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Canadian Agricultural Prospects

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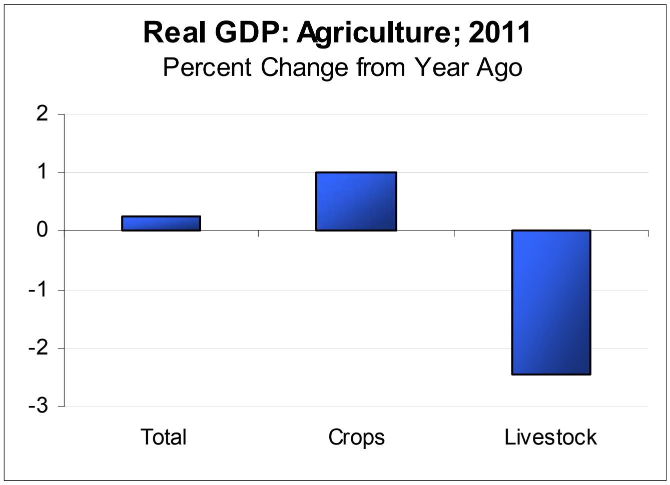
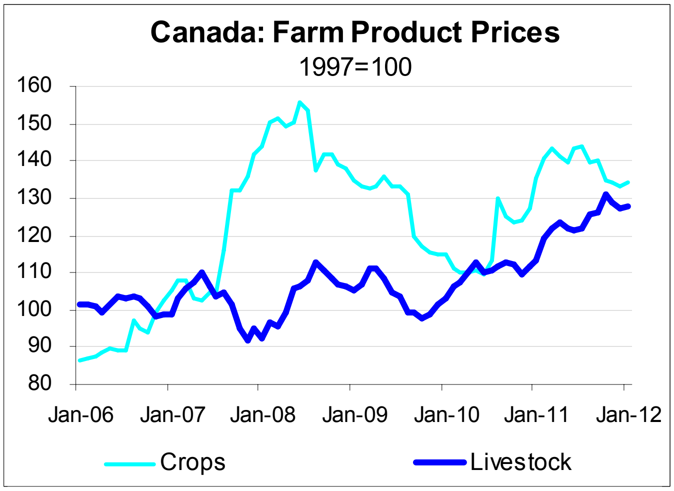
Recent Performance

After contracting during the two previous years, Canadian agricultural production remained largely flat in 2011 as a reduction in livestock production offset a modest improvement in crops. While the demand and price environment for both crops and livestock brightened notably last year, the weakness in production reflected a second year of poor weather, shrinking animal inventories, and a strong currency, all of which combined to limit farmer response. Specifically, although farmers managed to boost acreage, flooding and cool temperatures impaired yields and hampered production of the major field crops. Despite some loosening in the fundamentals for grains and oilseeds over the past year, crop prices remain at attractive levels and robust livestock prices have kept overall market conditions favourable. In January, the latest month for which data are available, total farm product prices were about 6% higher than a year ago. While grain prices had declined notably, livestock prices had risen by 13%. Even with meagre production growth, strong prices allowed Canadian farmers to extend a noteworthy stretch of improved financial performance last year, with an outsized gain in net income.

