



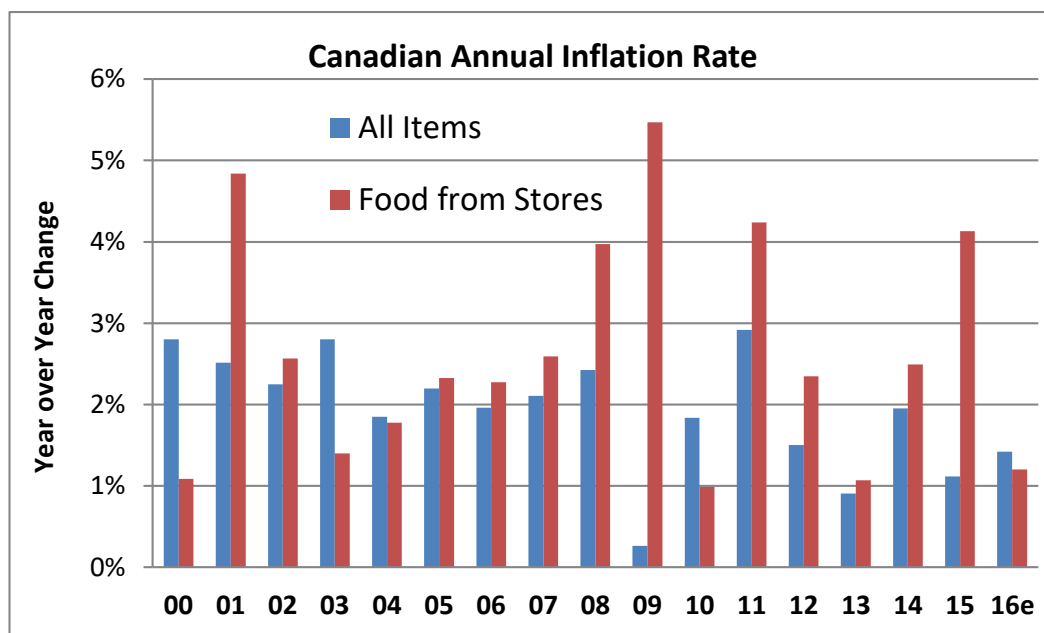
## 2016 & 2017 Food Inflation Assessment

By Kevin Grier, December 2016

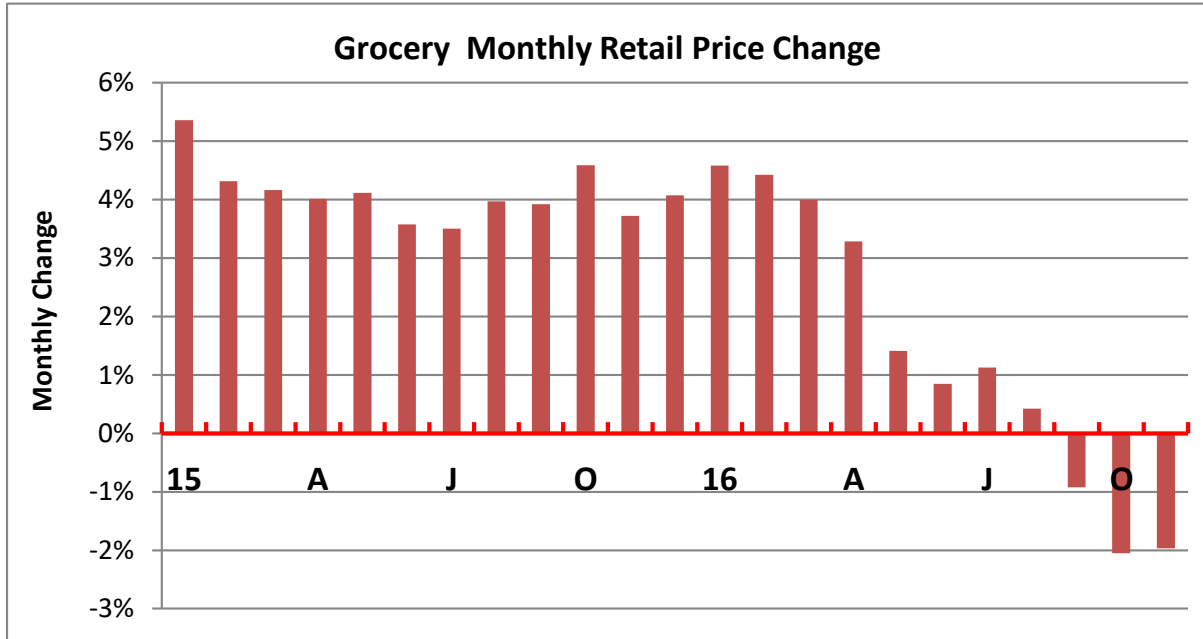
Last year ended with Canadian grocery prices in a deflationary trend. Based on pricing trends at the store level, agricultural commodity prices and the intensity of grocer competition, Canadians should see only modest food inflation in 2017.

