Rising input costs could soon overshadow profits from higher grains prices

12 July 2021

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At a time of an abundant harvest, the high agricultural commodity prices have been a windfall for South African farmers, particularly the grain and oilseed growers. But farmers shouldn't celebrate and spend too quickly. The rising input costs – oil, herbicides, and fertilizer – could erode these gains when farmers embark on the 2021/22 production season, starting in October this year.

At the end of the first week of July 2021, Brent crude oil price was up 72% y/y, trading around US$74 per barrel. The oil price has a close correlation with fertilizer prices and various agrochemicals inputs. As such, herbicides prices show similar increases in US dollar terms, with glyphosate up 144% y/y in June 2021. Importantly, South Africa imports all of its annual agrochemicals' consumption. This means that not only the rise in prices should be a concern but also the logistics on the back of disruption in supply chains and continuous reports of container shortages. The same is true with fertilizer, with potash, urea, monoammonium phosphate (MAP), and diammonium phosphate (DAP) prices, for example, up by 32% y/y, 52% y/y, 67% y/y, and 69% y/y, respectively, in the first week of July 2021.[1]

The tight global supplies, strong demand and geopolitical uncertainties in crucial producing countries have been the primary driver of prices in all these commodities. Recently, OPEC's failure to reach a deal to increase global oil production is one example of factors causing tight oil supplies in the global market and ultimately driving up prices.[2] The expectations from various analysts globally are that fertilizer prices could remain elevated for some time.[3] Now, South Africa is just three months away from the new season's planting period, which means that the country's farmers are unlikely to be spared the higher input costs.

Consider grain and oilseed farmers, who are the main subject of our discussion; fuel generally accounts for between 11% and 13% of production costs. The consumption is generally throughout the year, with the highest periods being during planting and harvesting. In terms of annual fuel usage, it is worth noting that South Africa transports by road roughly 81% of maize, 76% of wheat, and 69% of soybeans. On average, 75% of national grains and oilseeds are transported by road. This means farm managers and agribusinesses will have to plan for an environment different from last year, when input costs were relatively low, increasing cost this time around.

South Africa imports about 80% of its annual fertilizer consumption and is a minor player globally, accounting for a mere 0.5%. Local prices tend to be influenced by developments in the major producing and consuming countries, such as India, Russia, the USA and Canada. Hence, the higher global fertilizer prices will be a reality here in South Africa as well. Much of the fertilizer imported by South Africa is utilized in maize production, accounting for 41% of total fertilizer consumption in the country, the second-largest consumer being sugar cane at 18%. Fertilizer constitutes about 35% of grain farmers' input costs and a substantial share in other agricultural commodities and crops.

[1] Russ Quinn. 'Potash Leads Retail Fertilizer Price Higher with 7% Monthly Gain'. DTN, July 7, 2021.
[2] Pippa Stevens. 'Oil touches six-year high after OPEC fails to get deal, then turns negative'. CNBC. July 5, 2021.
[3] Fabiana Batista. 'The Price of Fertilizer Has Soared, There's No Sign of Pullback'. Yahoo Finance. July 8, 2021.

In essence, the higher grain prices and harvest might look good on the financial books in the near term, but farmers and agribusinesses will have to plan for a slightly challenging environment of rising costs in the coming months. Even worse, if the grain prices could soften somewhat from the current higher levels, which is all too likely on the back of an expected sizeable global harvest in the 2021/22 season, then the farmers' finances could be in an even slightly tighter environment in the coming months. Another critical factor for the domestic farmers will be the performance of the Rand to the US dollar, which is key in determining the ultimate prices that farmers will pay to their various suppliers of production inputs when planting begins in October. So, the current higher grain prices are a welcome development from a farmers' perspective, but more trouble lies ahead from potentially higher input costs.

Exhibit 1: Brent crude oil price

Source: Bloomberg and Agbiz Research

Weekly highlights

Farmers high spending on machinery a vote of confidence in the 2021/22 season

In a normal summer season, where there are favourable weather conditions, South African farmers plough roughly four million hectares for summer grains and oilseeds. This comprises maize, sunflower seed, soybeans groundnuts, sorghum and dry beans. While there remains some level of uncertainty about the weather conditions for the upcoming summer crop production season which begins in October, it is fair to say farmers are optimistic and are gearing up for it. The earlier indicator we have thus far is tractor sales which have remained robust since mid-2020.

Just last week, the data from the South African Agricultural Machinery Association showed that tractor sales were up by 43% y/y in June, with 633 units sold. If we consider the total tractor sales for the first half of this year, we are already 27% ahead of the corresponding period in 2020, with 3 385 units. However, it is worth noting that sales in the first half of last year were negatively affected by lockdown restrictions, so the base is slightly distorted. Still, 2020 was also a good year in South Africa's tractors sales, and so surpassing it means that we are witnessing some good momentum this year. In 2020, the tractor sales amounted to 5 738 units, up by 9% from 2019.

