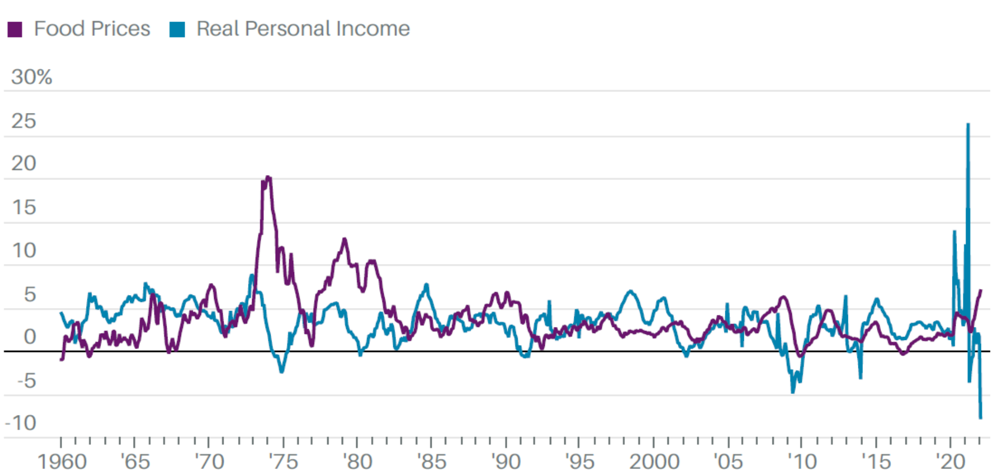
Food Inflation: The Perfect Storm

For the first time in over four decades, Americans are factoring inflation into their budgets more than ever. It is also the first time that the effects of inflation are being felt across everyday life for the Millennial and Gen Z populations. The economy is healing on many fronts, but skyrocketing prices are making the recovery painful for many.

While real asset owners have benefitted from inflation, most of the population is struggling in the face of rising costs for essential items, such as housing, gas prices, and food costs. The focus of this Thinking Man will be specifically on food inflation, given how inelastic food is, as well as the affordability problem that will determine consumer demand trends going forward. In this piece, we seek to break down some of the inflationary pressures that are ravaging across the food industry.

Why Food Inflation Matters

In the United States, total consumer prices rose 7.9% last month from a year earlier, marking a new 40-year high. This comes at a time when inflation-adjusted household incomes are falling at their fastest pace since 1959, which is the year that the government began tracking this data series. Inflation-adjusted wage growth was negative for most US workers in 2021, meaning their buying power weakened despite salaries rising at a historic pace. When you eliminate everything but essentials—which is the opposite of what economists do when they exclude food and energy prices to calculate core inflation—the average change in basic items rose more than 16% last month from a year earlier.



Source: Federal Reserve Bank of St. Louis

The Thinking Man's Approach

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- The economy is healing on many fronts, but skyrocketing prices are making the recovery painful for many.
- US total consumer prices rose last 7.9% last month from a year earlier, making a 40-year high, while household incomes adjusted for inflation are falling at their fastest pace since 1959.
- The lowest quintile households spend over 27% of their income on food, whereas those in the highest income quintile spend around 7%.
- Energy accounts for between 20% and 30% of absolute agricultural costs. Even with rising wholesale food prices, farmers are experiencing a significant hit to their margins.
- Businesses like restaurants and packaged-food companies that are absorbing price increases have been hit, while farm-equipment makers, supermarkets, and food processors are being seen as beneficiaries.