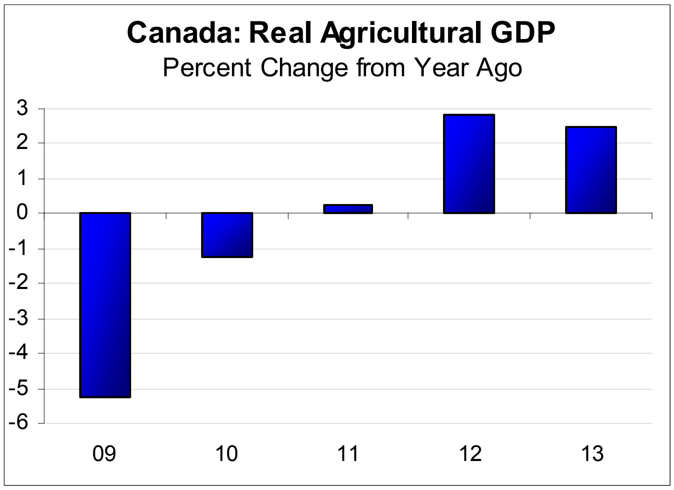


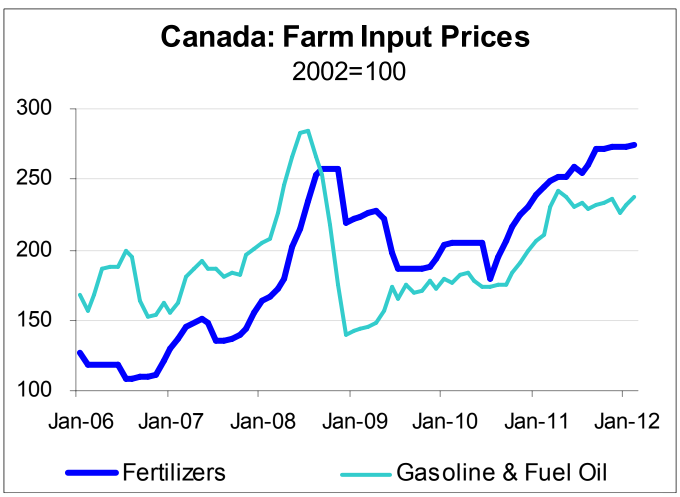


Outlook

While farm prices are expected to moderate this year, they should remain elevated in view of continued strong demand, particularly in fast-growth emerging markets. Moreover, there is some upside price risks as adverse weather in some regions (e.g., South America) has pared agricultural production and pushed grain and oilseed prices higher. A beneficial overall demand and pricing environment, along with a return to more favourable growing conditions and some improvement in market access (e.g., South Korea's lifting of import restrictions on beef), should facilitate increased production of crops and livestock. On the crops side, farmers are likely to boost output notably in response to last year's stellar prices, with a record large canola crop in the cards. However, livestock gains are expected to be more modest, constrained by the relatively small size of the cattle and hog herds. On balance, output in the agricultural sector is projected to expand at a pace between 2.5% and 3% in 2012, led by crops. Production would likely be even higher in the absence of constraints imposed by the strong loonie and elevated input costs. Given expectations of higher output and continued strong prices, Canadian farmers should experience another year of solid financial performance.

Next year and over the medium term, agriculture is likely to see annual growth in the range of 2% to 3%. This would be somewhat above the longer-term trend, reflecting the sector's increasing exposure to emerging markets, where incomes are growing briskly and consumption levels are low. Continued price strength should facilitate further increases in crop production. The prices of major grains and oilseeds are expected to remain above historical norms and to trend higher amid robust demand from developing countries, continuing expansion of biofuel production globally, and increasingly scare resources (e.g., arable land, water). Indeed, after a long-term decline, inflation-adjusted prices for a number of farm commodities have recently been rising. Meat demand is also projected to rise briskly, as expanding populations in fast-growth developing countries broaden their diets, a positive development for livestock as well as crop producers. Agricultural production will also be supported by increased demand in high-income nations for products embodying attributes – related, for instance, to health, environmental sustainability and food safety – that offer scope for greater value-added, as well as by the development of niche markets. In this regard, the production of greenhouse vegetables and specialty crops has been rising rapidly and organic agriculture has increasingly taken hold.





Challenges

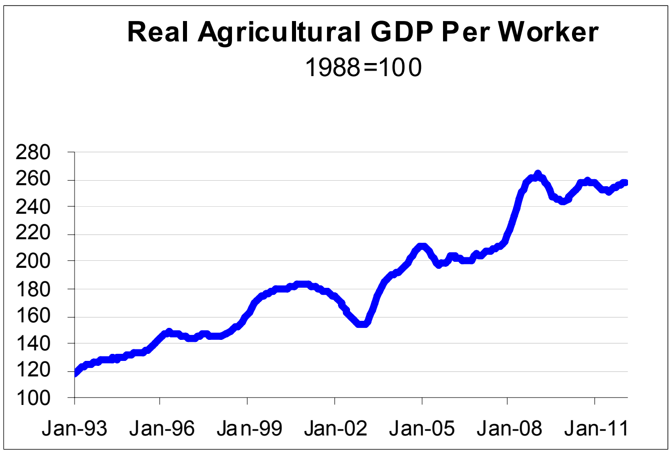
In order to benefit from the favourable demand and price prospects, Canadian farmers will have to effectively deal with a number of challenges in the areas of marketing and trade and input costs. The loonie is slated to remain strong, supported by high resource prices and foreign investor confidence in Canada's fiscal performance. The currency's strength will continue to constrain production and profitability, especially in segments such as grains and oilseeds and meat products, both of which are heavily reliant on foreign markets. In an increasingly competitive global market, domestic farmers may also have to contend with trade restrictions related to plant and animal diseases, allegations of unfair trade, and food safety concerns, which all raise border closure risk. These challenges compound the inherent variability of agricultural production and limit production by raising transactions costs.

