

EFFFP RETAIL FOOD PRICE FORECAST

IN ASSOCIATION WITH CRANFIELD SCHOOL OF MANAGEMENT

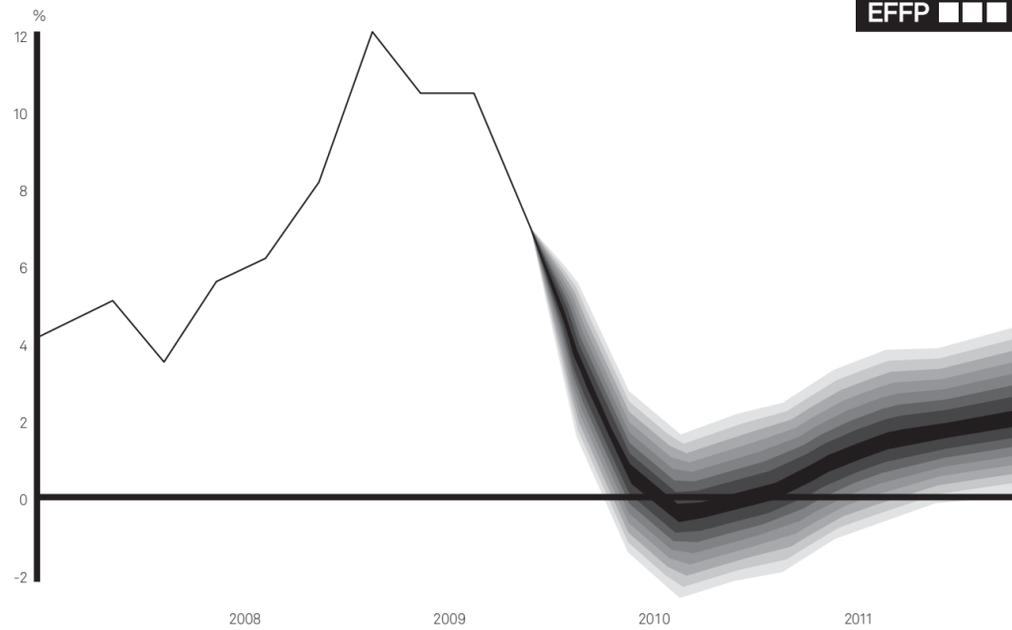
Cranfield
UNIVERSITY
School of Management

- Retail food price inflation has fallen sharply throughout 2009 – an outturn we have been forecasting since the autumn of last year. We now forecast that food price inflation will continue to fall towards zero before gently rising again throughout 2010.
- Despite the sharp fall in retail food price inflation, the actual level of food prices is still some 20% higher now than it was in 2007. We forecast that food prices will continue to remain at this higher plateau throughout 2010 and 2011.
- This, combined with the impact of the recession, has meant that food has become less affordable with little prospect of an improvement until well into 2011.

Recently published government statistics confirmed what we have been forecasting in previous editions of VIEW; namely, food inflation, as measured by the Retail Food Price Index (RFPI) is now firmly set on a downward trend and as shown in our forecast, set out in Figure 1 (overleaf), we expect the trend to bottom out around zero by the first quarter of next year. Although seasonal fruit and vegetable prices have the ability to disturb this downward trend the probability of such a disturbance is low.

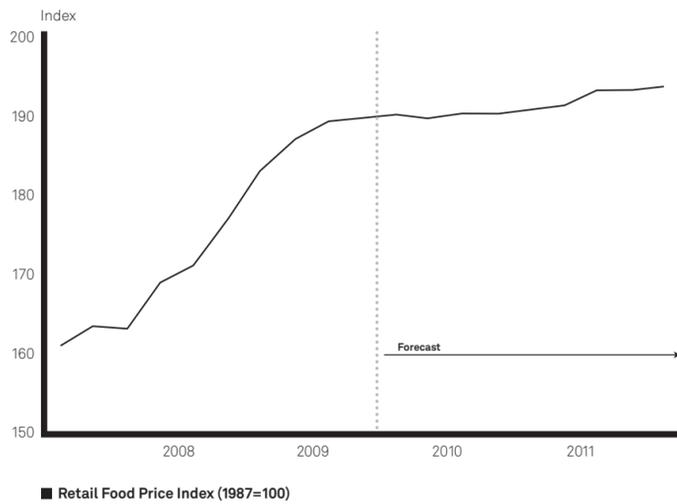
In contrast to the lingering effects of last year's adverse weather conditions, fruit and vegetables are currently enjoying favourable growing conditions and with plentiful supplies in prospect these items are likely to contribute to lower food inflation over the next year. Other factors reinforcing the downward trend shown in Figure 1 are the modest appreciation of sterling since the start of the year and, after several months of stubborn resistance, a marked downturn in the rate of increase in retail meat prices. But by far the biggest effect pushing food inflation towards zero is recession and the pressures it unleashes to lower prices.

