Taking out the Mystery of Food Inflation Prospects for 2014

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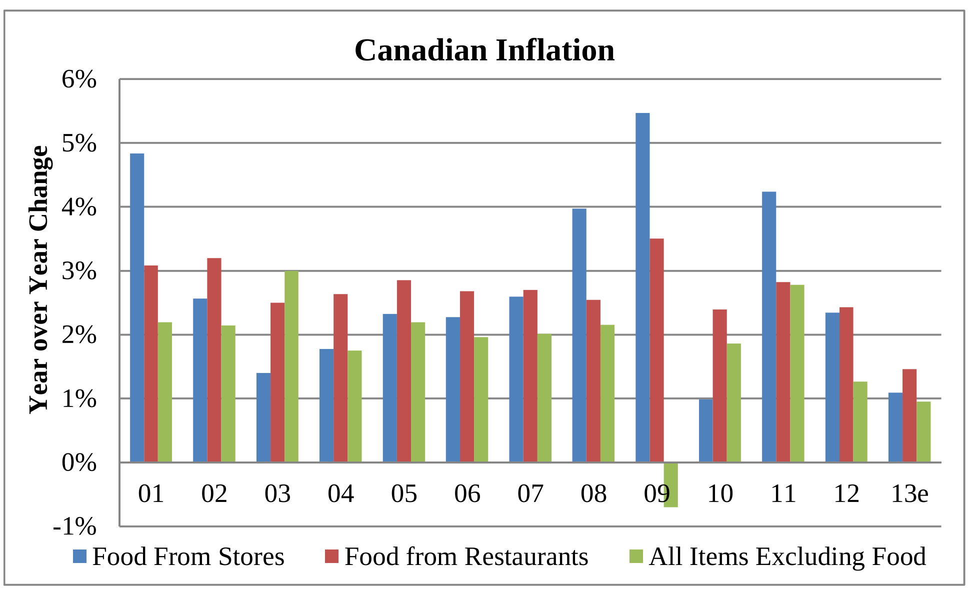
January 2014

Food inflation is a focus of much attention by consumers as well as by market participants throughout the food production, manufacturing and grocery chain. This paper explains what factors will drive inflation this year. Considering those factors and their direction can provide an indication of the overall magnitude and thrust of food inflation in 2014.

Performance in 2013

Once the final data is in, Canadian inflation for food from stores will be up by just 1% in 2013, according to the StatsCan Consumer Price Index. This rate of inflation compares to the previous ten year average of 3%, with a peak of over 5% in 2009. As can be seen on the graph below, there has been a sharp downward trend in inflation for food purchased from stores over the past four years. Price increases for food purchased from restaurants has also been on a downward trend over that time. By comparison, the price increases for all items, excluding food, has been more stable, averaging a 2% increase over the past ten years. The only move away from that all-item stability was the recessionary price decreases in 2009.

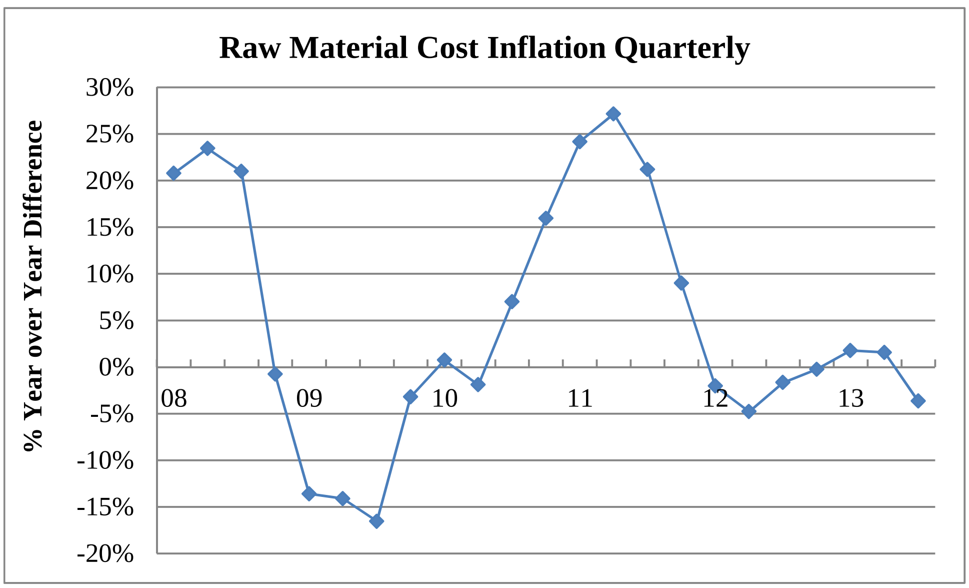


The question then becomes, what has driven the more modest rates of food inflation during the past year relative to the more robust increases of 2008-2012?

