Agriculture – A Powerful Inflation Hedge that may also help Grow your Portfolio

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The attractive thematic underpinning Australian Agriculture is well established within investment circles. With a growing global population and the related demand for food and fibre, Australia has world leading farming capabilities, good proximity and trade access to key global markets, strong export channels, and a reputation for clean, high-quality products.

These strong fundamentals point to an asset class that is a valuable long-term investment through any cycle. However, stepping back from the fundamentals and strong secular outlook for agricultural products, this asset class is also becoming an increasingly important option for its low correlation diversification; as an insulator to portfolio volatility; and, now more than ever, as a proven tool to hedge against inflation.

Inflation Risk

The COVID-19 pandemic pushed global economies into a snap recession unlike any downturn event in history. With varying trends in infection rates and different government policy settings around the globe, the recovery is ongoing and prone to relapses - it is not one paced and different sectors are impacted in different ways. However, a common response has been unprecedented fiscal policy from across the developed world including record low interest rates coupled with monetary easing.

The fiscal and monetary stimulus that has and will be required to drive a full global recovery, particularly the ongoing role of low interest rates, is now leading to a buildup of inflationary pressures. The market continues to debate if current inflation is transitionary or a permanent trend.

However, there is a broad market consensus that even as a transitory phase winds down, and inflation normalises over the longer term, that CPI is likely to remain above Australia's long-term average annual rate of 1.9% and potentially above the Reserve Bank target inflation rate of between 2 and 3%.

As a result, long term investors are looking at their current portfolios, evaluating what the impact of higher inflation may be, and assessing new investment opportunities that offer inflation protection and potential upside.

Hedging Against Inflation

With traditional hedges such as government bonds offering low returns in today's environment, investors are turning to alternatives, such as real assets, as solutions that can not only protect against inflation, but potentially benefit from an inflationary environment.

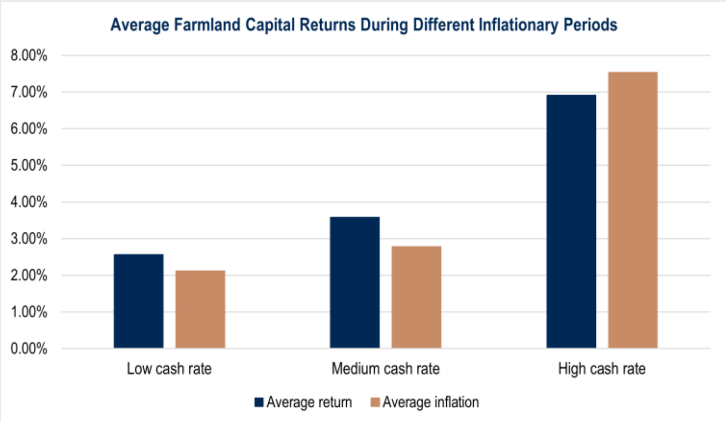
An increasingly popular investment solution in the real assets sector is agriculture/farmland, which provides investors with three key characteristics to fight inflation pressures within a diversified portfolio:

1. Inelastic demand of food consumption – the unquestionable necessity of food has been further highlighted through the pandemic.
2. Inelastic supply of assets – although productivity and efficiency can increase, ultimately the core elements of an agricultural investment (farmland and water resources) are finite and not something that can be manufactured or easily substituted.
3. Correlation to inflation - the commodities underpinning an agricultural investment, themselves, are highly correlated to inflation and product pricing has historically tracked with or beyond high economic growth rates.

Farmland Capital Returns during High Inflationary Periods

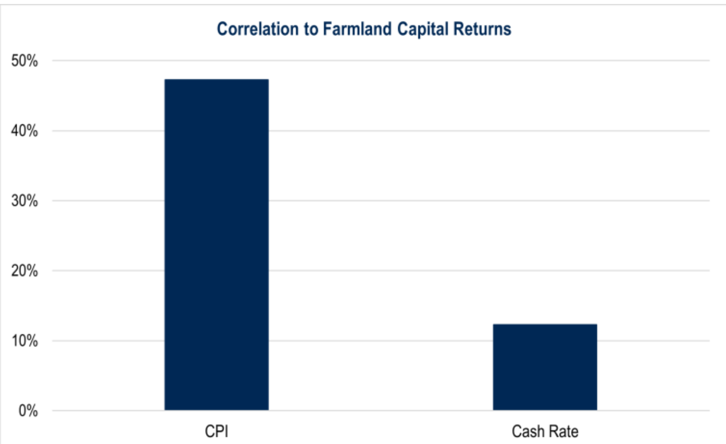
Although the impacts of inflation on income yield in agriculture can vary, there is a clear trend that in periods of high inflation, values of farmland assets do increase at their highest rates.

In the period between 1978 and 2019, farmland values in Australia increased at the highest rates during periods of high inflation and in particular when CPI has been above 4.2%.



Source: ABARES Australian Agricultural and Grazing industries Survey and Australian Dairy Industry Survey. ABS Australian Bureau of Statistics: Consumer Price Index

Interest rates can also have a profound effect on property values across all sectors, including farmland, as higher interest rates increase the cost of finance and in turn reduce net operational returns. However, as shown below, the impact of interest rates in agriculture is not as dramatic as that of inflation, which is more highly correlated to farmland capital returns than the RBA cash rate.



Source: ABS Australian Bureau of Statistics: Consumer Price Index. Reserve Bank of Australia (RBA)

The Impacts of High Inflation on Agriculture Income Yields

In line with performance through historic events of economic stress, agricultural investment returns have been highly resilient through the pandemic. Unlike traditional inflation hedges, such as gold, farmland is also an income generating asset that can produce a reliable yield.

Specifically for agricultural income returns, moderate to high inflation has different influences on key profit drivers and the impacts depend on relative inflation in agricultural outputs, as well as the economic position of our relevant trading partners.

Making up a large portion of the CPI basket of goods, agricultural outputs such as food and beverages are naturally exposed to inflation. A rise in prices can be indicative of higher revenue for producers of these goods, and if occurring at the same time as a depreciating Australian dollar (AUD), it has the potential to be very supportive of agricultural profits.

It must be noted that inflation in goods and services can increase the cost of farm inputs, potentially squeezing margins unless revenue growth fully compensates such extra costs. Upward cost pressures on labor would also be expected in an inflationary cycle. However, agriculture is a much more sophisticated and less labor-intensive sector than it once was, and a continued focus on technology, operating efficiency and automation across the food supply chain has reduced, and will continue reduce, wage pressures over time.

Summary

Quality farmland investments offer an attractive alternative to traditional asset classes, that is largely agnostic to economic cycles. With the prospect of inflation looming, adding or increasing exposure to agriculture within a well-balanced investment portfolio can offer considerable benefits to long-term investors.

Warakirri offers a 'Core Agricultural Property' investment strategy that has been established to buy, develop and lease property to high quality agricultural businesses, as tenant partners, providing investors access to a portfolio of investment grade Australian agricultural assets with low volatility returns. The target assets for this strategy include high value sectors of horticulture (nuts & fruit), viticulture (wine & table grapes), irrigated row crop farmland assets and water entitlements.