Figure 1: EFP Retail Food Price Inflation Forecast



EFP ■■■

Figure 2: The level of retail food prices



Our forecast is produced by EFP's food inflation model – built in partnership with the Cranfield School of Management. In illustrating the results we follow the common policy of showing a probability distribution, represented by a fan chart, rather than a point forecast. The dark centre of the fan shows the outcome to which we attach the highest probability; namely, a continuing decline over the coming months before beginning a modest rise throughout 2010 and 2011. The fan shows that the risk associated with this forecast is greater on the upside. That is, the risks attached to the variables used in making the forecast have probabilities that give more weight to higher rather than lower inflation. For example, if the world's harvest turns out to be shorter than expected this will impart upward pressure on food inflation which would become increasingly apparent in 2010. Similarly, if oil prices rise faster than we expect (see page 17) as the developed world recovers from recession and/or sterling's recent modest recovery is reversed, the outcome for our forecast of food inflation is likely to lie in the upper half of the fan diagram.

See Figure 1

Despite the rapid reduction we are projecting in the rate of retail food inflation, the level of food prices will not fall. Indeed, as can be seen from Figure 2, using our forecast to project the level of food prices they will remain, as measured by the RFPI, more-or-less flat over the next year before easing upwards during 2010 and 2011. The RFPI measures only the average level of food prices and within the average there will always be fluctuations caused by factors such as seasonal vicissitudes as well as relative price movements generated by promotions and fads.

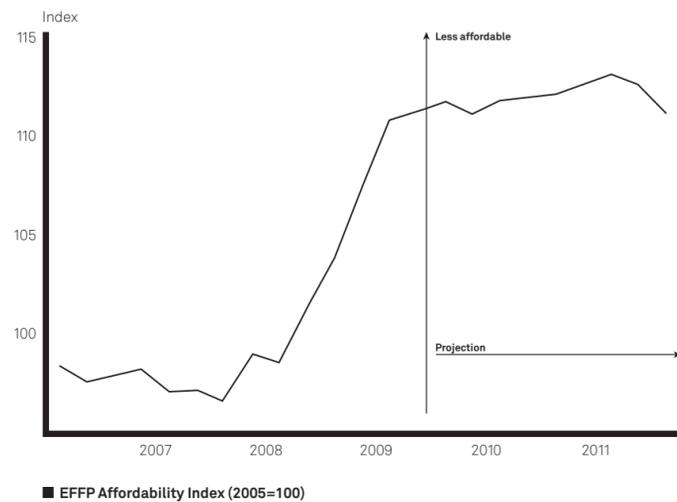
On the basis of the projections set out in Figures 1 and 2, by the start of 2010 the price of food will be some 18% higher than it was at the start of 2007. And given the economic outlook for a slow climb out of recession, wage restraint and rising unemployment, this leads naturally to the question of affordability.

See Figure 2

In Figure 3 we set out our projection of food affordability over the next two years based on EFP's food affordability index. In essence our model measures the affordability of food as the ratio of retail food prices to consumers' expenditure. If consumers' expenditure rises at a faster rate than food prices then food is deemed to become more affordable and vice versa. The index of food affordability takes the average for 2005 as 100; the lower the index the greater the affordability of food. As can be seen the index reached its lowest level in the third quarter of 2007 before rising sharply throughout 2008. On the basis of our projection the index will rise at a much slower rate during 2009 and 2010 before falling slightly in 2011. The projected affordability of food depends not only on our forecast for retail food prices but also on the growth of consumers' expenditure. Despite our projected fall in food inflation, as shown above, food prices are continuing to rise at a time when consumers' expenditure is suffering the effects of recession. The combination of these two effects is sufficient to slow down, but not reverse, the decline in the affordability of food.

