Macro Keys
Food price inflation – is there reason to worry?

Economics & Macro Strategy
Global

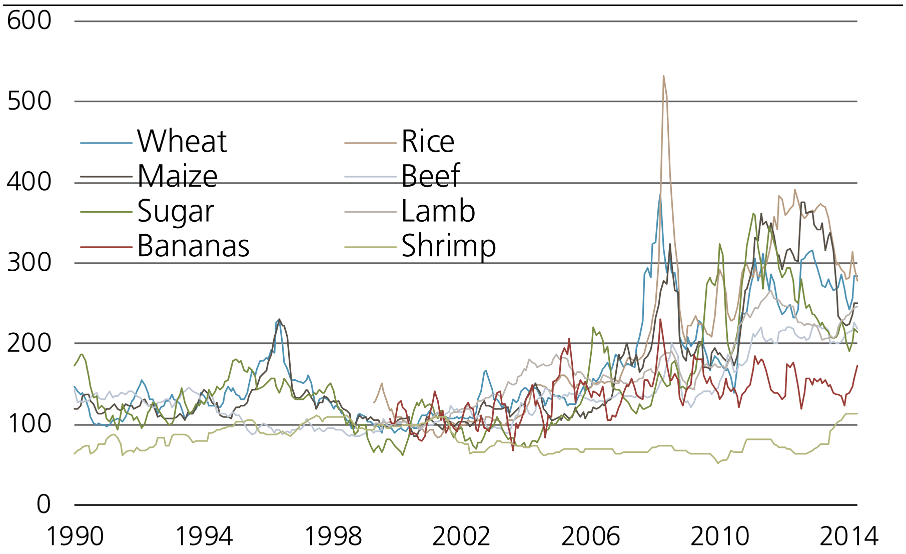
Paul Donovan
Economist
paul.donovan@ubs.com
+44-20-7568 3372
Global Macro Team

Food price inflation is always a highly sensitive political topic. It is also a concept that matters disproportionately in economic terms. Because food is a high frequency purchase, it carries an excessive weight in determining consumers' inflation perceptions. Because the forward looking, inflation predicting talents of consumers are not great, inflation perceptions are disproportionately important in shaping inflation expectations. Thus food (and the other high frequency purchase of fuel) will have a significant impact on consumer inflation expectations.

This means that food price inflation matters, even in OECD economies where food typically approximates between 8% and 15% of the consumer price basket. Consumers' overemphasis of food price inflation means that it is pertinent.

As the following chart shows (albeit in a somewhat messy fashion) there has been a slight upward drift in agricultural commodity prices in the course of the past few months. For some agricultural commodities this is little more than the cessation of price deflation (as with sugar, for instance). For other commodities there seems to be a more noticeable increase in price.

Assorted agricultural commodity prices in USD terms



Source: World Bank, Haver

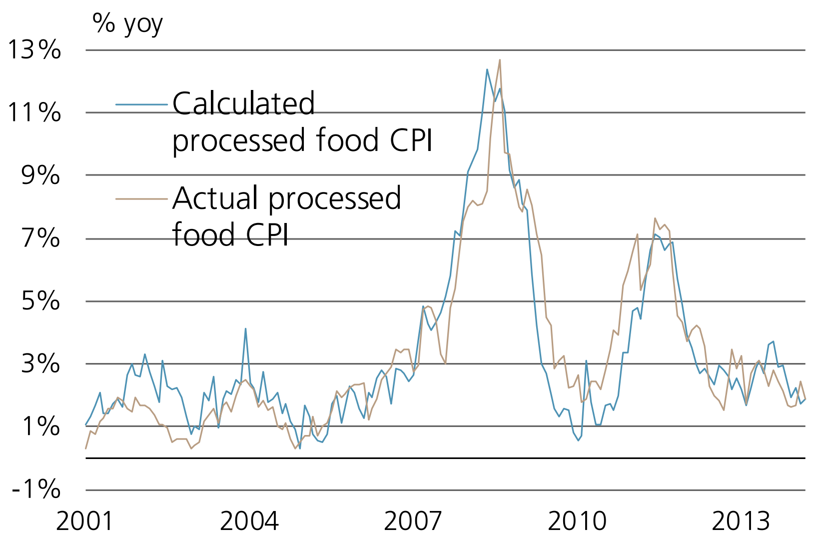
Nonetheless, commodity price inflation is not terribly relevant to OECD economies. This is because so much food consumed within the OECD is processed food, which means that labour costs (involved in processing and distributing food) completely overwhelm agricultural costs in the breakdown of food CPI. Broadly speaking food inflation in the OECD is between 70% and 80% labour costs, with only around 20% from agricultural commodities. The ending of deflation and even the onset of

inflation in agricultural commodity prices is therefore only a minor consideration in assessing food price inflation risks.