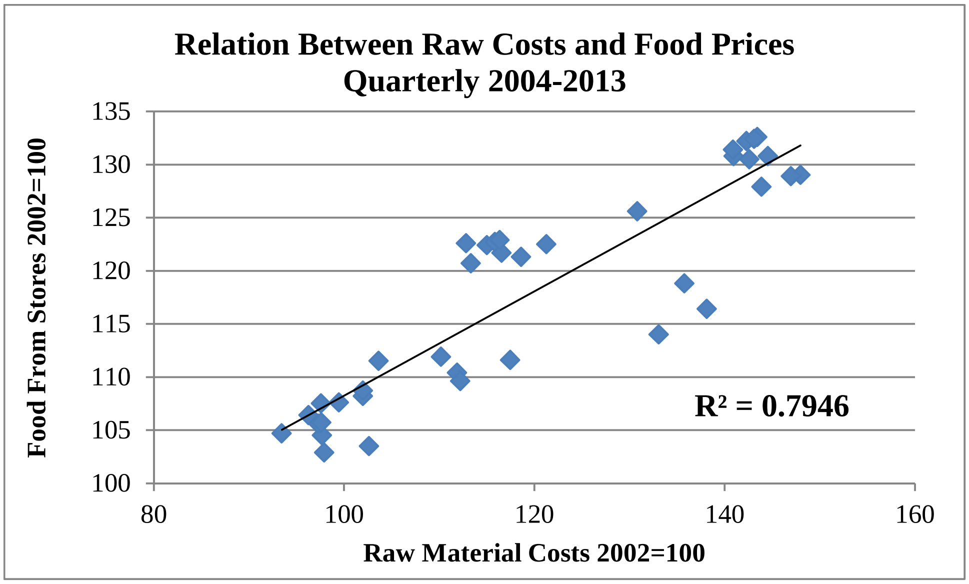
Raw Material Costs

As a starting point, one of the root drivers of food costs, of course, is raw material or commodity agricultural costs. The basic raw costs of food manufacturing production are animal products, vegetable and grain products and other raw materials such as energy. To measure this, the StatsCan Raw Materials Price Index can be broken into an index of animal, vegetable and other raw material prices which are reasonably reflective of food manufacturer raw input costs. The changes in this food manufacturer raw material index can be tracked on a quarterly basis to give an indication of the overall direction of food manufacturer costs.

As shown on the graph below food manufacturer raw costs have been very volatile from 2008, through the third quarter of 2013, although there has been stability since 2012. During the recession the manufacturer cost base declined sharply, as all commodities were under pressure. From that point the food manufacturer cost base increased sharply through early 2011. Since 2011 costs as tabulated by StatsCan have declined and even went into negative territory in early 2012, and the third quarter of 2013. On average, raw materials cost increases have been basically flat to negative over 2012 and the first three quarters of 2013.



Perhaps not surprisingly, the performance in the manufacturer cost base is a solid determinant of consumer food prices. As shown on the graph below, there is a strong correlation between food prices and the costs of animal and vegetable products as well as other raw materials. The graph shows raw costs on a quarterly basis lagged by one quarter against food from store costs.



Admittedly, correlation does not mean causation but in this case, it probably does. It is reasonable to assert that raw food commodity costs have an influence over consumer food costs. In the case of Canadian prices as shown on the graph above, the raw costs and prices clearly do have a close relationship.

