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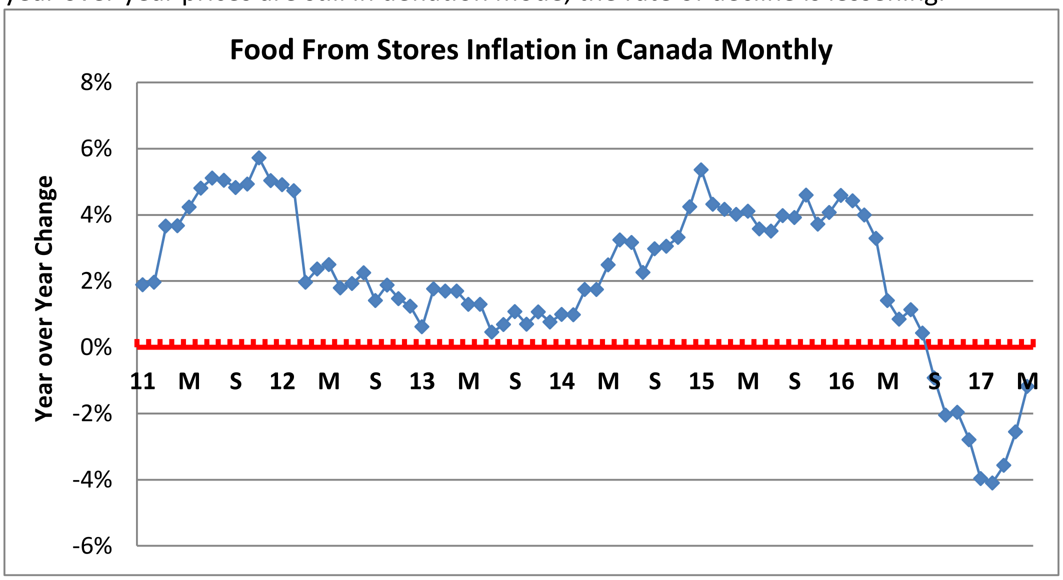
Food Pricing Signals for the Rest of 2017

According to the Statistics Canada Consumer Prices Division, the Consumer Price Index (CPI) for Food Purchased from stores declined in May by 1.2% compared to May 2016. On average prices over the last 12 months have declined by 1.7% compared to the previous 12 months. Prices of food purchased from stores have declined year over year for nine straight months. The rate of decline seems to be abating, however, as CPI prices declined by 4% in January and February versus the 1.2% in May. That is, while year over year prices are still in deflation mode, the rate of decline is lessening.



Criticizing StatsCan

Within that context there was the Dalhousie University report entitled Canada's Food Price Report Mid-Year Update which was released in June. The mid-year update report cited the prior Dalhousie December Food Price Report that suggested that food prices in Canada would increase by 3% to 5% during 2017. Among some of the reasons cited for the forecasted jump in pricing was "the incoming Trump administration in the U.S. — which, while rife with uncertainty, suggests a forthcoming period of American protectionism that could initiate a "commodity super-cycle, raising food prices for Canadians."

This is the same forecast series that said that 2016 food inflation would increase in the range of 2-4%. That was not a particularly bold forecast given that the average food inflation from 2000-2016 is just under 3%. In the 17 years from 2000-2016, food prices have only been out of that range five times, and not by much. Four of those times it was 1% inflation and one time it was 5% inflation. Nevertheless that

Dalhousie forecast for 2016 managed to be wrong. This is despite the high probability of getting a forecast in the range without any effort at all. Actual inflation of food from stores in 2016 according to the StatsCan CPI was just 1% and all food inflation including restaurants was 1.5%.

Despite being wrong on the 2016 forecast, however, the December Dalhousie 2017 report states that "Our 2016 forecast was accurate, for the most part, until deflationary pressures reached Canada in August." So it was accurate, until it wasn't accurate.

