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Unit 2 News Analysis: Supply & Demand

Expect food to be a bigger bite of your budget

Rising commodity costs could lead to a 4% price hike in 2011.

By MIKE HUGHLETT[1], Star Tribune

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It might be your Lucky Charms, or maybe your Cheerios -- General Mills won't say which -- but prepare for a price hike on some of your favorite Big G cereals next week.

Meanwhile Kraft Foods, the nation's largest packaged foodmaker, has announced or implemented price hikes on about 40 percent of its North American product line.

And have you seen the price of bacon lately? It was 16 percent more expensive in September than a year earlier, according to federal data.

American consumers, after enjoying at least 20 months of stable food prices, are beginning to see them climb again. It's the result of rising ingredient and commodity costs, a trend highlighted Tuesday by the U.S. government's latest crop forecast.

Most analysts aren't expecting a return to the 5.5 percent food inflation rate of 2008. But some say prices could rise by around 4 percent on average next year, a sharp departure from the 1.8 percent rate of 2009 and the even tamer increase expected for all of 2010.

"I think over the past year or so we've developed a pretty big bubble in the food system," said Bill Lapp, an economist at Omaha-based Advanced Economic Solutions, which specializes in food and commodities.

Commodity costs have been building, particularly over the summer. But until recently foodmakers have been reluctant to pass down those expenses, Lapp said.

"It's a very competitive environment for grocery stores and restaurants, and it's been difficult to pass down costs," he said. But the breaking point appears to be here.

Golden Valley-based General Mills said recently that it would increase prices by "low-single digits" on 25 percent of its cereal portfolio on Nov. 15, the first such price increase in 3 1/2 years. The maker of Gold Medal and Pillsbury flour and Betty Crockerand Bisquick baking mixes has also said that some of those products will see priceincreases in the mid-single digits in early January.

Analysts expect Kellogg to raise cereal prices, too. Global packaged foods giants Unilever and Nestle have recently signaled higher prices on the horizon. And fast-food behemoth McDonald's said last month it plans on raising prices to offset rising costs.

Since many of the price increases have only recently been announced, the biggest impact won't hit until 2011.Indeed, a food inflation rate of only 1 percent to 1.5 percent is expected for all of 2010, said Ephraim Leibtag, an economist for the U.S. Department of Agriculture. That would be the lowest annual food inflation rate since 1992.

For next year, though, Leibtag sees the rate rising to 2 to 3 percent, which is in line with recent historical averages. Other analysts are less conservative.

"The USDA doesn't like to break bad news," said Michael Swanson, an agricultural economist at Wells Fargo in Minneapolis. Swanson is projecting at least 4 percent food inflation next year. Lapp, of Advanced Economics, is looking for 3 to 5 percent.

Commodity surge

At the heart of the increase is a cost surge in the ingredients for food production. U.S. sugar prices are at highs not seen in at least two decades. Commodity prices for coffee are at a 13-year high. And wheat prices hit a two-year high in August and have remained high since.

Soybean prices Tuesday hit a peak not seen since August 2008, the tail end of the last big commodity price run-up. The USDA's monthly crop forecast out Tuesday cut the U. S. soybean crop by 1 percent, more than analysts expected, so shrinking supply is clashing with growing worldwide demand.

The USDA Tuesday also again cut estimates for corn production, though they were in line with expectations and corn prices fell back a bit. Still, corn prices are near 26-month highs, and corn futures for December delivery -- a key price gauge -- are up about 45 percent since the end of July. "Nobody was expecting this kind of run on corn," Swanson said.

Corn is king when it comes to influencing food prices, a staple ingredient in everything from sweeteners to breakfast cereals, and the main component of almost all types of animal feed. The price spike is being driven by a smaller-than-expected crop due to badweather in some parts of the country, rising corn export demand and increasing demand from the ethanol industry.

Rising meat prices

Even before corn's run-up, pork and beef prices were already rising at a heady clip.

Cattle and hog producers, after a couple of terrible years, began thinning their herds last year, tightening supply. That factor, along with strong export demand, brightened their business outlook for 2010, but put pressure on prices at the meat counter.

Pork prices are expected to rise 4.5 to 5.5 percent this year, the highest increase in any primary food category, according to government data analyzed by Janney Capital Markets. Beef and veal were second with 2.5 to 3.5 percent increases expected for 2010.

Beef prices are anticipated to grow at the same rate next year, while pork prices should fall back, but just a bit. The Janney report also forecasts increases of up to 5.5 percent in dairy products in 2011. In recent months, U.S. milk prices have been growing at a year-over-year rate of 6 to 8 percent, according to the U.S. Bureau of Labor Statistics.

Farm costs increase

High corn prices will only make things worse over the next year for livestock and dairy producers.

And input cost pressures are building up on other fronts. Diesel fuel prices are up 11 percent over the same time last year, according to U.S. Energy Department data, and fuel is the main driver of food transportation costs.

Even cotton prices, which are at heights not seen in decades, are having an effect on food costs, Swanson said.

Polyethylene Terephthalose (PET) is a key ingredient in making soda and juice bottles, but it can also be used as substitute for cotton fiber. As cotton prices have soared, the demand for PET has risen as an alternative, in turn pushing up PET prices for packaging companies and ultimately foodmakers, Swanson said.

"If you talk to a food producer, they're not catching a break anywhere." And if those food makers are able to pass down their cost increases to the grocery shelves -- which many analysts expect - consumers won't be catching a break either.

After reading the article, answer the following questions ON YOUR OWN PAPER:

1. In your own words, summarize the article (3-4 concise sentences).
2. What brands and restaurants are being forced to raise prices? Why is this happening?
3. Why are corn prices so influential on food prices?
4. Why are beef and pork prices expected to rise?
5. What rising input costs are affecting livestock and dairy farmers?
6. Related Goods: Draw a supply & demand graph of the market for PET. Show how rising cotton prices are affecting the PET market.
7. According to your graph in (6), will PET prices rise or fall as a result of rising cotton prices?

PLEASE DO NOT WRITE ON THIS ARTICLE!