The large summer grains and oilseeds harvest in 2019/20, and yet another good agricultural season in 2020/21, both of which coincided with higher commodities prices boosted farmers finances and subsequently, the tractor sales. The relatively stronger exchange rate has also been a positive buffer for the imported agricultural machinery, particularly this year.

Earlier in the year, we were somewhat pessimistic that the robust 2020 tractor sales' momentum would extend into 2021. We viewed the large grains and oilseeds harvest of the 2020/21 season as not a sufficient condition to support the sales. This train of thought was that; typically, a relatively good sales year, such as 2020, would likely be followed by a somewhat lower sales period. This was in anticipation that the replacement rate of machinery with new ones would usually be down from the previous years. Another factor to keep a close eye on was the exchange rate. Although the current firmer levels supported the sales, we felt that any changes into a weaker domestic currency would likely lead to higher prices for imported agricultural machinery and discourage sales.

Still, while there is always uncertainty about the exchange rate due to numerous domestic and global factors influencing it, farmers improved finances seem to be continuously supporting the exuberance in tractor sales. We are now inclined to revise our view and take a more optimistic one that the tractor sales could maintain a generally positive path this year compared to levels of last year.

In fact, we see a similar pattern with combine harvester sales, which in June 2021 were up by 76% y/y with 30 units sold. In the first half of the year, we have seen 154 units of combine harvesters sold, which is a third higher than a corresponding period last year. The previous year was also as favourable as in the tractor sales, with combine harvester sales up by 23% from 2019. The tractor and combine harvester sales tend to go in tandem in times of optimism – large area plantings typically lead to a large harvest. Hence, we hold a similarly optimistic view about the harvesters' sales this year.

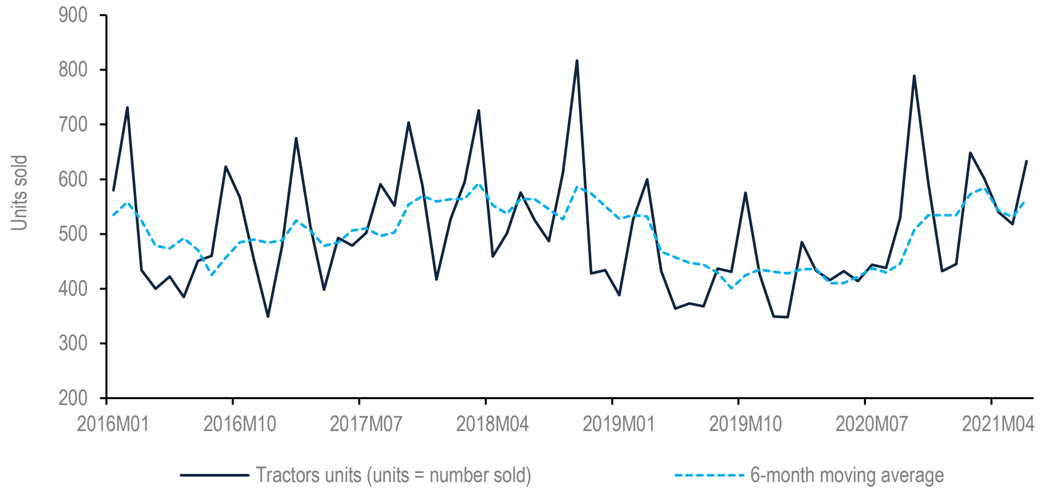
These numbers show us a picture of optimism about the following season and general agricultural conditions from farmers' part. After all, we cannot doubt the optimistic picture as this was clear also from agribusiness confidence levels in the second quarter of the year. The Agbiz/IDC Agribusiness Confidence Index, which measures the sentiment amongst agribusinesses and major farming entities, reached a record high (since its inception in 2001) of 75 in the second quarter of this year, from 64 in the first quarter of 2021. These results were reflective of favourable conditions for all subsectors of agriculture, with various crops set to reach record output levels in the 2020/21 season.

The planting season begins in three months for summer grains and oilseeds, as such the sales for the next two or three months will be worth watching. Where we are somewhat pessimistic about the sales in the last quarter of the year. We fear that the rising input costs, such as fertilizers, herbicides and fuel could add pressure on farmers finances and thus lead to a change in machinery-buying decisions. Also, the planting will be in full swing and there would be limited incentive to bring more new machinery. Still, the pace of sales in the first half of the year convinces us that in aggregate, the annual sales for 2021 could still be larger than the previous year.