With regard to the bolder 2017 forecast of 3-5% inflation, the mid-year update report states "Based on results so far, we remain comfortable with our initial forecast. Due to ongoing deflationary pressures earlier this year, we have slightly modified our initial forecast of food prices to rise between 3% and 4% by the end of this year." The forecasters are staying the course, sort of.

Given the reality of food prices as measured by the CPI in comparison to the Dalhousie predictions, however, the report goes out of its way to question StatsCan. The report says, "The Consumer Price Index (CPI) was never meant to be perfect. However, this year, with food inflation, the CPI seems off, way off." It asks whether the CPI having a really bad year?

In reference to the decline in prices as reported by the CPI, the Dalhousie report says "Social media conversations suggest Canadians have barely noticed. Many have even become skeptical about what is being reported." Yes, a Dalhousie University report actually said people on social media are skeptical.

The report goes on to cite their own "non-scientific survey" research which shows some prices have risen sharply, at least since January 2017. The report says that "Back in January, Dalhousie University recorded prices of over 100 randomly selected food products from several stores that may not normally be captured by the CPI." Those prices from went up by 5% from January to May.

As can be seen on the graph above, the StatsCan data also shows that prices began to increase from January to May. Nevertheless the fact that prices might be greater in May and January, does not take away from the fact that Canadian food prices are still in deflation mode in the first five months of the year. In the first five months of 2017 Food from Store prices are down 3% compared to the same time last year.

The Dalhousie mid-year update effort to discredit StatsCan is a classic example of attacking the messenger.

Further to that, the mid-year report offers a final kick at StatsCan by saying "In the end, Canadians deserve to know the real story behind food prices. …Second guessing what may be happening to their grocery bill is not something we should accept." The number of people that "second guess" what is happening to their grocery bill due to StatsCan reports was left unsaid.

In any event, for some reason, StatsCanada felt the need or desire to respond to the Dalhousie derision about its CPI. While not mentioning Dalhousie at all, the June 23 timing of a two-page note from StatsCan could not have been coincidental. It was entitled "How to measure changes in Canada's grocery bill." One can suppose that if they did cite the Dalhousie report, it would have been entitled, "How not to measure changes in Canada's grocery bill."

The StatsCan release says the price collection team records the prices of approximately 100,000 consumer items each month, in 40 cities across Canada. Of these items, almost half…are food. Price collectors visit approximately 500 food retailers, from small local shops to big box supermarkets, and methodically record the prices of items on the shelves. They also record any changes in size, weight, number of units in a box and other features that determine what consumers are actually paying for, and note when an item is discontinued.

Richard Evans, Director of Consumer Prices Division at Statistics Canada, describes how they work: "The price collectors operate very independently. They go down the aisles, most people think they're other shoppers. They just go around, check prices, and they're out."

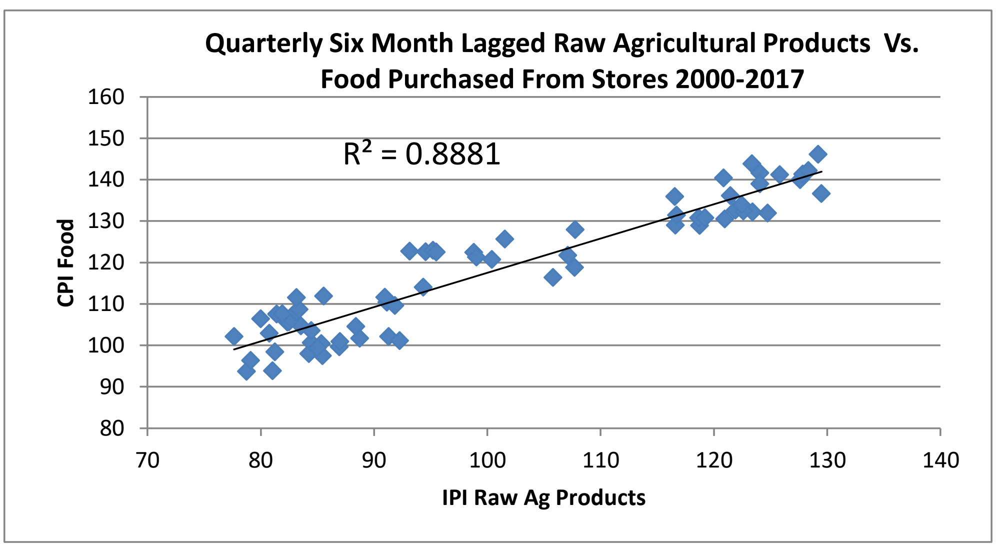
"The CPI is in the best shape it's ever been," explains Mr. Evans. "We update the basket every two years. We've significantly increased the quality of the sample, the monthly pricing that we do. We've done that by adding more prices. We also have a better method for selecting stores, and for selecting products in stores, than we used to have. We're world leaders in this area."

