

Economy about to throw us a curve

According to the S & P/Case & Shiller House Price Index, the national average house price currently sets at 72% of the peak that was reached in the second quarter of 2006. Before the current economic meltdown is done, the national average price will be **less than 50%** of that peak — in other words, prices are going to fall by another third before they bottom out. This time, the mostly rural areas of the Upper Midwest are going to feel the pain, too. The resale values of hog barns, machine shed and grain bins are going to experience the same declines.

Do I have your attention?

So far, the area in which we live has shown relatively minor softness - nothing like the crashes seen in Las Vegas; Fort Myers, FL.; or Stockton, CA. Our home values have remained fairly stable because we stoic Midwesterners do everything in moderation – spending, borrowing and making merry.

However, none of us are going to escape the next problem lurking around the corner. *The boogeyman that none of the Harvard MBAs seem to see is the declining cost to build new.*

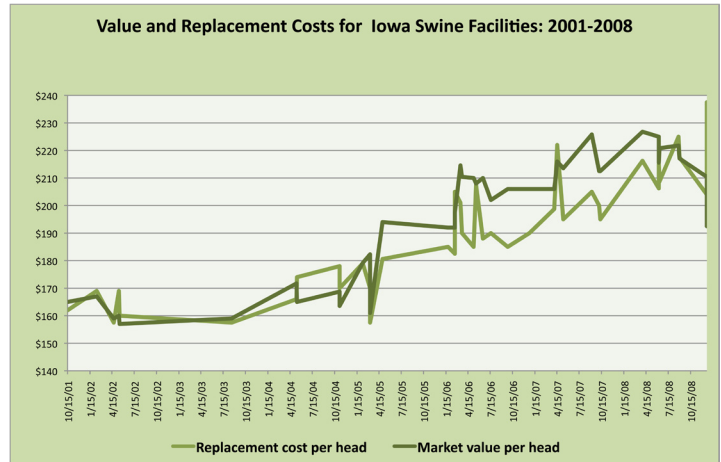
Why did prices increase anyway?

I paid \$87,500.00 for my house in 1987. The Mason City Assessor currently has my house assessed at \$191,580.00. I think I could have gotten that price at the peak. I think it's still worth around \$175,000.00. I've replaced the roof and furnace and spent \$2,000 to give a ¾ bathroom a face lift. Otherwise, it is the same house as 22 years ago - same kitchen, same windows, even some of the same carpets. Why would it be worth twice what I paid for it? There are several reasons, not the least of which is sloppy lending standards, but the most obvious reason is that **the cost to build it all over again has increased dramatically over that time.**

The same thing happened to hog barns and grain bins. Ten-year-old hog barns have sold for more than the original cost to build them because that was still less than the cost to replace them.

I offer as evidence the chart at the **top right**.

I have a regular lender client for whom I've been doing hog finishing facility appraisals for nearly 10 years. There have been a half dozen new finisher site appraisals each year for this customer (until 2009 when the pace of new finisher



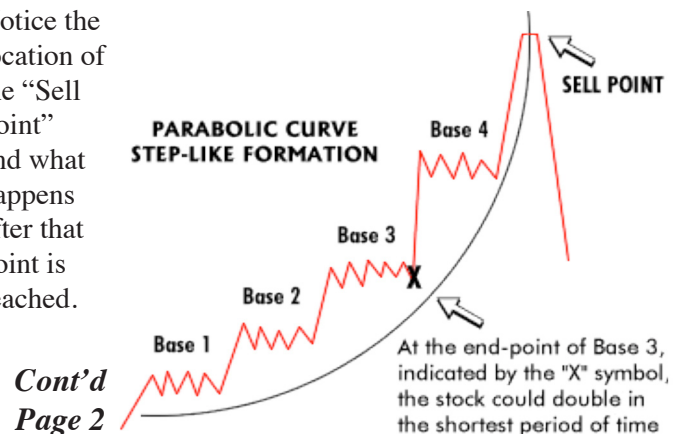
construction dropped dramatically). The cost to build new finishers has been plotted in this chart against the appraised value. As the cost to build new finishers went up, the resale price went up. That is in spite of the relatively stable income generated by the contract grower agreements over the same time frame.

A similar chart for houses, pole machine sheds and grain bins would show the same relationship.