See Figure 3

Figure 3: Projected affordability of food



GENERAL INFLATION AND RECESSION



Figure 4: General and food inflation

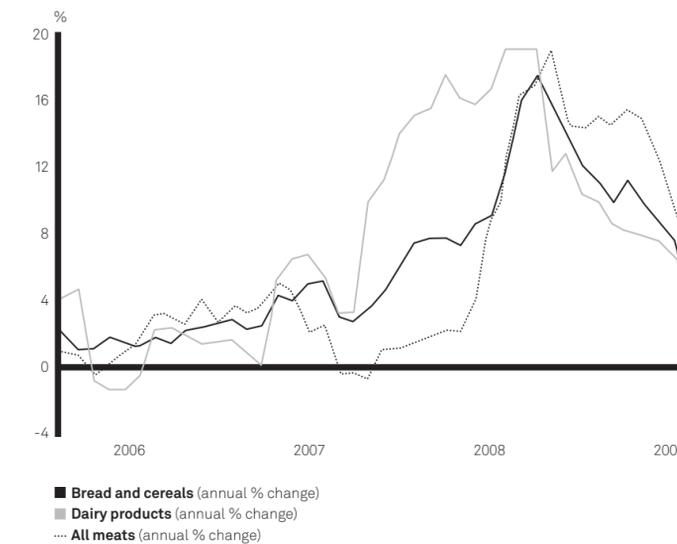


The forecasts and projections set out on page 14 are strongly influenced by the prevailing economic climate. Since the last issue of VIEW, a number of forecasts have been published for the UK economy all indicating a sharp fall in GDP this year – the average fall is 4% – followed, at best, by a subdued recovery spread over two years or more. The effect of this is that unemployment will go on rising well into 2010 – peaking at around 3 million – and consumers' expenditure will not only fall this year but also remain depressed throughout 2010. Whether it is reduced earnings, rising unemployment or a desire to save more, the evidence is mounting that consumers' behaviour and expectations have changed markedly over recent months. As a result the recent shift to 'value' items and much reduced discretionary spending will continue to be a feature of consumers' food expenditure over the next two years.

A characteristic of recessions is an overall decline in the general rate of inflation as demand shrinks and this effect is captured in the Consumers' Price Index (CPI) and the Retail Price Index (RPI). In line with the descent into recession the CPI has fallen from a peak inflation rate of 5.25% last September to 1.83% in June; and in the case of the RPI – which includes the cost of mortgages – the rate has turned negative falling to -1.57% in June. The prices of the goods and services that make up these two broad measures of inflation are the product of a range of costs that also apply to food manufacturers, distributors and retailers; for example, energy, wages and raw materials. Consequently we would expect there to be a high correlation between the CPI, the RPI and the RFPI and this is confirmed by the relative movements in these three inflation measures shown in Figure 4.

See Figure 4

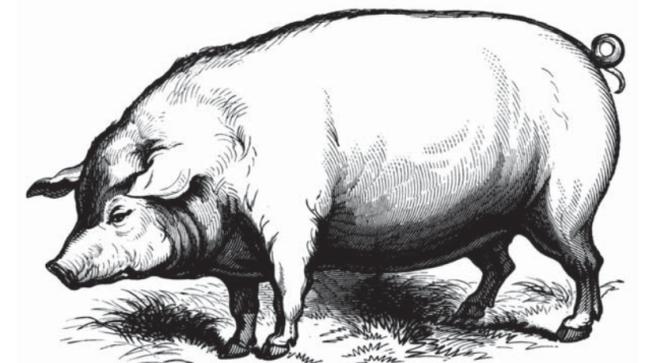
Figure 5: Category prices



The relationship between the RFPI and the CPI is complex. The CPI is itself influenced by the prices of food products which have a weighting of just over 10% in the CPI. Thus, changes in food inflation will influence the general rate of inflation and vice versa. Of interest here are the factors likely to cause a divergence between the CPI and the RFPI and of these agricultural commodity prices, particularly global cereal prices are by far the most important.

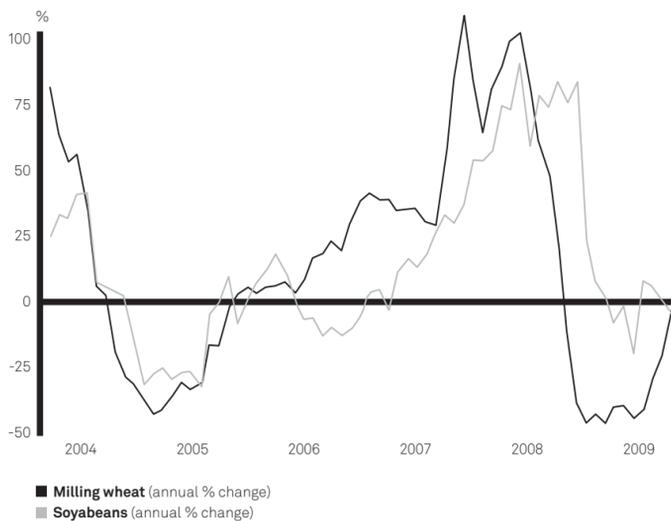
Cereals not only have a direct influence on bread and biscuits but also, along with soya, they form the basis of animal feeds and hence changes in the prices of either of these commodities will, after a period, show up in the prices of meat and dairy products. But global demand also plays a role. Set out in Figure 5 are the rates of inflation for three broad food categories: bread and (breakfast) cereals; dairy products; and meat. The figure shows clearly that a major external influence – e.g. global demand – caused the retail prices of dairy products to start rising approximately one year before the retail price of bread and cereals. As explained above we would normally expect the prices of dairy products to follow after a lag of several months and indeed, this is precisely what has happened in the case of retail meat prices. The patterns for the three data series illustrated in Figure 5 reinforce confidence in our forecast that the rate of increase in food prices is rapidly slowing.