### 2016: A Tale of Two Price Levels

While the final StatsCan data for December is not yet reported, based on the first 11 months of the year, the overall 2016 food inflation picture is very clear. Based on the Statistics Canada Consumer Price Index (CPI) the prices of Food Purchased From Stores will have increased at just over 1% in 2016. That is modestly lower than the price increase for All Items in the CPI. The 1+% increase this year also compares to the robust 4% increase in food purchased from stores prices in 2015. The 2011-2015 five year average rate of food store inflation was 3%. The food store inflation rate will likely be the second or third lowest rate of inflation since 2000 with 2010 standing as the lowest at 1%.

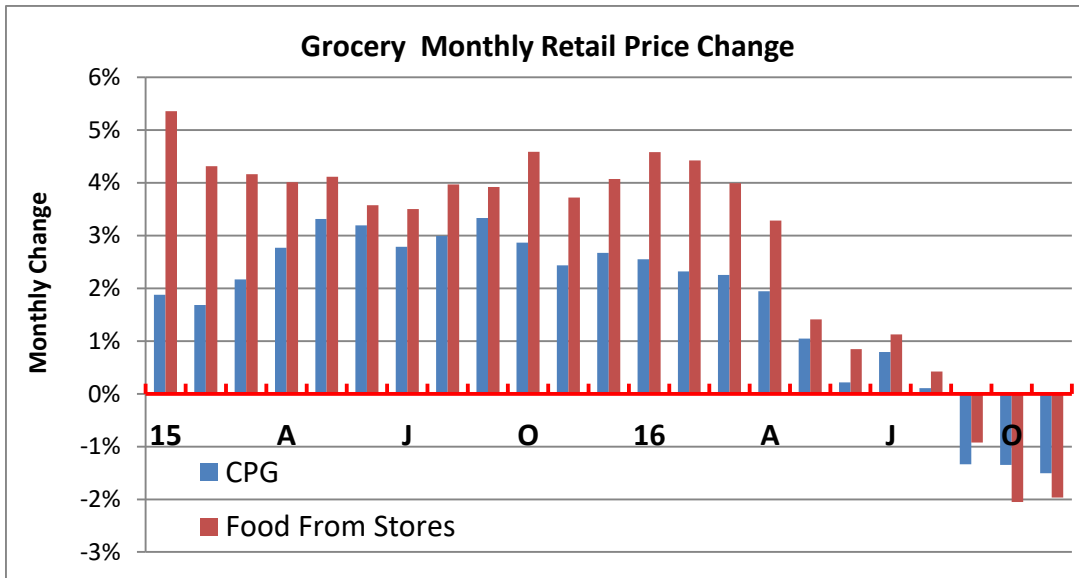


The food inflation picture during 2016 was particularly interesting as the year can easily be divided into two distinct pricing periods. The first four months of 2016 looked very much like 2015 in terms of inflation. By June however, price increases became much more tepid and by September, prices were actually in deflation mode. As seen on the graph below the price of food began to tip below year ago levels in September and continued through the latest data for November.

