or recapture on Tractor Z. Tractor A will be put on the depreciation schedule at $150,000 cost (basis.) The sale of equipment and livestock is reported on a Form 4797 on the income tax return. The sale generally results in gain being reported as recaptured depreciation (taxed at ordinary income tax rates) or capital gain (taxed at capital gain rates.) Neither of which are subject to self-employment tax. Let’s assume that Tractor Z was depreciated out, the entire sales price of $70,000 would be income reported on the Form 4797, under the new law.

The entire cost of $150,000 of Tractor A is available for depreciation on your Schedule F (farm income and expenses.) Most likely some combination of depreciation allowances like Section 179 and/or Bonus Depreciation will be used to get the Schedule F to the net amount preferred.

Keep in mind that the goal of tax planning is not to avoid taxes but rather to be consistent in the income tax brackets and avoid large swings in income levels from one year to the next. Continuing the example above, let’s assume the taxpayer has no other means of income and generally keeps the amount of adjusted gross income in the area of $75,000. The gain on the sale of the tractor was $70,000 on the Form 4797. Ideally, the taxpayer would then have a Schedule F net income of $5,000 to be consistent on the overall amount of adjusted gross income. Remember, self-employment tax is only on earned income such as the Schedule F and not Form 4797.
On the positive side, taxpayers could pay less in self-employment tax than they have in previous years. In the example, the taxpayer is paying self-employment tax on $5,000 rather than $75,000. The flip side of that argument is that taxpayers need to keep in mind that paying less (or zero) amounts of self-employment tax could have a negative impact of future retirement earnings or even qualified quarters for disability payments.

Another factor to consider is the difference between federal and state depreciation laws. Kentucky has limited the Section 179 deduction to $25,000 and the deduction gets phased out if the equipment purchases are greater than $225,000. Kentucky also does not allow for bonus depreciation. This means that there will likely be substantial differences in gain between the Kentucky and federal income tax returns.

Taxpayers will need to let their tax preparers know when items have been traded and how much was allowed on the trade-in. As always, taxpayers need to plan ahead and visit with their tax preparers before the end of the year to avoid any surprises when they file their returns.