For my part, I will stick with StatsCan. With all of that noted, however, what can be expected in food inflation for the remainder of the year?

Raw Product Pricing and Food from Stores

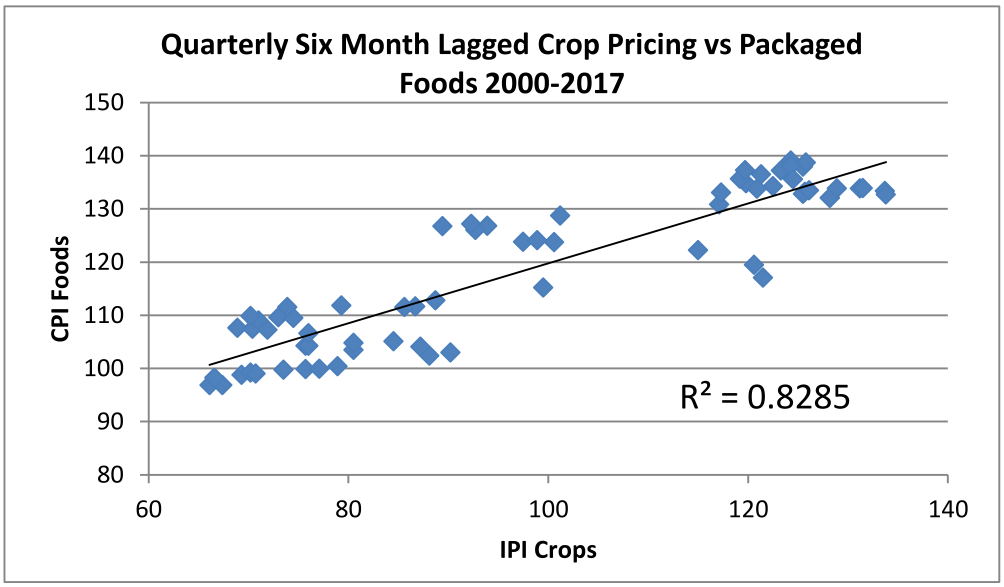
Each edition of *Grocery Trade Report* contains charts and commentary on the direction and trendlines of the raw product or agricultural prices. The reason for concentrating on the raw product prices is the direct relationship between those prices and the prices of consumer food products. There is strong correlation between the raw product prices and the consumer prices.

For example, the StatsCan Raw Materials Price Index for agricultural products can be compared against the Consumer Price Index for prices of food purchased from stores. The raw prices can be lagged by six months to allow those prices to work through the chain to the store level. When that is done quarterly from 2000 to Q1 2017 there is a very strong statistical relationship that evolves.
There is often a hazard in reading too much into correlations as they can and are often be used to prove