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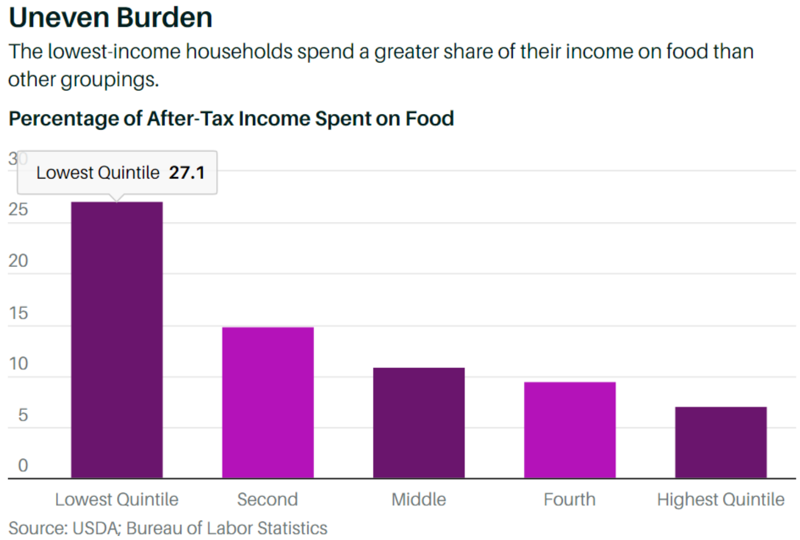
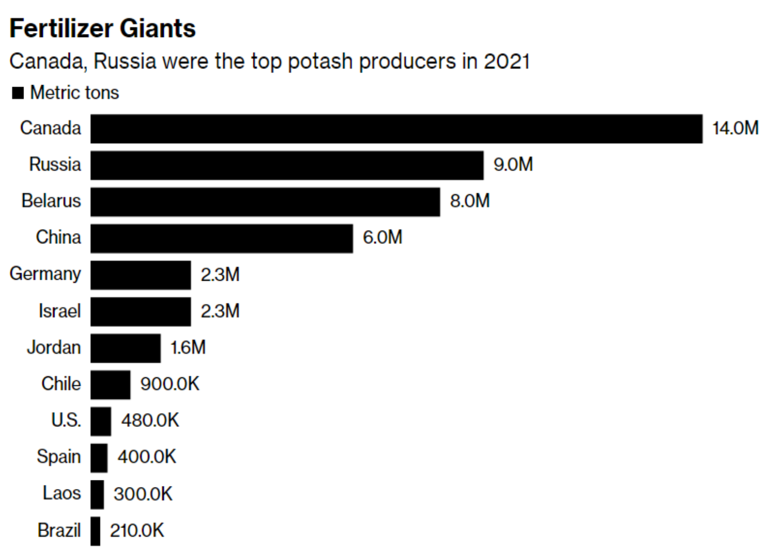
With food prices rising, low-income Americans are being hit the hardest given that expenditures on food make up a significant portion of their disposable income. To put things into perspective, the lowest quintile households spend over 27% of their income on food, whereas those in the highest income quintile spend just over 7%. The higher this percentage rises, the less that individuals have to spend elsewhere across the economy, which is why food inflation is so destabilizing. As grocery prices climb, so do the odds of unhinged inflation expectations, opening the door to an upward spiral. On top of that, these households have the least savings to cushion against rising prices, and wage growth is expected to slow as more people return to the job market – brewing the perfect storm for consumer demand. On a global basis, the Food and Agriculture Organization of the United Nations noted that its food index had also hit an all-time high in February, up 20.7% from its level one year ago.



Supply Chain Disruptions & Sanctions

Food production costs were already high throughout the COVID-19 pandemic, driven by supply chain disruptions, elevated shipping costs, pent-up consumer demand, and consumer hoarding trends. Not only are we still facing many of these COVID-related disruptions, but Russia's invasion of Ukraine is threatening to drive prices exponentially higher. Russia's invasion has already lifted energy prices to their highest levels since 2008, and sanctions on Russia have thrown new headwinds to global supply chains. How long this conflict lasts will ultimately determine if inflationary trends on food are more permanent or transitory.

Why is Russia so important in the food inflation conversation? Russia accounts for about 25% of the world's wheat exports, 20% of the world's corn exports, and 10% of the world's oil exports – all of which effectively went offline after Russia invaded Ukraine amidst global sanctions. Russia is also the biggest global exporter of urea, an important animal feed additive and supplement, and the 2nd largest global producer and exporter of potash – the most essential plant nutrient used for

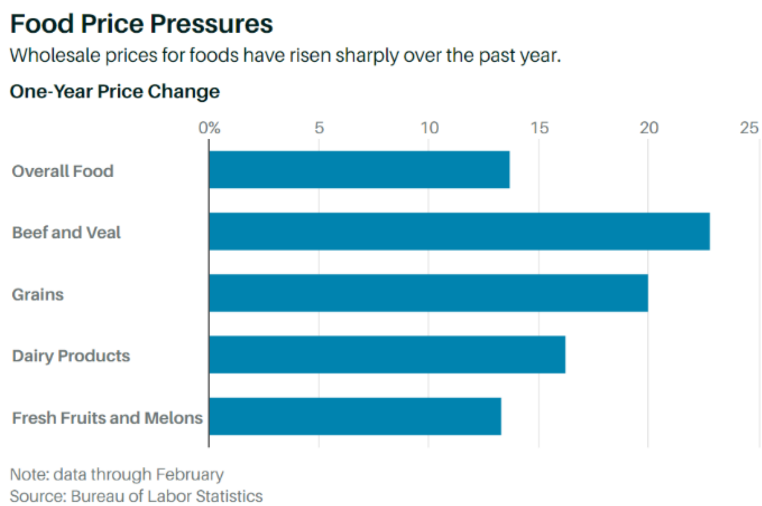


soil fertilization, as it improves water retention, crop yield and nutrient value, as well as provides disease resistance for the majority of food crops. As an example of rising costs, the price of potash has already increased over 75% year-to-date.

