Trade deals won't mean disaster for supply management

Farm Credit Canada's J.P. Gervais says Canadian farmers can compete against imports

BY ALLAN DAWSON
Co-operator staff

Canadian dairy and poultry farmers will be able to compete with more foreign imports, says J.P. Gervais, Farm Credit Canada's (FCC) vice-president and chief agricultural economist.

"I think we can compete with foreign products coming in because we've had this growth in the sector and we've made changes in terms of how we market the product," Gervais told reporters April 18 during a briefing on FCC's latest farmland values report. "So I am not overly cautious. I think that we can actually compete in the marketplace against foreign products coming in. And I think our dairy producers are going to remain financially healthy."

Canadian dairy production has increased 19 per cent over the last four years, he said. But while production went up increasing dairy receipts, prices were reduced.

"There are a lot of producers who haven't been able to catch-up their (new milk) allocation," Gervais said. "Some producers have had to make a lot of investments in terms of expanding their barns. I would say there are some challenges as well in dairy. It's not just everything is so positive. It's not an industry without challenges. I think milk producers are doing well in the current situation."

Canada has agreed to allow more imports of dairy and poultry products under the Comprehensive Economic Trade Agreement with the European Union and the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) with Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.

The United States had been part of an earlier Trans-Pacific Partnership trade deal, but President Donald Trump pulled the U.S. out soon after being elected in 2016.

Trump instructed his economic advisers April 12 to look into rejoining the TPP "if the deal were substantially better."

Trump also referred to TPP when he recently met senators worried about a trade war with China.

"I don't want to go back into TPP, but if they offered us a deal that I can't refuse, on behalf of the United States, I would do it," Trump said April 18. "But I like bilateral. I think it's better for our country. I think it's better for our workers. And I would much prefer a bilateral deal, a deal directly with Japan. We already have a deal with six of the 11 nations in the TPP. So we already have trade deals, and the others we can make very easily."

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COLUMN

Don't let currencies drive you 'loonie'

There are a few practical ways to look at managing currency fluctuations

DAVID DERWIN
Hedging your bets

A question I often get asked at hedging workshops and marketing presentations is about currency risk management. In particular, how to best manage it from a practical point of view. Farmers ultimately get paid in Canadian dollars, even though their commodity is priced either directly or indirectly in U.S. dollars. Whether it's a flat price for wheat, a soybean price based on futures with a currency component added on to it after or a canola futures hedge, the currency is in there somewhere.

While farmers are always essentially long the U.S. dollar from their revenues, the largest farm expenses like seed, fertilizer, fuel and chemicals as well as equipment and machinery are directly or indirectly priced in U.S. currency. As a result, there are a lot of natural hedges built in to a farming operation which partially shield you from the full effect of a strengthening Canadian dollar.

Previous research and analysis in these articles have already shown that the Canadian dollar tends to move in five- to 10-year cyclical trends. Interestingly, during those longer-term trends, a weakening greenback and rising loonie has typically been associated with higher grain prices. Most of the time, corn, wheat and soybean futures move in the opposite direction of the U.S. dollar, often going up when the U.S. dollar goes down and vice versa. Likewise, there is an overall trend toward better domestic prices for canola, wheat, corn and soybeans for Canadian farmers when the Canadian dollar is higher.

This all makes sense given commodities are priced around the world in U.S. currency, with people in Europe and Asia buying more and pushing up prices if the U.S. dollar weakens at a greater rate than the strong Canadian dollar hurts Canadian farm prices. Over the past 20 years, the highest grain prices in Canadian dollars have been when the loonie was near par. What we lose on a strong Canadian dollar, we tend to gain from higher grain prices, and then some.

In reality, farmers are most exposed to their commodity price fluctuations. The volatility of canola, wheat, soybeans, corn, cattle or hogs is often between 20 per cent to 30 per cent. Meanwhile Canadian dollar volatility is usually only around 10 per cent. That doesn't mean the currency isn't a meaningful exposure, it just means that it's less that the commodity risk, so sometimes you have to pick and choose your battles.

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So the question is: should we even bother managing Canadian dollar risks and opportunities at all? My answer to this is yes, but it depends and perhaps it can also be done selectively and opportunistically.

I've asked a lot of questions here so now let's look at a few answers to provide some guidance going forward.