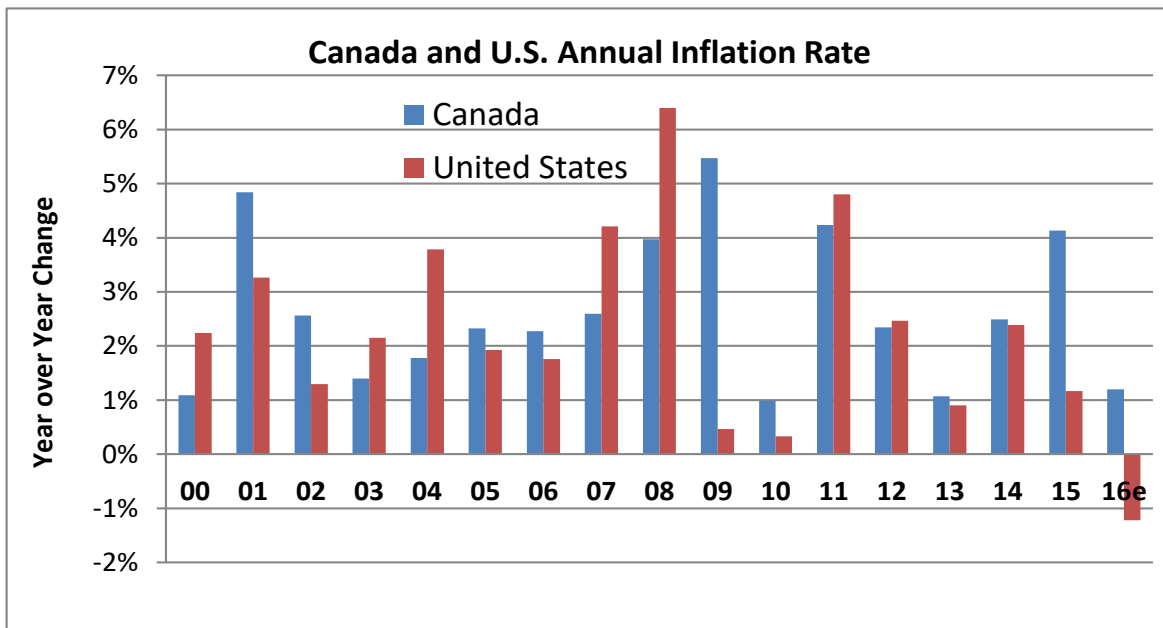


The specific food product pricing during the year is also very interesting. It is interesting because the pricing declines were nearly universal across the store. Given the decline in cattle and pricing, it was only a matter of time before meat prices began to decline. Meats make up about a fifth of the food CPI and so their direction plays a big role. With that said, however, almost all items from bakery, processed fruits and vegetables as well as dairy and eggs saw deflation in October and/or November.

In other words, the decline in price is not just related to declining meat commodity pricing. In fact my tabulation of consumer packaged goods (CPG) has declined right along with the overall food rate. As I have argued here before, the direction of consumer packaged goods can be a good indication of the level of grocery competition. That is, the only way to compete on ketchup, cookies or cereal is with price. The weakening of CPG suggests that grocer competition was robust in the second half of 2016.