A crude way of modelling food price pressures in the OECD is therefore to focus on processed foodstuffs, and to look at the relationship between food retail prices and the costs (including labour costs) that a food retailer faces. This presents a somewhat more varied picture across several economies.

In the UK the price of processed food has actually tracked the model relatively well over the course of the past couple of years. This compares very favourably to the 2010-2011 period when opportunistic pricing meant that food retailers were raising prices noticeably faster than their cost base. With a general election due in May 2015, politics may act to prevent food price inflation rising (at least, rising more rapidly than a cost-based model would imply); increases in food prices in this way would risk provoking unwelcome political attention.

UK processed food prices: inflation compared to cost-based model

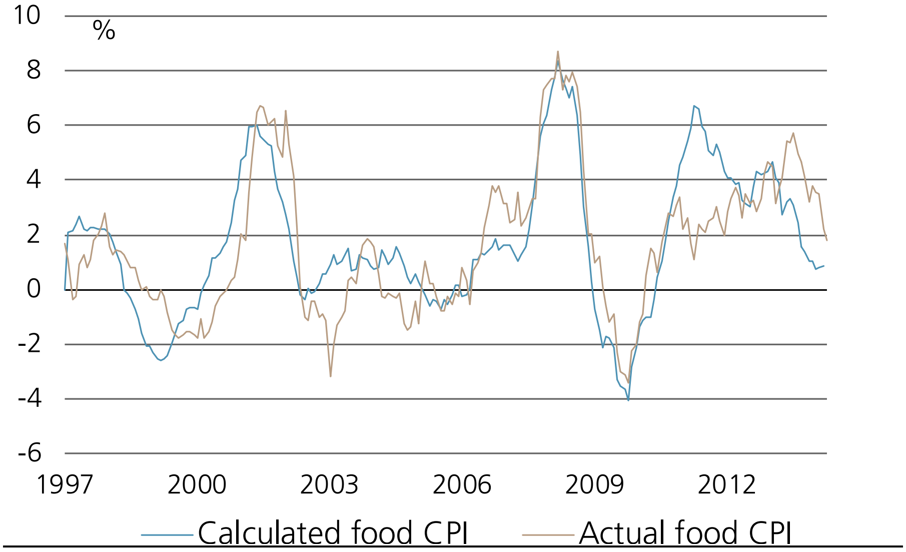


Source: UBS

In Germany food price inflation should be decelerating. This is in part due to the strength of the Euro, acting on the small proportion of food prices that is due to commodity prices. The German model uses total CPI, rather than the narrower processed food CPI, and as such the importance of commodities and thus the importance of a stronger Euro are somewhat more significant.

However, labour costs have also been relatively subdued in the retail sector, and the lower labour costs has had a considerable impact on food price disinflation. In spite of this, processed food prices are not falling as fast in Germany as the costs of food retailers would imply. The full effects of lower wages are not being passed onto the consumer.

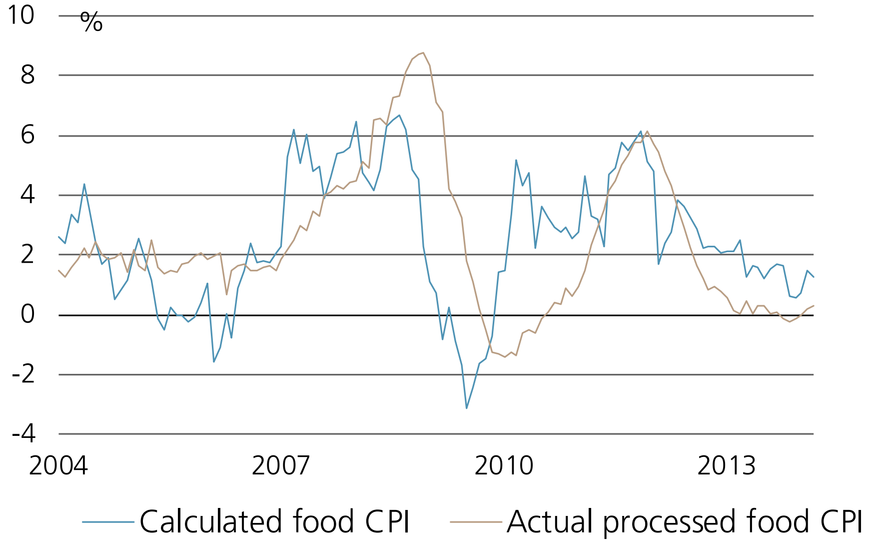
Germany: total food prices: inflation compared to cost-based model



Source: UBS

In the US there is a contrast again, in that the model of food prices suggests a higher level of inflation (marginally) than is currently being experienced. The food retail sector has been reluctant to pass on higher dollar denominated agricultural commodity prices. Retail sector labour costs have been very restrained.