Further, input prices have been rising sharply. Over the past year, the prices of fertilizers and gasoline & fuel increased by approximately 25% and the likelihood that they will remain high and variable by historical standards in the years ahead is significant. Canadian farmland values have also been rising on the prospect of longer-term farm commodity price strength, sustained low interest rates, and a dearth of attractive alternative investment opportunities. While land values have increased across Canada, gains have been especially large in Saskatchewan and, to a lesser extent, in Ontario. High and volatile input prices would keep upward pressure on costs, squeeze margins, and challenge the resourcefulness and risk management capabilities of farmers.

For the first time in more than 70 years, farmers in Western Canada will be able to market grains outside the monopoly of the Canadian Wheat Board. On December 15, 2011, the Marketing Freedom for Grain Farmers Act was passed by Parliament, giving farmers the ability to enter into forward contracts with any buyer – including the Wheat Board – for delivery of wheat and barley beginning August 1, 2012. Initially, this may introduce an element of uncertainty in grain marketing, potentially alter the mix of agricultural enterprises, and lead to lower output and prices, as farmers compete to sell their crops to large new buyers.

Keys to Success

To adequately address these challenges, Canadian farmers must continue to reduce costs through scale, technological advances, and better organization. They also have to boost value-added by catering to shifting customer preferences. Value added possibilities lie, for instance, in the development or expansion of new enterprises such as production of organic products and the supply of local markets. Opportunities for expanding sales to local markets reflect the growing interest by advanced-country consumers in knowing and being able to relate to the sources of their food. This reflects increasing concerns about consumer safety that have accompanied the globalization of food markets. Notwithstanding this opportunity to expand local markets, farmers must continue to target fast-growth emerging markets, where income gains and population growth are lifting demand at a much faster pace.



The sector has shown a remarkable adaptability over the years, evident in superior productivity performance, rising export orientation, a shift in output mix toward value-added products, and the launch of new enterprises. Productivity growth has been the primary driver of Canadian farm output over the past two decades, as employment has shrunk in that timeframe. Specifically, as far as new enterprises go, greenhouse vegetable production has expanded rapidly – in Ontario, Quebec and British Columbia – and specialty crops (e.g., pulses) are altering the agricultural landscape in the Prairies. These trends should hold as farmers continue to adapt. Critically, despite their solid record on this score, farmers will have target further productivity gains to offset the challenges of rising input costs and the strong loonie. In addition, sophisticated risk management strategies will be needed to address increasing volatility in input and output prices, production and profits. The need for ongoing cost reduction, innovation, market diversification, and risk management capacity is likely to spur consolidation and the development of larger, more capital-intensive, complex operations.

The Bottom Line

From the standpoint of production, agriculture struggled to make headway in 2011 even though strong prices underwrote another solid financial performance. This year, however, with the demand and price outlook still favourable, activity in the sector is poised to strengthen amid better growing conditions and more normal levels crop yields. The sector should continue to expand over the medium term at annual rates somewhat above its historical trend. Factors supporting growth include brisk population and income gains in emerging markets, and rising global biofuel production. Additionally, consumer concerns about health, the environment and food safety are promoting value-added activity throughout the supply chain and increasing opportunities in local markets. However, in order to benefit, Canadian farmers must enhance their competitiveness, which requires superior productivity and proper risk management. Consequently, the sector is likely to see continued consolidation.