Price Pressures for Food Producers

The impact of higher energy prices on the cost of agricultural goods is quite dramatic, and it is one of the many reasons that we are beginning to see "de-globalization" trends arise as countries seek to become less reliant on trading partners for key resources. It is estimated that energy accounts for 20% to 30% of absolute agricultural costs. Increasing fuel prices are raising expenses for farmers who have to run a significant amount of heavy machinery for sowing, tilling and harvesting. It also makes heating barns that house livestock costlier. All of these factors combined threaten to further fan global food inflation, given that if farmers cannot keep up with higher costs, there is the possibility that they pull back on production, leaving the global food supply in an even more precarious situation.

There is already evidence of increased demand for food. Such sales are usually quite steady, but a meaningful increase signals that households are accumulating groceries in anticipation of further price increases and potential shortages, similar to at the start of the pandemic. Elevated food demand and artificial scarcity created by hoarding have the potential to drive food inflation even further.



The producer price index for food was up 13.4% in the year ended in February, with grains and the beef and veal categories rising 20% or more. Even with rising wholesale food prices, farmers are experiencing a significant hit to their margins. Farmers are reducing their variable costs across the board with the hope of mitigating margin pressures, but are finding it increasingly difficult to do so. To combat the price volatility, many farmers are buying all of their necessary fixed production inputs at today's prices, versus taking a gamble that prices will normalize in the coming months. They are doing so in order to budget a profitable production (albeit at nearly break-even margins), and to ensure supplies and resources arrive on time, given supply chain concerns. Even if commodity prices normalize, it is expected that end-products will remain high for some time.

Conclusion

Clients have approached us about how to position portfolios to benefit from a continued rise in food prices, which we believe to be a secular trend. Looking across the board, businesses like restaurants and packaged-food companies that are absorbing price increases have been hit strongly, while farm-equipment makers, supermarkets, and food processors are being seen as beneficiaries.

In conclusion, below we provide our high level thoughts on the effects of inflation across some of the major food sub-industries, as well as where we see the most competitive advantage and long-term sustainable value:

Agricultural Equipment: A strong U.S. farm economy helps producers of agricultural equipment, as farmers need improved technologies to further improve yields, reduce fertilizer usage and electrify their fleets over time. Leading companies in the space are changing their narrative from just selling equipment en masse to providing additional value and cost savings for farmers through innovation. They are also transitioning a meaningful percentage of their sales into recurring revenue subscriptions, through analytical software-based services. We believe these trends will continue, even if there is a normalization in food inflation.

Agribusiness Companies: Agribusiness companies that benefit from wider "crush margins," or profit on turning crops like soybeans into oil, are also experiencing upside from improving demand for food and renewable fuels. Agribusiness companies provide vital links from producer to consumer by sourcing oilseeds and crushing them to produce vegetable oils and protein meals. These are used to produce animal feed, make cooking oils, margarine, shortening and plant-based proteins and in the biodiesel industry. Processors can use the crush spread in order to lock in a gross profit margin, and cover the risk of adverse price fluctuations on the underlying commodity.

Grocery Stores: Grocers tend to benefit from higher food inflation, given the potential to generate wider margins. Grocers that have significant exposure to private-label products will benefit most as prices rise, and grocers with subscription-based membership models will be further bolstered by recurring revenue streams that provide stability during uncertain times. Companies with membership models are also typically catering to middle and higher income individuals that might be less sensitive to price increases, which is why we prefer to hold these names across portfolios.

Packaged-food companies: Packaged-food companies have been getting squeezed by higher input costs, which is leading to margin compression across the sub-sector. As food companies face rising costs, we are also beginning to see "shrinkflation" take place, which is a form of hidden inflation. While the consumer continues to pay the same price they are accustomed to paying, there is an embedded reduction in the size of the food item (i.e. 28 ounces of liquid in a bottle instead of 32 ounces). We believe packaged-food companies will continue to suffer until there is more clarity and less volatility in commodity prices.

Restaurants: Restaurant stocks have underperformed the broader market as investors are worried that rising prices across the board – namely food, gasoline, and rent – will entice consumers to eat in rather than eat out. While we maintain this view, some blue chip names are approaching oversold territory, which we believe could soon present an attractive buying opportunity.

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