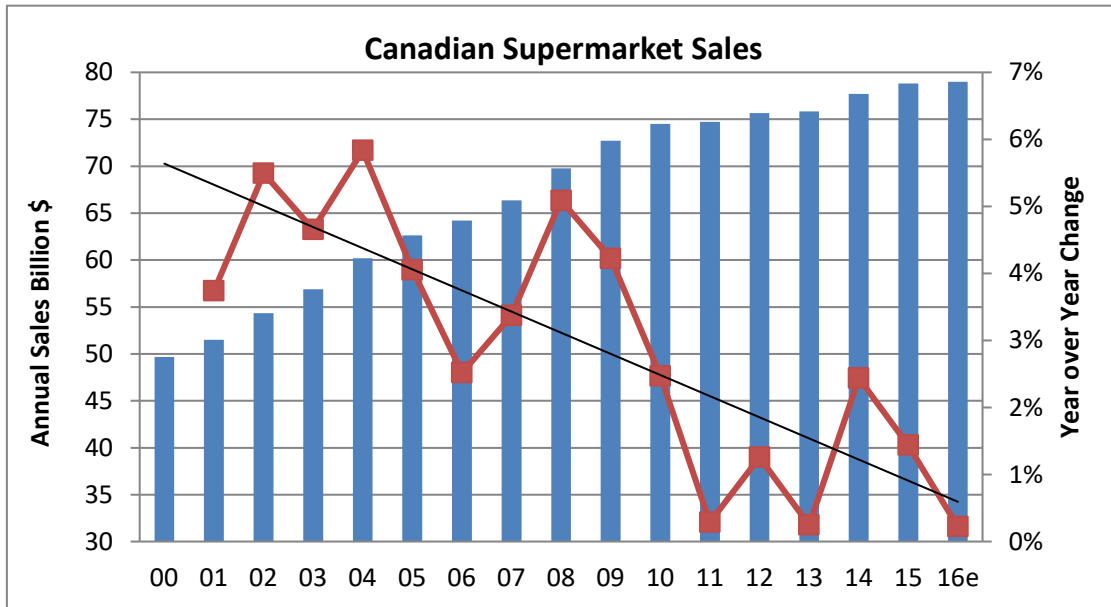


It is also of interest to look at the experience in the United States. In that regard, while Canadian prices increased by just a percentage point in 2016, U.S. pricing actually declined for the year. That comes on the heels of 2015 in which U.S. pricing only increased by about a percent versus the 4% in Canada. The divergence of experience in 2015 and 2016 demonstrates that Canada and U.S. pricing are not tightly linked. The U.S. deflation of 2016 does not portend the same in Canada. With that noted, the 2016 U.S. performance indicates there is no inflationary pressure coming to Canada from the United States.



## Stagnant Supermarket Sales in 2016

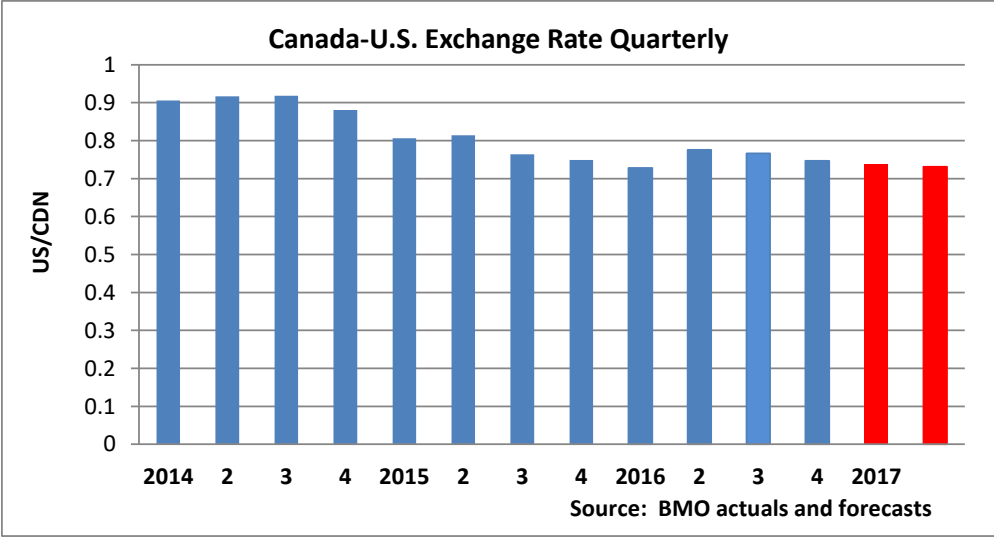
The inflation rate of food purchased from stores of course has a direct impact on total sales for supermarkets. Based on sales data over the first ten months of 2016 as tabulated by Statistics Canada, it is likely that 2016 total Canadian supermarket sales will amount to just under \$79 billion. That is up just marginally if at all compared to sales in 2015. Further to that point, 2016 will be the third year in the last six in which sales showed nearly no growth at all. In addition, as can be seen on the graph below, the year over year trend in sales over the past 16 years has been decidedly lower