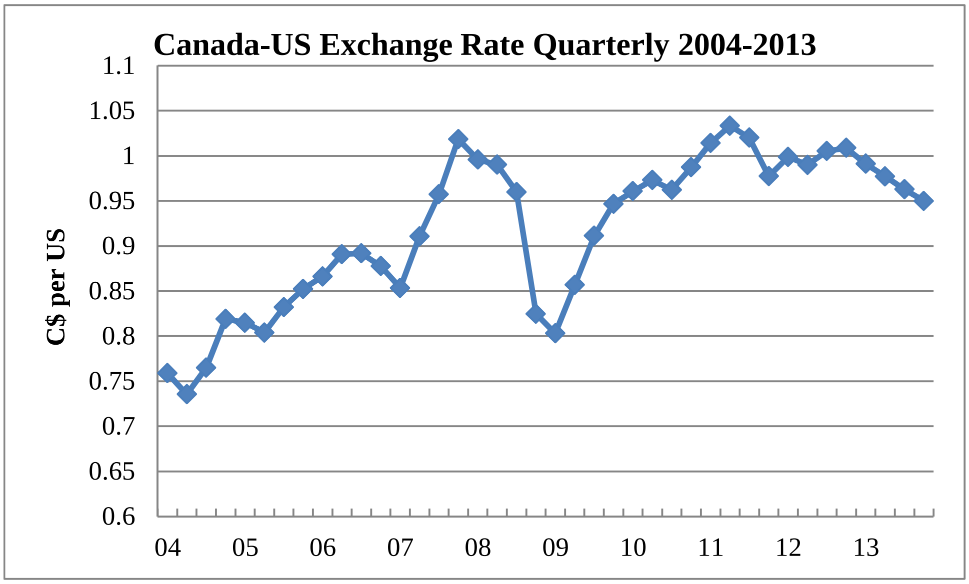
In summary, food manufacturer raw material costs have been in decline or stable over the past two years. In addition there is a strong correlation between raw costs and consumer food prices. As such, it is reasonable to assert that food prices will not be under any upward pressure at all during 2014. The one important caveat to that will be meat. Cattle and hog supplies are tight and meat prices will be under upward pressure. Aside from the meat issue, there is no strong argument that commodities or raw material costs are going to force food pricing higher.

Exchange Rate

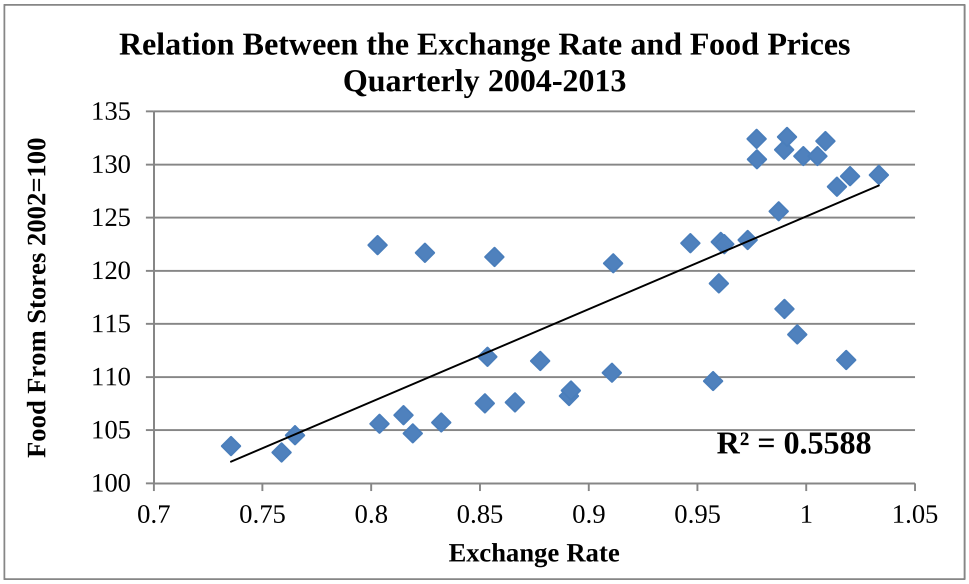
Canada as a trading nation is open to the vagaries and movements of changes in the exchange rate. At the most basic level, fluctuations in the exchange rate result in changes in values of the traded goods. An appreciation of the exchange rate makes imported products less costly for Canadian importers to purchase. If a case of US product is worth US$50, Canadians must pay C$66.67 when the exchange rate is $0.75 but only C$50 when the exchange rate is at par. Conversely, if Canada is selling a case of product to the US and the prevailing price in the US is US$50, Canadians can generate C$66.67 from that sale at a $0.75 exchange rate. At par value, Canadian exporters can only generate C$50 for the same case. If the Canadian cost of production is C$60/case, it is a profitable

sale at 0.75 and very unprofitable at par. The point is that fluctuations in the exchange rate have serious and immediate impacts on costs, prices and profits. Changes in the exchange rate impact buyer and seller motivations and marketing patterns.
Changes in the exchange rate have indirect implications on consumer food pricing. That indirect effect is on the cost of imported and exported food products, either finished or raw. In other words, the exchange rate impacts food prices through its impact on raw materials pricing and finished products.