It's challenging to predict which way the dollar is going to go at the best of times. At present, a few things make this even tougher.

First, central banks are starting to adjust interest rate policies around the world; some raising rates, while others still maintaining very easy money. These diverging interest rate policies will have an impact.

Second, potential NAFTA changes, trade wars and protectionist tariffs add another wrinkle to the foreign exchange analysis. With all the associated unintended and unpredictable consequences, collateral damage of this trade war talk could be the Canadian dollar, but it's hard to predict whether it would cause the loonie to rise or fall.

Over the years, I've crunched a lot of economic and price data to determine if any relationships hold over time that shed some light on the Canadian dollar. There are two that consistently stand out.

The first is the historical difference between Canada-U.S. interest rates. In the past 30 years, there are long periods of time when the correlation between the two is quite strong at 90 per cent, and other times when it is much lower, providing less predictive or indicative value. We are currently, however, in one of those times when the two are tracking each other extremely closely.

Over the past 10 years since the financial crisis in 2008, the connection has been near 90 per cent, moving almost one for one as the one-year government bond interest rate spread and Canadian dollar chart comparison shows.

The other factor is oil. The Canadian dollar has often been called a petro-currency. Given the energy industry is almost 10 per cent of Canadian GDP and represents over 20 per cent of our stock market value, the impact of oil certainly shows up in our currency. Over the past 30 years, the correlation between the Canadian dollar and crude oil has hovered around 90 per cent. That figure has also held true for the past 10 years as shown on a chart comparing oil with the Canadian dollar.

CHART 1

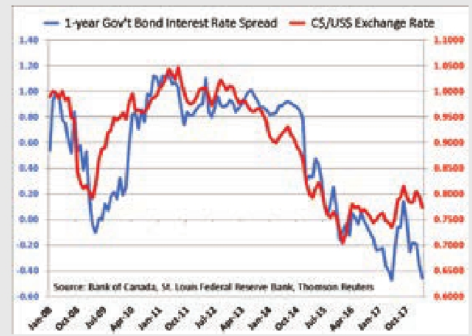
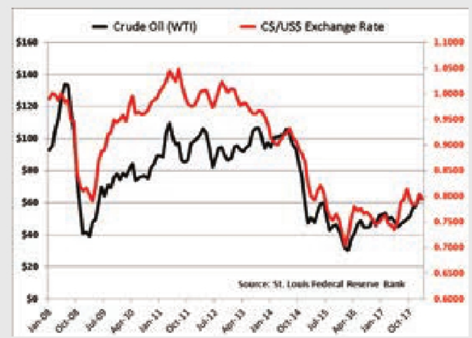


CHART 2



Currently, the Canadian dollar has been trading in a four-cent range between 77 and 81 U.S. cents almost 80 per cent of the time in the past year. However, with U.S. rates rising more than Canadian rates, suggesting a weaker loonie, but oil going higher, these two indicators are a bit at odds with one another.

Now that we know what to look for in the longer-term bigger picture, there are still practical monthly, quarterly and semi-annual fluctuations that necessitate a proactive currency approach. For instance, it could be a one-time large equipment purchase from the U.S. whereby you want to protect against a lower loonie. Or, it could even be the annual input costs that you'll want to hedge every year.

Perhaps you hedge the currency to coincide with a specific cattle futures position or grain in the bin waiting for spring delivery. You could also use currency futures and options as a way to partially protect your basis levels, especially for crops like durum, lentils or peas that don't have a futures associated with them. At least you can manage some of their associated price risk.

Sometimes it's better to use wheat options or futures and then manage the currency and basis separately instead of selling to an elevator at an all-in flat price. Canola futures are already priced in Canadian dollars so to some extent the currency is protected when you establish the hedge.

Bottom line, these are all practical issues to consider and the underlying theme is to separate your currency decisions from your commodity decisions. But don't forget about managing your main revenue driver which is your grain or livestock.

There is no one answer for everyone and it will vary for each farm but a practical and effective way forward is to at least consider hedging your gross profit margin amount. This can be done taking both a regular as well as a more opportunistic approach using short-, medium- and long-term hedging methodologies.

And of course, don't let the political and trade war talk affect your thinking too much. Keep an eye on interest rates and oil as a guide, but not a guarantee, for your currency decisions.

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