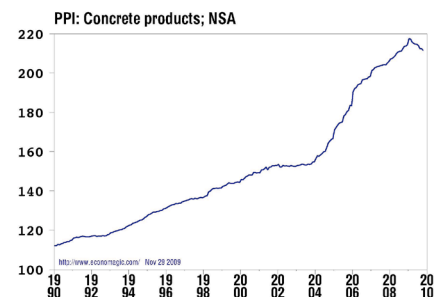
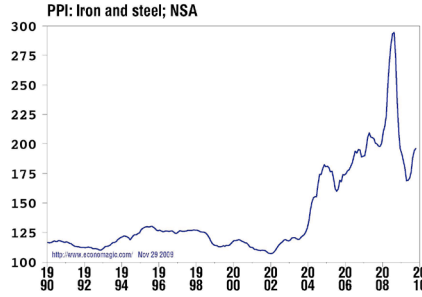
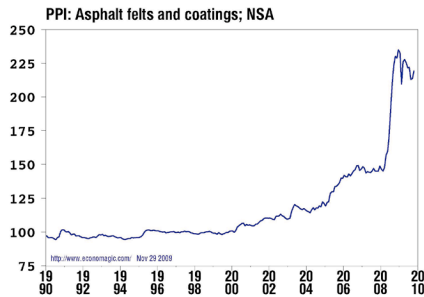
So, why would prices drop now?

Why am I convinced replacement costs are now going down? I offer you the wonders of the parabolic curve. I could have had a double major at Iowa State University, but I would have needed calculus to also major in Agricultural Business. I didn't need a double major that badly, and you don't need to know calculus to appreciate a parabolic curve. Below is a classic parabolic curve.

Notice the location of the "Sell Point" and what happens after that point is reached.



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Above, I offer you more parabolic curves.

Get ready for the slide

The Iowa Department of Revenue prepares a Real Estate Manual every ten years. According to the Department of Revenue, the cost to build the typical Iowa house went up more than 35% between 1998 and the publication of the 2008 manual. I predict home construction costs and outbuilding construction costs will return to at least 1998 levels.

There is precedence for my gloomy forecast. During the Farm Credit Crisis of the 1980s, five-year-old hog confinement buildings were selling for less than 35% of the new construction cost.

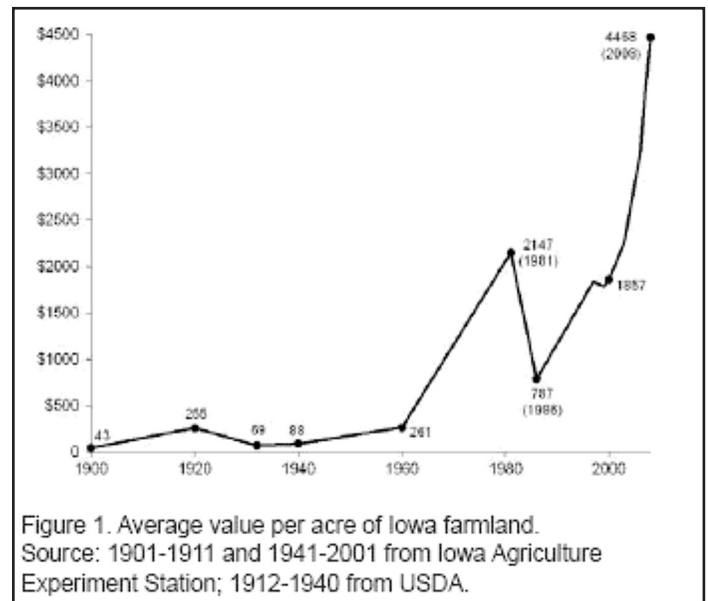
Rural real estate values fell for five years during the 1980s. Today's credit crisis is much more widespread. In the 1980s, the much larger national economy was able to stabilize the farm economy. The smaller farm economy can't return the favor this time. The national economy is barely three years into this cycle. It is my opinion that we will be riding this side of the cycle down for at least another three years.

That means the agricultural economy can't escape the impacts, and we need to brace ourselves now for the drop in values that is sure to come.

You've read the quick and simple explanation, but it isn't possible to fully cover this subject on these two pages. I'm available for a more complete presentation with more audio-visual aids. Some of you have already had the pleasure!

I'll close with one final chart. It is self-explanatory – a classic parabolic curve.

Average Value Per Acre of Iowa Farmland



Looking for more quick takes on today's markets? Check out my *Real Estate B... S... Bingo* game for a reality check, or see more predictions and pithy observations in *Thoughts and Forecasts* on www.benchmarkagribusiness.com.

*With wishes for a Merry Christmas
 and Happy New Year,
 we thank you for your continuing business!*

Ebenezer Rudy