See Figure 5



COMMODITY PRICES

Figure 6: Cereal and soya prices



See Figure 6

We turn now to the behaviour of the variables that are used by the EFP model in the process of forecasting the RFPI. Short-term movements in the RFPI – or rather fluctuations – are largely driven by the prices of fresh vegetables and fruit but, as explained, cereals and to a lesser extent soya prices can have a marked influence on the level of retail food prices over an extended period. Figure 6 shows how changes in the prices of these two very volatile commodities have moved over recent years. The prices for both rose strongly in 2006 and 2007 though the rate of increase fell back sharply in 2008 and particularly in the case of cereals where the rate of increase turned negative reinforcing falling prices. As can be seen both series are currently displaying little movement but both are tantalisingly poised for a period of rising prices. Much now depends on the 2009 global harvest. Forward soya prices have increased in dollar-terms reflecting a multitude of uncertainties including continuing demand from China and export restrictions in Argentina. The outlook for cereal prices is more problematic. The International Grains Council is predicting an overall fall in the global production of grains following last year's record harvest but production remains high compared to earlier years. The Council's prediction is based on forecast yields and much now depends on the weather.

Our forecast for retail food inflation necessarily includes an assumption regarding future cereal prices and this necessitates a judgement regarding yields. We expect cereal yields across Europe to fall below last year's levels. The main reason for this assumption is that in 2008 weather conditions in northern Europe were particularly favourable for cereals. Although plentiful rainfall in June and July this year is likely to have benefited yields, the combination of lower cereal prices and the substantial increase in fertilizer and fuel prices last year will have reduced fertilizer usage with adverse consequences for yields. Predicting the precise effects of these assumptions on cereal prices is impossible but we believe that these factors will result in a modest rise in cereal prices over the second half of 2009.

OIL PRICES AND STERLING

Two important influences on food inflation are the price of oil – essential a proxy for energy costs – and the rate of exchange. Oil prices reached a peak last June but over the year have fallen to a low of £29.30 a barrel in June – the lowest price since May 2005. As can be seen in Figure 7 the rate of increase in oil prices – represented by Brent crude – slowed during 2006, rose strongly throughout 2007 before falling steadily during 2008. Although the rate of increase in oil prices turned negative in November this merely reflected the very high prices a year earlier: after reaching a low point of £26.37 a barrel in December oil prices rose to £41.98 a barrel in June – an increase over the six months of 60%.

Figure 7 superimposes changes in the price of oil on changes in the retail food price inflation. As can be seen changes in the price of oil take some months to be reflected in food prices and appear to have a stronger influence when they are increasing than when they are falling. The data set out in Figure 7 suggests that over the coming months the price of oil will not prevent the continued downward path in retail food inflation and we have further assumed that the sterling price of oil will rise only modestly throughout 2009 and 2010, primarily because of the effects of the global slowdown on demand. Looking further ahead as global recovery sets in oil prices are likely to rise and this will have an influence in 2011 and beyond.

See Figure 7

If oil prices are unlikely to frustrate a falling rate of inflation for food prices over the coming months the situation regarding the influence of sterling is more complex – see Figure 8. Between January 2008 and March 2009 sterling lost some 27% of its value against a basket of currencies. The upward pressure this puts on imports of foodstuffs is still working its way through the food chain though the effect is rapidly diminishing and since March sterling has risen some 9% which will partially reverse the effects over coming months. Exchange rate forecasts are notoriously unreliable; however, given the depth of the UK's recession and the exposure of its financial sector we have assumed for our forecast that the modest recovery in sterling's value over recent months will not continue.