US: processed food prices: inflation compared to cost-based model



Source: UBS

Why do food prices in these three particular countries matter? They matter because inflation perceptions and inflation expectations from consumers will have an economic impact when labour markets tighten. Germany, the UK and the US all have relatively tight labour markets. If food price inflation increases inflation perceptions on the part of the consumer then there is a risk of higher wage demands coming through, which will then potentially feed through into higher inflation or squeezed margins in a broader range of economic sectors than food alone.

Of the three countries the UK is perhaps the least vulnerable. Whether because of political sensitivity or increased competition, food prices have been relatively well

behaved relative to the model of food prices. Commodity increases in sterling terms have been muted, and wage pressures limited.

The German economy has more vulnerability as there appears to have been some opportunistic pricing (food prices have risen faster than the model would suggest). It is worth observing that German inflation expectations and perceptions have been relatively elevated compared to the average of the past decade. This is unusual in that it has taken place in the absence of commodity price inflation in Euro terms. If the Euro weakens in an environment where opportunistic pricing has become established then the perception of inflation may rise more rapidly via perceptions of food prices – a fact that may be somewhat disquieting for the ECB and its credibility within Germany, if it is pursuing a more aggressive monetary policy after June.

The United States is the reverse picture of Germany, with retailers keeping prices lower than would normally be the case. This would suggest, however, that any future reduction in agricultural commodity prices in dollar terms is unlikely to be passed onto the consumer. The question is the extent to which higher raw material or labour costs could be passed on in the future, as retailers seek to catch up on the more limited pricing power that they seem to be experiencing today. It is noticeable, for instance, that the price of food measured by the output price of producers (rather than retailers) has risen sharply of late.

Food price inflation is therefore something to monitor, in both an economic and (less directly) a political sense. Both Germany and the US present some interesting possibilities in the recent behaviour of their food prices; in both countries, though for different reasons, there is the potential for upward pressure on food prices, and via that for upward pressure on consumer inflation perceptions.

Required Disclosures

This report has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures. The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request. UBS Securities Co. Limited is licensed to conduct securities investment consultancy businesses by the China Securities Regulatory Commission.

Analyst Certification: Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to UBS, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Global Disclaimer

This document has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

This document is for distribution only as may be permitted by law. It is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject UBS to any registration or licensing requirement within such jurisdiction. It is published solely for information purposes; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial instruments or to participate in any particular trading strategy. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in this document ('the Information'), except with respect to Information concerning UBS. The Information is not intended to be a complete statement or summary of the securities, markets or developments referred to in the document. UBS does not undertake to update or keep current the Information. Any opinions expressed in this document may change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS. Any statements contained in this report attributed to a third party represent UBS's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party.

Nothing in this document constitutes a representation that any investment strategy or recommendation is suitable or appropriate to an investor's individual circumstances or otherwise constitutes a personal recommendation. Investments involve risks, and investors should exercise prudence and their own judgement in making their investment decisions. The financial instruments described in the document may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates or other market conditions. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument referred to in the document. For investment advice, trade execution or other enquiries, clients should contact their local sales representative.

The value of any investment or income may go down as well as up, and investors may not get back the full amount invested. Past performance is not necessarily a guide to future performance. Neither UBS nor any of its directors, employees or agents accepts any liability for any loss (including investment loss) or damage arising out of the use of all or any of the Information.

Any prices stated in this document are for information purposes only and do not represent valuations for individual securities or other financial instruments. There is no representation that any transaction can or could have been effected at those prices, and any prices do not necessarily reflect UBS's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions by UBS or any other source may yield substantially different results.

Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management. The analysis contained in this document is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this document may interact with trading desk personnel, sales personnel and other parties for the purpose of gathering, applying and interpreting market information. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this document is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues; however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this document. For financial instruments admitted to trading on a non-EU regulated market: UBS may act as a market maker save that where this activity is carried out in the US in accordance with the definition given to it by the relevant laws and regulations, such activity will be specifically disclosed in this document. UBS may have issued a warrant the value of which is based on one or more of the financial instruments referred to in the document. UBS and its affiliates and employees may have long or short positions, trade as principal and buy and sell in instruments or derivatives identified herein; such transactions or positions may be inconsistent with the opinions expressed in this document.

UBS