The long term trend over the past ten years is that the exchange rate has been appreciating. In the short term, however, the exchange rate has recently been depreciating (see the graph below).



As can be seen on the graph below, there is a direct positive relationship between consumer food prices and the currency. At a more basic level, a depreciating currency will have upward pressure on food pricing while an appreciation will mean lower price pressure. The long term trend therefore has been towards lower Canadian pricing. In the short term however, as the exchange rate depreciates and is expected to depreciate into 2014, the opposite could occur.

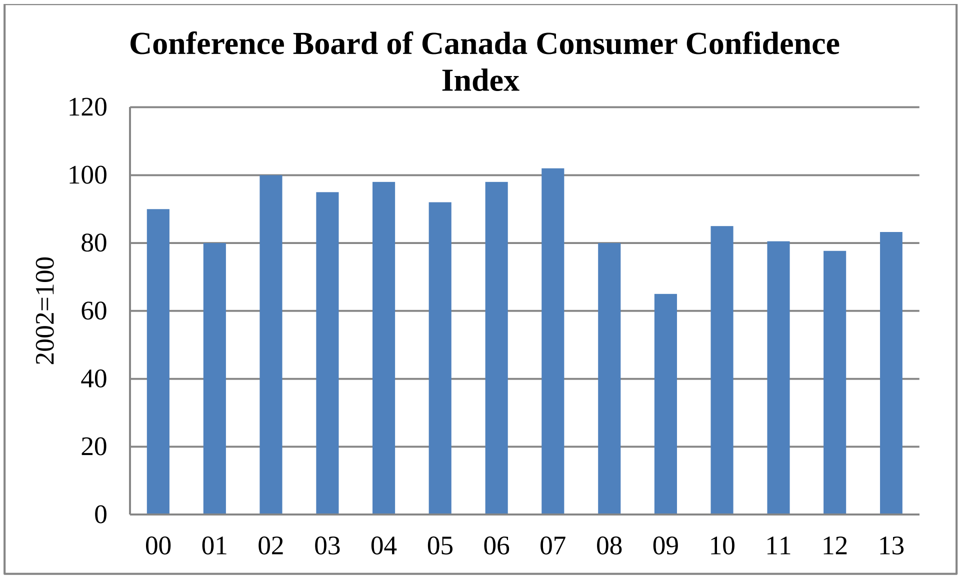


Broader Economy and Consumer Demand

Canada's economy is expected to continue to strengthen only slightly over the next 2 years, with the Bank of Canada projecting 2.3% growth in GDP in 2014. Other projections for the Canadian economy are less optimistic, Capital Economics for example is projecting slightly less growth in 2014 at 1.5%, compared to 1.7% in 2013. Generally relatively slow economic growth does not typically coincide with an environment in which prices can be readily increased.