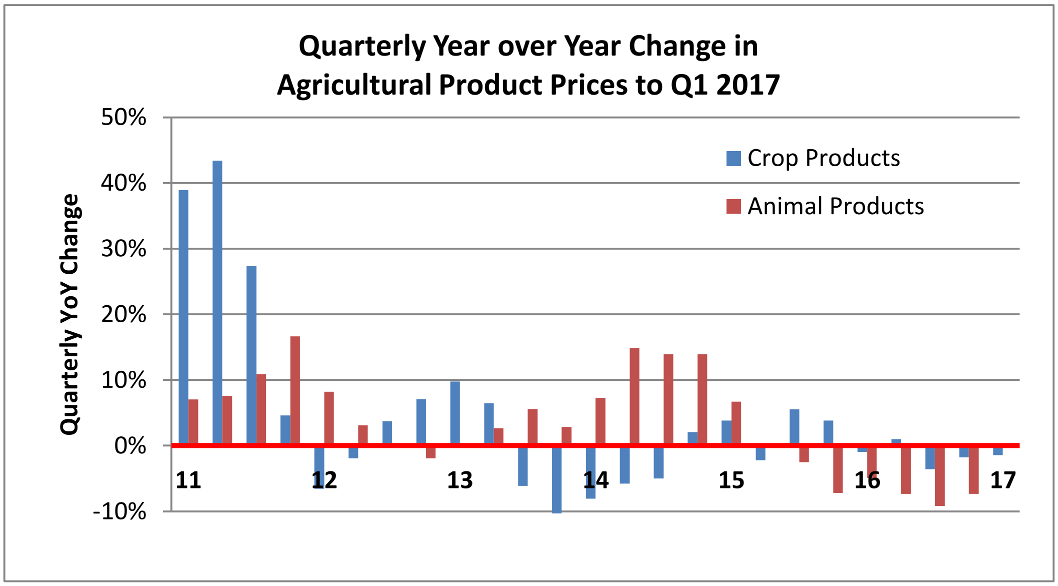


any relationship. With that acknowledged there is an intuitive logic that there should be a relationship between the base ingredient and the final cost of a food product. This makes particular sense in meat products where the livestock can amount to two thirds or more of the cost to the retailer. Even in the consumer packaged goods however, the raw crop costing looks to be a direct influence in pricing of the final product. That is, while the wheat or oat cost in Cheerios might not be as significant as the cattle cost in a prime rib, it is still the main ingredient.

This relationship can be tested by lagging the StatsCan Crop Products index six months against indexed consumer packaged goods food prices (CPG). As with all agriculture and food, again there is a strong relationship that can be seen between the two. This is particularly interesting given all the other factors that can go into pricing CPG such as marketing, packaging and labor. It demonstrates the importance of the raw commodity and the need to track them for future direction.



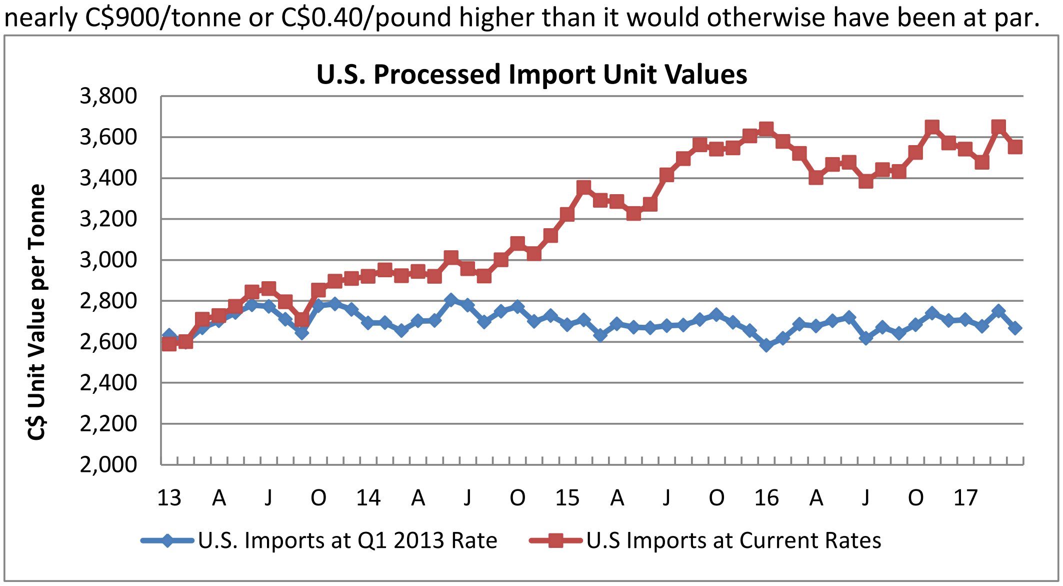
Clearly the raw materials pricing are at least one harbinger of consumer food price direction. In that regard, the current direction of the raw product costing does not signal increases in the consumer food inflation. While there has been upward pressure on cattle and hog prices in the last two months the expected production in the coming months appears ample. Futures prices on cattle have been under downward pressure in June. Hog prices have been soaring but seasonally pricing typically begins to recede in September or sooner. Furthermore, as of late June, crop conditions in the United States are very good. While that can change rapidly, as of now expected production of the key crops is expected to be abundant again in 2017. That is important is it will impact all plant based prices including processed vegetables.