Importantly, we believe that the 2021/22 season with the optimism of a possible slight increase in planting. The current season of 2020/21 was 4,2 million hectares to be exact, a 5% increase from the previous year. We will likely remain at such higher levels or even see a slight inch up in the area. The one factor that we all look forward to right now is the weather outlook. To this end, a positive note is that there aren't prospects of an El Niño or La Niña. The data from the Australian Bureau of Meteorology paints prospects of a neutral season. This is a view also held by the local weather authorities, who noted on the 28th of June 2021 that "the El Niño-Southern Oscillation is currently in a neutral state and the forecast indicates that it will most likely remain in a neutral state for the remainder of winter and most of the spring."

In sum, farmers are spending more on agricultural machinery and we view this, not merely as the result of improved finances, but also confidence in the coming production seasons.

Exhibit 2: South Africa's tractor sales



Source: South African Agricultural Machinery Association and Agbiz Research

Global food price index declined for the first time in 12-months

The improved weather conditions in the US and parts of Europe, along with harvest pressure in South America has led to a slight cooling of global grains and vegetable oil prices. This is evident in the FAO Global Food Price Index which fell by 3% in June 2021 from the previous month to 125 points; the first drop in 12 consecutive monthly increases. The decline in grains and oilseeds was a major driver of this development. With that said, the index is still 34% higher than the corresponding period last year.

While grains and oilseeds price direction going forward will be influenced by the stock levels, which are fairly tight and leading to a continued knee-reaction on prices whenever there is news of unfavourable weather conditions, the production prospects are positive. For example, on 24 June 2021, the International Grains Council (IGC) released its monthly update of the global grains and oilseeds production forecasts for the 2021/22 season. The Council's view is broadly optimistic pointing to an annual uptick in production of all major grains and oilseeds. The drier weather conditions in parts of the US and Canada, along with extreme cold in parts of Europe, which had slowed the planting and threatened the 2021/22 season have all subsided.

As such, the IGC forecasts the 2021/22 global maize production at a new peak of 1,2 billion tonnes, up by 6% y/y. This is on the back of an expected large crop in the US, Brazil, Argentina, Ukraine, China, EU, and Russia. Similarly, the global wheat production conditions have improved. The IGC now forecasts the 2021/22 global wheat production at a record 789 million tonnes, up 2% y/y. This is boosted by expected large crops in the EU, the US, Ukraine, Argentina, China, India, and the UK.

Also, worth noting is that the global rice supplies and stocks are also at comfortable positions, well above the 2020/21 production season. The IGC forecasts the 2021/22 global rice production at a record 512 million tonnes, up 2% y/y. This is on the back of possible expansions in area plantings in Asia, combined with expected better yields as a result of favourable weather conditions. The observations are similar in the global soybeans production prospects, with the 2021/22 harvest estimated at 383 million tonnes, up by 6% y/y. The beneficial weather conditions will likely boost the yields in the US, Brazil, Argentina, India, Paraguay, Russia, Ukraine, and Uruguay.

These production forecasts suggest that global crop prices from the second half of the year could continue softening, slightly, from the recent months' levels. If such transpires, the South African grain prices could follow a similar path, which bodes well for consumer food price inflation. The only major upside risk on grain prices, as we have noted in various writings are the lower grains stocks, and progressively also the growing consumption from the renewable energy industry. With that said, the data so far points to a positive direction for a consumer than much of the first half of the year.