Consumer Confidence

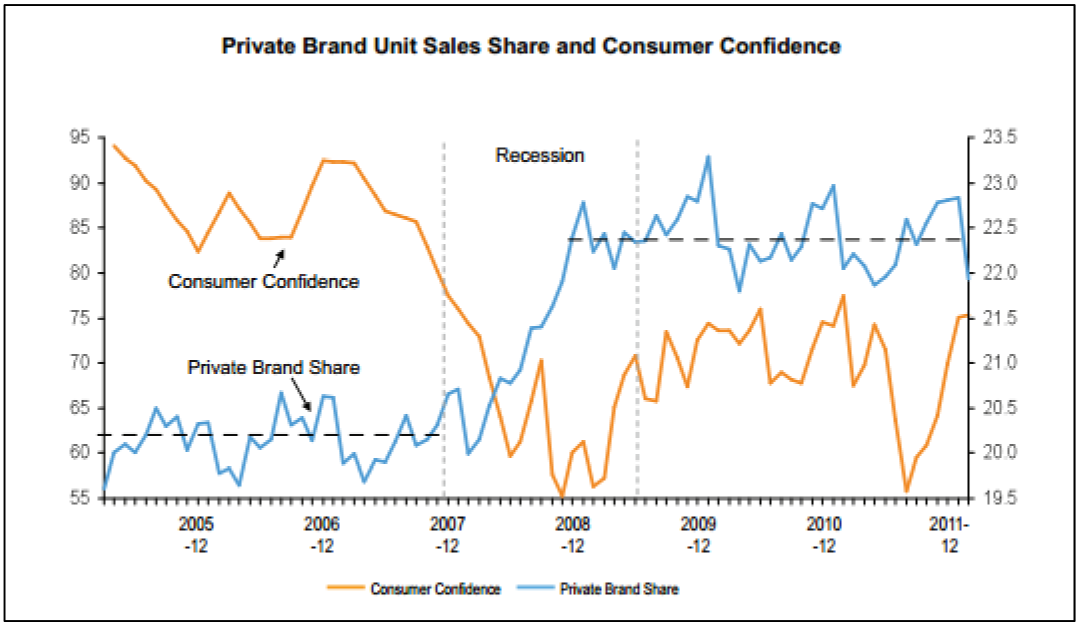
Consumer confidence can be defined as "the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending. Such measurement is indicative of consumption component level of the gross domestic product." The Conference Board of Canada has a monthly Index of Consumer Confidence which is constructed from responses to four attitudinal questions posed to a random sample of Canadian households. The Conference Board of Canada's Consumer Confidence Index is benchmarked at 100 for 2002. For perspective, it averaged 83 for 2013, up from 78 the previous year.



While consumer confidence is up in 2013, it remains well below pre-recession levels. That suggests that consumers will remain cautious spenders. With regard to food inflation, a tepid cautious consumer base is not an environment that is conducive to aggressive price increases. Weaker consumer confidence in Canada is an argument for modest food inflation.

It is well documented that during the recession many consumers sought to lower their grocery bills by substituting for cheaper options. Over time this has been relaxing, but it still has the effect of holding down food prices, as consumers are now further conditioned to substitution when prices begin to creep upwards. Industry Canada's Consumer Trends Update released in August 2013 notes this enduring trend, as well as the increase in consumption of private label products, as a cheaper alternative to brand name products.

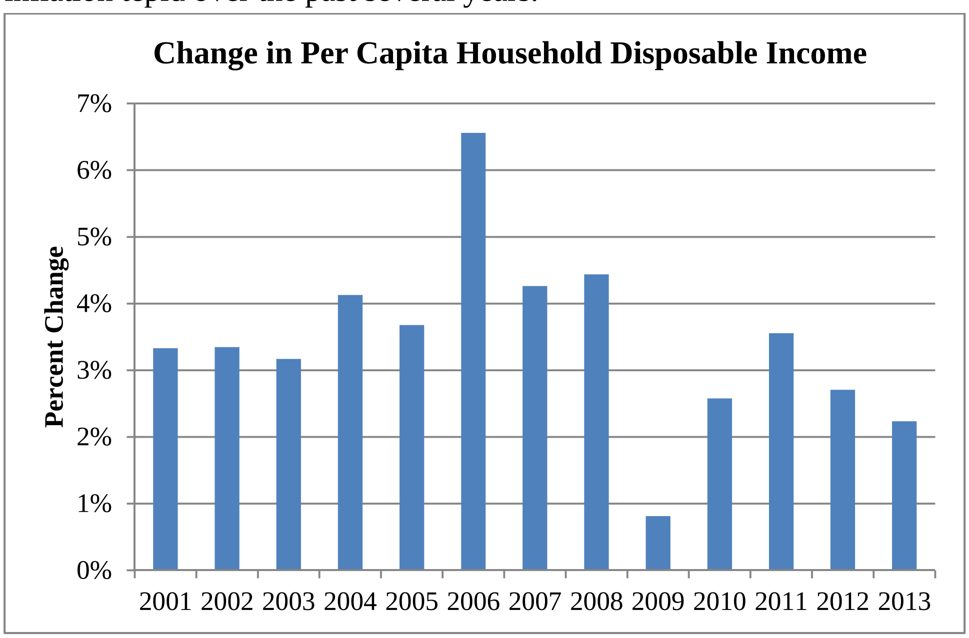
The following graph shows the relationship between consumer confidence and private brand sales based on the Thomson Reuters University of Michigan Survey of Consumers. While the graph shows American data, it clearly demonstrates that in the post recessionary period, consumers have gravitated back to store brands when consumer confidence declines. In addition, private label consumption remains higher than before the recession; even though consumer confidence levels were also well below pre-recession levels.