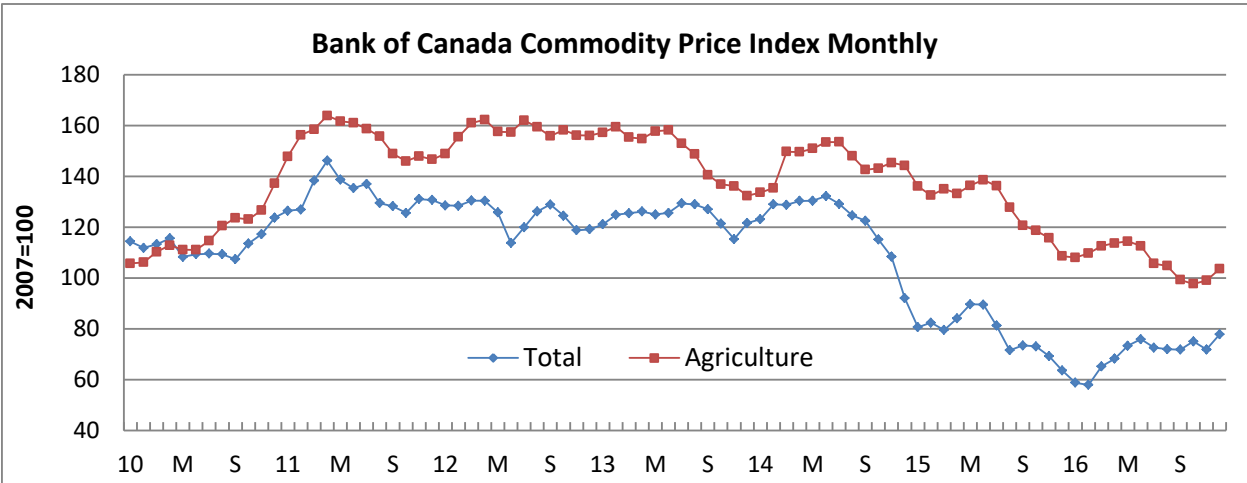
## 2017 Prospects

Looking ahead to 2017, the question of the direction of food inflation is critical to the prospects for both manufacturers and grocers. The key drivers of food inflation in Canada are the direction of commodity prices and grocer competition.

There is a strong correlation between commodity prices and consumer grocery prices. Commodity prices in Canada are also closely tied to the direction of the Canada-US currency exchange rate. Further to that exchange rate question, the Bank of Montreal is forecasting a 2017 first half exchange rate of 0.7345. That compares to a first half in 2016 of 0.752. For the year 2017 the BMO sees an exchange rate of 0.73 compared to 0.754 in 2016. For further reference CIBC's 2017 average is 0.735 while Scotiabank is closer to 0.725 and TD is at 0.7435. As such from an exchange rate perspective, there is inflationary pressure on commodities, if the BMO forecast is reasonably correct.



With that noted, according to the Bank of Canada tracking of commodities pricing, the agricultural commodities are showing signs of life but remain at very low levels compared to recent years. The point is that anything can happen to commodity prices due to weather, currency or politics, but at the very least they start 2017 at very low levels. In other words, if commodities are going to cause inflation in 2017, it would have to be due to events that have not yet unfolded or are not yet at work. Further to that, cattle and hog inventories are on the rise. Based on pending slaughter levels, both beef and pork pricing should remain low or lower than 2016. As such the critical meat pricing part of the CPI is not likely to be a cause of inflation in 2017.



The intensity of grocer competition is also a key factor in pricing and inflation at grocery. In that regard, based on the performance of the CPG pricing, it appears that grocery competition is currently at very intense levels. To augment that statement, there are the well-publicized demands by the leading grocers for pricing concessions from manufacturers. That indicates that the grocers want consumers to think they are fighting on their behalf. It also indicates that they expect to see a tight pricing environment for the foreseeable future. In addition, with regard to competition, the well-publicized margin and profit challenges at Sobeys have led them to articulate pricing-related competitive responses. Finally with

regard to competition, Peter Sklar of BMO Capital Markets wrote in mid-December that based on their research, pricing at Walmart is continuing to deflate with significant declines in Montreal. Clearly Walmart is upping its game with regard to its food pricing positioning.

The main point is that with the exception of the exchange rate, the main drivers of inflation remain very tepid. The food pricing outlook for 2017 is for ongoing deflation into the first quarter with gradual increases in the second through fourth quarters. The average food store inflation for 2017 is not likely to exceed 2%.

### **Why it Matters**

The grocery industry is likely to stay in intense competitive mode through at least the first half of 2017. A weaker dollar could cause some commodities such as fresh produce to increase in price in the first half. Beyond that however, it is likely that grocers and manufacturers will absorb the costing impact of the weaker dollar into tighter margins. A low inflation and even deflation environment is going to cause margin stress through the chain.

*This report first appeared in the Kevin Grier publication, Grocery Trade Review. If you are interested in a free two month trial subscription, email [kevin@kevingrier.com](mailto:kevin@kevingrier.com).*