See Figure 8

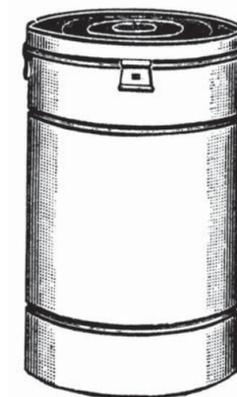


Figure 7: Food and oil prices

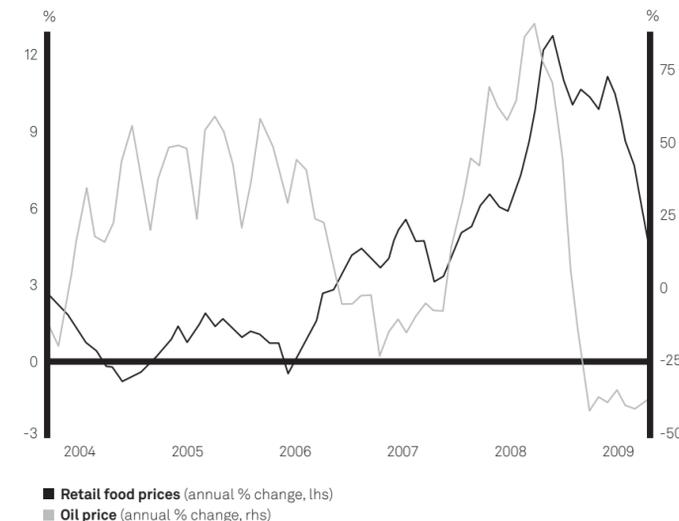


Figure 8: Food prices and the effective exchange rate

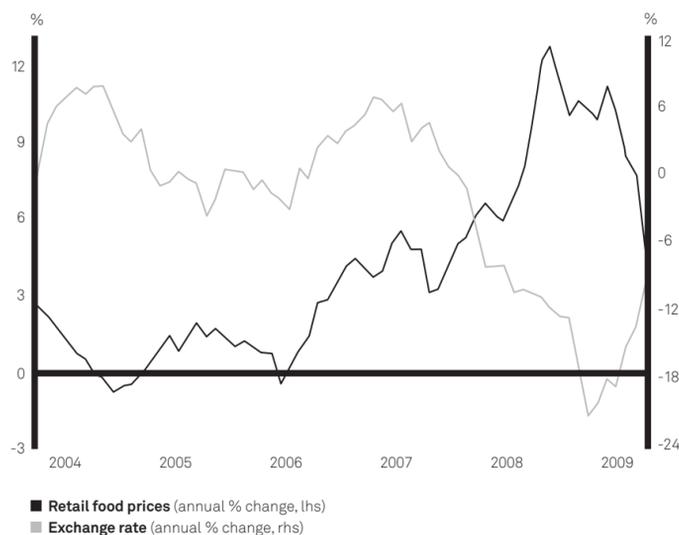
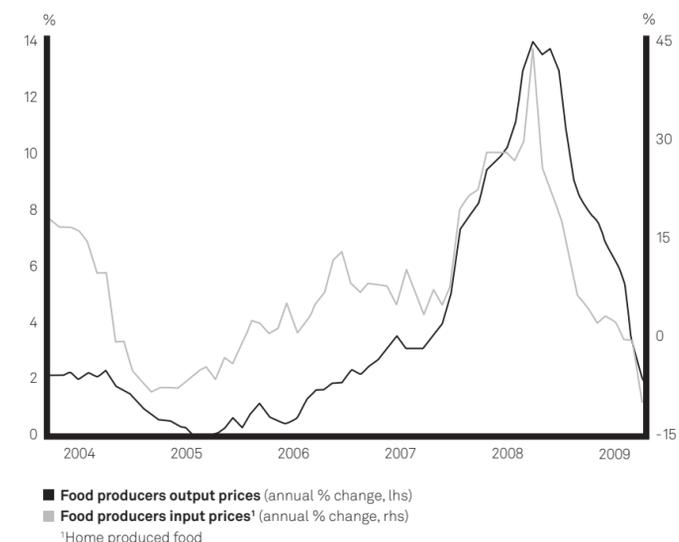


Figure 9: Food producers input and output prices



Our prediction that retail food inflation is now firmly on a downward trend is reinforced by the latest producer price data for food manufacturers and processors. With consumers' demand slowing, companies are under pressure to absorb any cost increases and to resist inflationary wage settlements. As can be seen in Figure 9, since June last year the rate of increase in the prices of inputs purchased by food manufacturers and processors has been falling rapidly. In April this year the rate of increase turned negative reflecting the fact that input prices are now lower than they were a year ago. Figure 9 also reveals a high correlation between the rate of increase in input and output prices for food manufacturers and processors. Output prices for this sector also peaked in June last year and since then the rate of increase has fallen steadily to a rate of increase of just over 2% in June.

See Figure 9

FOOD COMPANIES