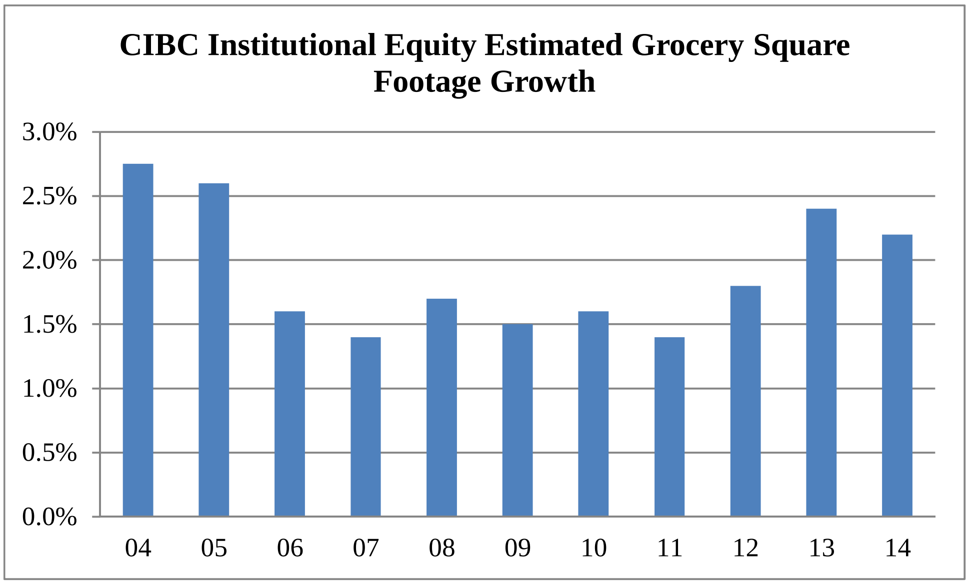
Source: Food Marketing Institute. US Grocery Shopper Trends 2012.

<u>Disposable Income</u>

Disposable incomes in 2013 rose slower than they did in 2012, at 2.2% through the first three quarters of the year, compared to 2.7% in 2012 and 3.6% in 2011. Slower growth in per capita incomes and increased household savings has also helped to keep food inflation tepid over the past several years.