Exhibit 3: FAO Global Food Price Index

Source: FAO and Agbiz Research

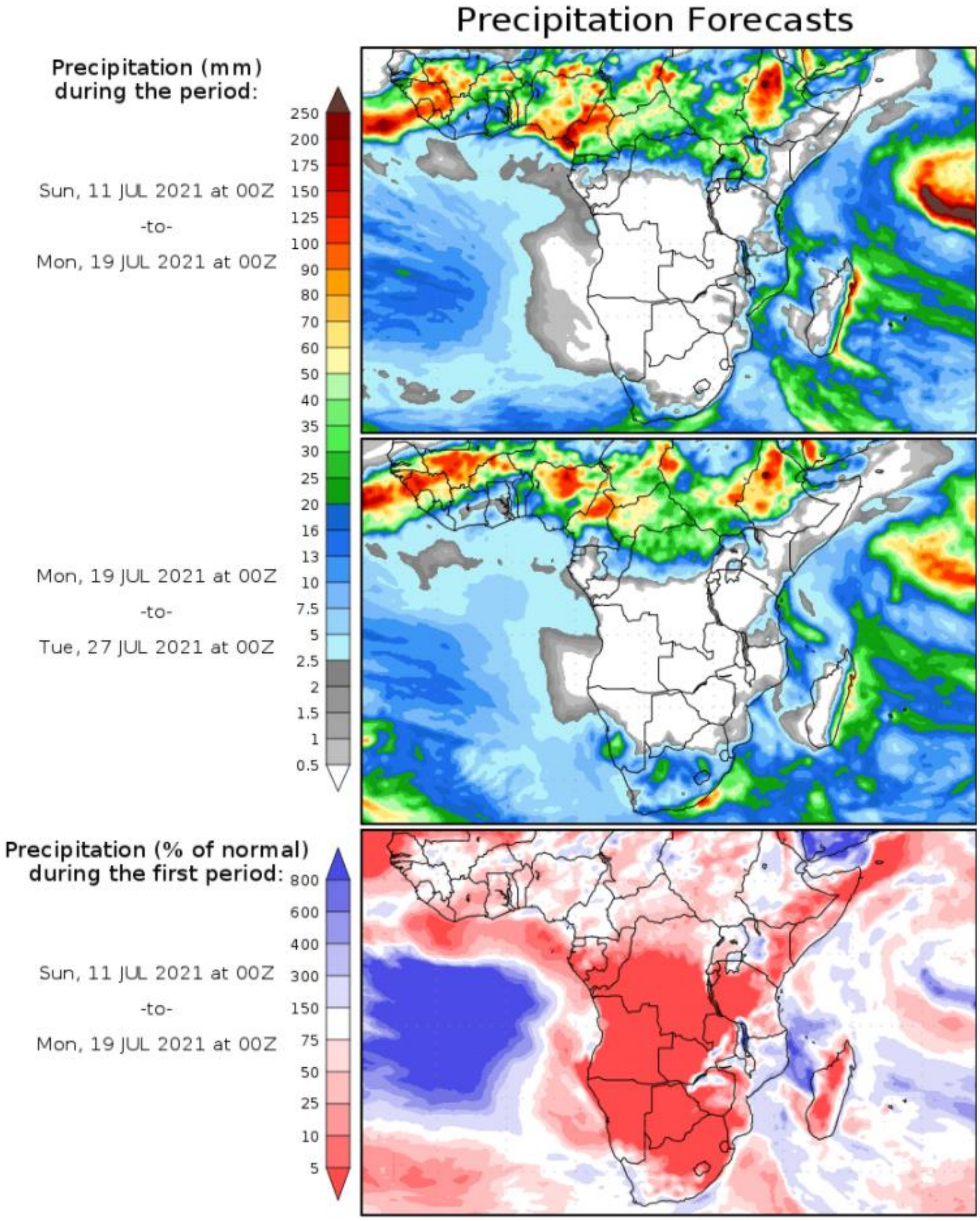
Data releases this week

We start the week with a global focus, as the United States Department of Agriculture (USDA) will release the **US Crop Progress Report** and the **World Agricultural Supply and Demand Estimates** report today. Our interest in these reports will be to view the crop growing conditions in the US, and also a broader view of the global grains and oilseeds production estimates. We know from the aforementioned IGC estimates (discussed above) that the global grains and oilseeds production prospects are generally positive. We look to see if the USDA will confirm such a view. The **US Weekly Export Sales** data is due for release, also by the USDA, on Thursday.

On the domestic front, on Wednesday, SAGIS will release the **Weekly Grain Producer Deliveries** data for 9 July 2021. This data cover summer and winter crops, although we only focus on summer crops for now where harvesting is at completion. To recap, on 2 July, about 2 759 tonnes of soybeans were delivered to commercial silos. This placed the soybean producer deliveries for seventeen weeks of the 2021/22 marketing year at 1,79 million tonnes, which equals 93% of the expected harvest of 1,92 million tonnes. Moreover, 563 310 tonnes of sunflower seed for the 2021/22 season had already been delivered to commercial silos in the same week, out of the expected crop of 677 240 tonnes. In maize, the marketing year is different from oilseeds; we are still in the ninth week of the 2021/22 marketing year, which began at the start of May. The producer deliveries currently amount to 9,6 million tonnes, which equates to 59% of the expected crop of 16,2 million tonnes.

On Thursday, SAGIS will release the **Weekly Grain Trade** data for the week of 9 July 2021. In the week of 2 July, which was the ninth week of South Africa's 2021/22 maize marketing year, total maize exports amounted to 712 488 tonnes. The seasonal export forecast is 2,6 million tonnes, roughly 10% below the previous season because of an anticipated decline in Southern African demand, a region that is typically a key importer of maize from South Africa. In terms of wheat, South Africa is a net importer. On 2 July, imports amounted to 1,3 million tonnes, equating to 81% of the seasonal import forecast of 1,6 million tonnes.

Exhibit 4: South Africa's precipitation forecast



Source: George Mason University (wxmaps)

The weather forecast for this week shows clear skies over most regions of South Africa, which is supportive of the summer crop harvesting process.

The only region that could receive rains this week are the coastal parts of the Western Cape, which is a welcome development as it could support the winter crops.

The following week, however, could bring rain over most parts of the country.