Another portent of inflation that is often used is the exchange rate. That is why the exchange rate and the BMO forecast is also included in each edition of this report. In effect however, the impact of the exchange rate is simply reflected in the raw costing. Most raw costs are traded freely and priced in U.S. dollars. As such, any change in the exchange rate is immediately reflected in the raw costs to Canadian processors or grocers. As such for the most part, I tend to consider the exchange rate as part of raw materials costs.

The obvious inflationary impact of the exchange rate that is not, however, raw materials related is the cost of finished imports. Every Canadian understands the impact of the exchange rate on every purchase they make in the United States and the same is true for importers of CPG. Whether the product is imported directly by grocers or by brokers or manufacturer representatives, the deflation of recent years results in higher costs of finished goods.

For example at the start of 2013, the exchange rate was right at par. At that time the price in the U.S. was the price here in Canada plus logistics. As the exchange rate depreciated, the cost increased. By the first quarter of 2017, the cost of processed food products from the United States into Canada was nearly C$900/tonne or C$0.40/pound higher than it would otherwise have been at par.



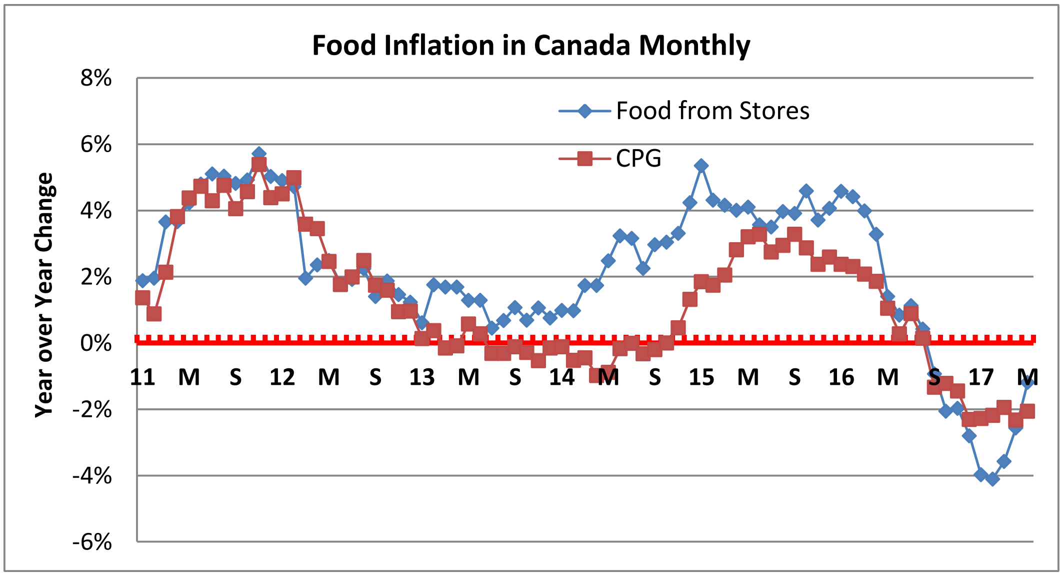
With that acknowledged the inflationary impacts occur when the exchange rate is in depreciation, not in periods of stability. The exchange rate has been trending roughly sideways or perhaps in modest depreciation since 2015. In fact, in June the C$ showed signs of appreciation. It finished June at C$.077, up from 0.74 at the start of the month. That would ease import costs lower. Predicting the direction of the C$ is probably impossible, but as of now there are no inflationary signals coming from the current trendline.