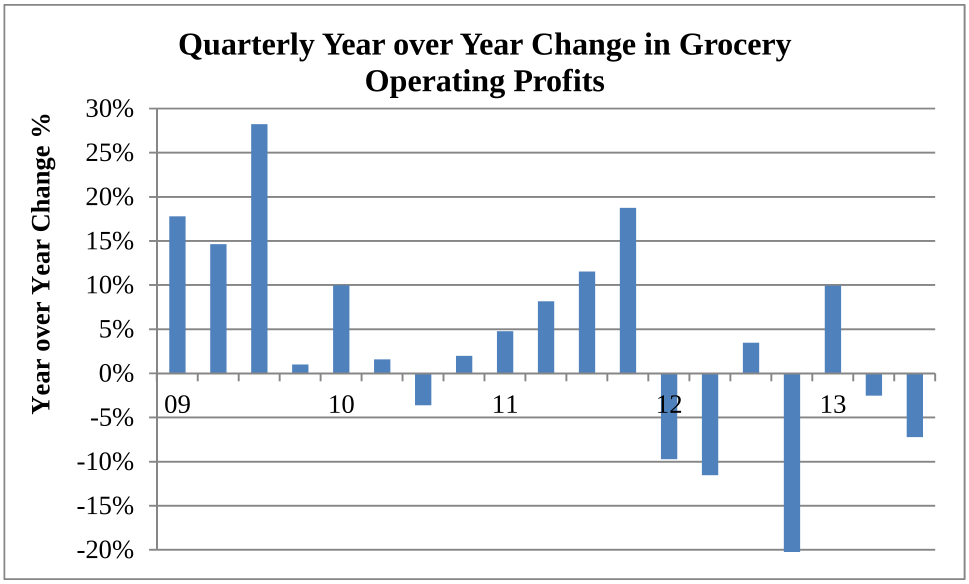


Grocery Competition
Another factor that is very important to food pricing is competition at the grocery level. Competition can be considered as an intangible, but there are ways to gauge the degree of competition. One measure of competition is square footage. As shown on the graph below from CIBC Institutional Equity, grocery square footage has been growing at a rapid pace in 2012 and 2013. CIBC is expecting a more rapid pace in 2014 as well. Most of this growth is due to the Target conversion of the Zellers stores.



Another mention of competition could be the performance of margins and profits. It is reasonable to assert that if margins are under downward pressure, competition is robust and vice versa. That in turn means that in a more competitive environment, there is lower propensity towards higher grocery pricing.

In that regard, the following is the Statistics Canada Industrial Organization and Finance Division measure of grocery store profit change on a year over year basis. As can be seen on the graph, grocery margins have been under pressure in the last two years, which suggests that competition has been intensifying. That in turn indicates that prices will be under downward pressure if the competition continues to be intense in the industry.



With regard to competitive levels in 2014, CIBC Institutional Equity Research is arguing that competition will continue to be robust. The following are the CIBC Institutional Equity Research rationale for arguing that competition will be robust in 2014:

> Freshco will keep driving its business until it hits a level of sales production that delivers material profitability. At only 11% of Sobeys current business, and 6% of Sobeys post-SWY business, it's not material to Empire, but its impact in Ontario is massive. Our guess is that Freshco keeps its foot on the gas right through 2014.
>
> Target is unhappy with its Canadian business and will be lucky to generate even $130 million (nationally) in grocery-type sales this year. For its model to work, it needs to get that number into the $700-$800 million range in 2014. Part of that will come from a full year's operation of stores; part will come from the likely installation of its "P-fresh" offering; part will come from better in-stock positions; and part will come from a stronger weekly flyer. We believe that Target will go all out to drive its food business (a key to its need to be seen as an everyday shopping trip), and that alone could take 50-60 bp of sales growth off everyone else.
>
> Wal-Mart cannot be happy with its same-store sales performance in Canada – negative for three quarters in a row. Although it has indicated that food was among the better performers, we believe it can do much better in groceries – and it is setting itself up for just that. We see Wal-Mart repairing its store conditions, running a stronger flyer, sharpening its assortments, and improving its fresh departments in 2014.

The Asian grocers are on fire. With over 90 in the GTA, and probably 200 nationally, they are continually lowering prices (usually meaningfully below discount stores); improving distribution; and attracting more and more non-Asian clientele. Ethnic grocers probably do as much food business as Wal-Mart, and are probably growing faster.

Costco. Enough said.

In our view, the Canadian grocery market will not begin to ease until we see Target and Wal-Mart putting up consistently better results; Freshco cracking into the black; and numerous stores closed or re-purposed. To us, that's not until 2015 at the earliest.
(*By Perry Caicco, Eric Balshin, Mark Petrie, and Matt Bank, CIBC Institutional Equity Research, December 12, 2013)*

Summary

When the main factors driving food price inflation are considered, there are two main factors that suggest higher food prices. Those two factors are the depreciation of the exchange rate into 2014 and the increase in meat prices. Conversely, there are a number of factors that argue for lower food prices: competition and raw product costs, as well as performance of the general economy and lukewarm consumer confidence. With the exception of meat, raw product costs will remain low by historic standards. In addition, the CIBC's argument regarding competition at grocery is persuasive. Competition at grocery will continue to be intense. While competition is an intangible, it is the most persuasive of the influences for 2014.

Despite sound arguments for increased food prices, the weightier arguments point to food prices that continue to run at or below the overall rate of inflation. Expect food price inflation to run around or less than 1% in 2014.

A version of this report first appeared in the George Morris Centre publication, Grocery Trade Review. If you would like a free, two month trial subscription please email, Kevin@georgemorris.org