



SPRING INFLATION REPORT

Continued Calm in Food Price Inflation



Food Inflation at 2%, Stays Near 20-Year Average

A barrage of changes were made to the January and February 2016 outlooks by USDA economists. Their current and relatively calm update signals that food price inflation will remain at 2%, which is near the 20-year average. Most of the risk on food prices remains low given the strength in the U.S. dollar, ample supplies and low transportation costs. The shift from El Nino to neutral or La Nina conditions looms over the commodity sector. Any impacts will unfold until later this year.


At the other extreme, any enjoyment of lower ingredient costs in food manufacturing needs to be tempered by realizing the effect this price weakness has on the ultimate ingredient suppliers — crop growers. Farmers producing wheat, corn and soybeans have experienced drastic reductions in incomes that, according to most calculations, have fallen below the cost of production. Just how these

financial difficulties will determine what crops are grown and how much is planted is still to play out. Concern exists about supply adequacy and also about choices that might make the present situation appear favorable.

Benign agricultural commodity price inflation will keep a lid on food inflation. Consumers remain cautious spenders and vigilant about “value” grocery shopping.

Non-perishable goods are seeing below-average inflation because commodities and the factors that go into producing them haven’t been increasing the same way as previous years. A big drop in energy prices in the past two years and a strong dollar have combined to keep inflation low.

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These factors suggest recent food inflation springs from special factors that constrain supplies in a few areas. This, as opposed to broad increases in demand, might propel the kind of across-the-board consumer price increases that the Fed tries to stem.

The Fed's official statement of objectives targets 2% inflation over the medium term as measured by a broad index of inflation called the personal consumption expenditure price index (which includes measures of food and energy). A sharper fall for the market had been caused by suppliers being forced to be more aggressive on price in order to drive volume.

Different food categories are expected to rise and fall at different rates. The largest price movements this year were seen in fish (up 5.9%) and dairy (down 4.7%) with notable movements downward in meat, oils and fats. The outlook for food inflation in the second half of the year ahead is likely to be relatively benevolent.

Consumer trends also influence prices. The three major consumer trends we expect throughout 2016 are supply chain transparency and animal welfare, consumer health and vegetable proteins. All these trends have the potential to increase prices over the long term. Suppliers are revisiting their procurement strategies and ingredient lists as more consumers want to know where their food comes from, how it is made and under what conditions. Since food is in the public eye, consumer curiosity is probing into the practices of processing plants and farms. Social media, not labels, has changed the power relations among corporations, stakeholders and consumers when it comes to "clean" ingredients. We expect to see more products focused on consumer health with an initial focus on less processed foods. Overall, we are seeing some breathing room and respite from inflation presently.

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**Dairy decreased
4.7%**



**Fish increased
5.9%**



Beef

The dismal cattle feeding margins will continue to curtail fed beef production through mid-year. In addition, competing meat supplies are lessening, exports are expected to trend higher and imports are declining, further tempering domestic beef supplies. While the nation's cattle inventory is being aggressively rebuilt from the sharp declines of recent years, sustained increases in beef output will be delayed into the last half of 2016. Limited fed beef supplies and renewed buyer interest for seasonal features heading into spring, will likely support a strong seasonal price advance from mid-winter lows.



Chicken

Most of the focus following the holiday season and up to the Super Bowl was on chicken wings. However, a very similar story was unfolding for chicken tenders because they are a key item for boneless wings, strips and in sandwiches. Foodservice demand was hopping during this recent stretch, which fueled huge gains in the tender market. Spot prices in the Northeast had fallen to around \$1 per pound late last year, according to Urner Barry, but has made a hard charge into the \$1.50s. With football season out of the way, the chicken tender market has been much quieter of late, but isn't yielding ground that easily.



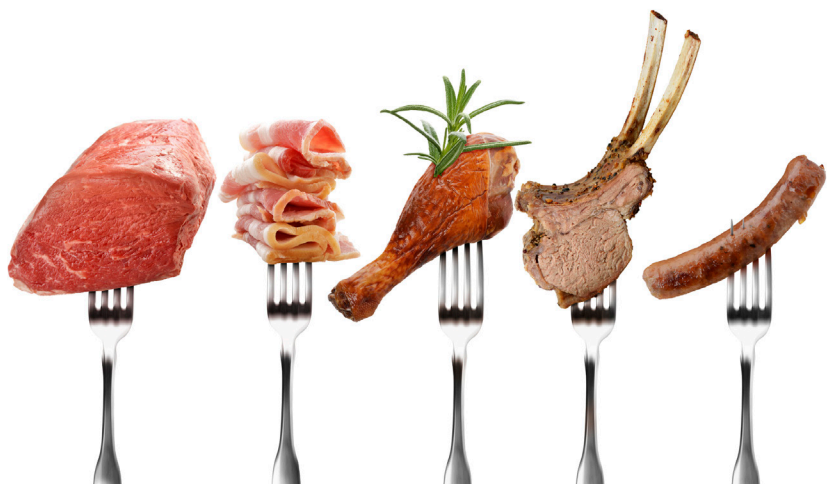
Pork

Belly prices have been rallying sharply since the beginning of the year with derind 9-13# bellies surging into the upper \$150s to very low \$160s. That roughly represents a \$35 increase since the first of the year. Some of the supply disruptions during late January and early February brought on by harsh winter weather has contributed to this furious rally. A few buyers appear to be on a buying binge and willing to chase after product wherever it's available. Retail and foodservice interest in breakfast items (particularly bacon and sausage) has been very strong so far this year. This trend is likely to continue through the winter along with tightening available hog supplies.

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Dairy

There has been very little change in U.S. dairy prices this quarter. Powder prices are being held at low levels by the still bearish world market, while CME cheese and butter prices are being driven by domestic demand and buyer's budget targets.

Milk

U.S. milk production has been lower than forecasted. Production is expected to recover relatively quickly, but in the short term, there is less milk around than expected. That has also tightened our butter production forecast slightly.

Cheese

CME cheese prices have steadily been in the \$1.40 range. There is a slight risk that prices could dip to world market levels (below \$1.30), but with cheese production slowing and a strong domestic demand, we do not expect this to happen. If prices drop, it will most likely be temporary and a buying opportunity.



Turkey

It's a slow time of year for processed meats and as a result, mechanically deboned turkey is feeling the heat. Turkey producers are working aggressively to rebuild from last year's avian influenza outbreak and to expand their operations. It may not be until

mid-year before ready-to-cook (RTC) meat output is running consistently above last year's levels.



Domestic Sugar

The Hershey Company has announced that it will begin using only non-genetically modified organism (non-GMO) ingredients. Other manufacturers may soon follow. Some states are looking into GMO labeling for foods, which may impact consumer demand. In the U.S., only cane sugar will meet the definition of non-GMO, which could cause tightness in cane sugar supplies relative to beet sugar.



1Q16 INFLATION REPORT SOURCES: American Restaurant Association | Chicago Mercantile Exchange (CME) Food Business News | Food Price Report 2016, University of Guelph Economic Brief | HospitalityBusinessDevelopment.com Informa Economics | ProFarmer News | Urner Barry | U.S. Bureau of Labor Statistics | U.S. Department of Agriculture (USDA) Wall Street Journal