Another factor that drives food prices is the level of competition in the grocery industry. Intuitively the more intense the level of competition between the players, the better it is for consumers. I am not going to go into detailed discussion about competition measures in grocery, but the following are key indicators:

1. Floor Space Growth
   The greater the growth in floor space the greater the likelihood that competitive rivalry will increase. According to CIBC Institutional Equity Researchers, grocery square footage growth has been increasing at about 1.8% last year and another 1.7% this year. Canada's population grows about 1% each year. CIBC considers the current rate of growth to be within a range that will not generate challenges for grocers. Note that in 2013 and 2014 footage growth was above 2% and food inflation tanked sharply, as seen on the graph on page 2. While current rates may not be excessive, they are also not low enough to say it is going to help fuel inflation. Call it neutral.

2. Market Share Changes
   Market shares that are stable or unchanging over time indicate a lack of competition. Dynamism in market shares suggest ongoing jockeying and competitive rivalry. In food, CIBC market shares indicate that even just between 2016 and 2017, Sobey has lost share, as perhaps has Metro and Overwaitea. Costco and Walmart have gained share. Over longer periods of time, as has been reported in this publication many times, the general merchandisers (Walmart and Costco) have been rapidly gaining share of food sales at the expense of the food stores. Market share data indicate that there is a competitive environment, at least in 2017.

3. Consumer Packaged Goods Prices
   As noted here often, the only way grocers can compete on consumer packaged goods is through price. The Heinz at a high end Longos is going to be the same Heinz as at a No Frills. Therefore the direction of the pricing on these products gives an indication of competition. Arguably this measure is probably more of a symptom of competition rather than a driver, but nevertheless it is instructive to watch. In that regard, the CPG pricing has been signaling a competitive marketplace in Canada. While the CPG pricing did not sink as low as the overall food from stores, it appears to be stickier on the downside as the rest of pricing starts to firm.



4. Meat Pricing on Flyers
   Food industry experts have been predicting the demise of the flyer for the past twenty years. Flyers however, appear to be more important than ever. Flyers draw traffic and an attractive meat price on the front of the flyer is seen as an important draw. On holidays in particular it is critical to "win" the weekend with the most impressive meat item. If there is meat in the shopping cart, there is going to be a much greater cash receipt than if not. Based on meat on the front page of the flyer as a gauge, the competitive rivalry is very intense. Walmart's Victoria Day bone-in striploin at $5.77 sent a major signal. Loblaw ran a July 1 Boneless breast ad at $2.99/pound. That had every industry participant take note. That would have amounted to significant losses or "investment" on their part.

The main point is that competitive rivalry appears to be intense now. That contributes to the deflation that consumers are enjoying. How long this will continue is not possible to predict. I expect the grocers don't know themselves. With that said, they are in the fight now and it is going to be hard to pull out first.

Why it Matters

The bottom line is that I look at two factors that I think are the main drivers of food inflation: competition and commodities. Donald Trump is not on this list as it was on the Dalhousie list. Both of these drivers indicate that pricing increases should continue to be very tepid if not negligible for the next few months at least. In the first five months of 2017 prices are down 3% compared to the same time last year. If there is going to be a 3-4% increase in average prices for 2017, as predicted by Dalhousie, it would mean dramatic pricing increases for the rest of the year. These increases could be caused by major problems on crop production or a severe weakness in the C$. In any case if a big jump does occur and I am wrong, I won't blame StatsCan.

A version of this article first appeared in Grocery Trade Report. For a free trial to GTR send an email to kevin@kevingrier.com