January 2019

FCC Ag Economics
2019 Outlook

Canada's food processing sector

FCC Ag Economics helps you make sense of the top economic trends likely to affect your operation in 2019:

- Increased export opportunities
- Pricing of raw commodities
- Shifts in consumer demands
- A weaker Canadian dollar and higher interest rates

Canada's food processing sectors continue to expand, yet the profitability outlook for each is uneven in 2019. Production challenges, trade uncertainty and higher input costs generally dampen this outlook, while expansion in export markets, strong household disposable income and a lower Canadian dollar will support revenues of food manufacturers.

Fruit and vegetable processing

Profit margins for fruit and vegetable processors improved slightly in 2018 as revenues increased faster than the cost of raw products. Margins are likely to remain positive in 2019 despite climbing operating costs, including labour and energy. A tight labour market will continue to push wages higher and lead to continued robust consumer demand. Strengthening demand can support processors' profits, but only if the upward pressures on wages that give rise to that demand don't raise labour costs enough to offset its positive impact. Higher interest rates are likely to also pressure households' budgets in 2019 and may deflate consumption of high-quality or expensive foods.

Potato processing

Strong demand for both fresh potatoes and french fries supported potato processing margins in 2018. Margins in 2019 are expected to soften due a higher average price for raw potatoes. Hot and dry conditions reduced 2018 yields, while a wet harvest resulted in an estimated unharvested 15,000 acres. Higher energy and labour costs will only exacerbate last year's difficult crop by pinching margins further in 2019.

Meat processing

Margins were inconsistent throughout the meat processing sector in 2018. While they were positive for beef and pork throughout the year, they softened in the poultry sector, a contrast that arose as a result of different pricing. Lower prices for cattle and hogs contributed to packers' strong profits, while processor prices for broilers were, on average, slightly higher. It didn't help that processed chicken prices declined slightly at the same time. What did help: the continued strength in consumer demand for chicken supporting processors' revenues.

Labour, energy and interest rate increases will lift meat processors' costs in 2019, as they did in 2018. Although 2019's profitability outlook is relatively unchanged from that of a year ago, there will be differences in how the industry gets there. For one thing, beef and pork export values are likely to improve in 2019 as tariffs fall and processors continue to expand into European and Asian markets. But, expect some warning shots too: demand for plant proteins is growing quickly, and while they may not be directly substitutable for meat proteins, neither can they be easily discounted.

Bread and bakery processing

Margins for bread and bakery processing tightened in 2018 due to a combination of higher wheat prices and lower prices for baked goods. Overall wheat supplies should remain healthy in 2019, as estimates call for more wheat acres to be planted in North America. That is likely to lower wheat prices slightly overall, even as Canada's recent production challenges have boosted premiums for high-quality wheat. Because of that, profits are likely to trend sideways in 2019.

Canola processing

Canola crush margins in 2018 reached their lowest value in more than a decade as domestic processors competed with strong export demand. U.S.-China trade tensions lowered soybean prices and placed a premium on canola. Lower 2018 crop production estimates for canola and continued strong export demand are likely to result in similar crush margins in 2019.

How will this affect your bottom line?

The labour market should remain tight this year, especially in central Canada. New fiscal measures should encourage investment to automate processing and gain productivity. Enhance efficiency by reducing the ratio of operating costs relative to revenues.

Proper evaluation of financial risks will be especially important on loans due for renewal in 2019, as periods of rising interest rates may require greater shares of revenues to cover interest payments. Watch your debt repayment capacity, especially those businesses with recent, significant investments.

Trends to watch in 2019

Increased export opportunities

Trade agreements will provide new export opportunities for Canadian food processors. In 2019, the third year of implementation of the Comprehensive Economic Trade Agreement, exports of beef, pork, maple syrup, canola oil and plant-based proteins should pick up. Canadian food processors increased food exports to the EU in 2018, but food imports from Europe climbed faster. As a result, Canada's processed food trade balance with the EU worsened 15.6% between January and October 2018. Strengthening our relationships with European buyers is needed to reverse the trend in 2019.

Seven countries (Australia, Canada, Japan, Mexico, New Zealand, Singapore, Vietnam) have now ratified the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP). In 2019, Year 2 of CPTPP's implementation, we expect Canadian agri-food exports to Japan to expand. If that happens, it will likely be at the expense of the U.S., which lacks privileged market access.

Inflationary pressures to influence consumer food demand

We expect food inflation in 2019 to exceed the most recent 12-month figure of 1.8% as food retailers seek to pass higher labour and energy costs on to consumers. The good news is that low unemployment rates and stronger participation in the labour market are expected to support wage growth in 2019 at levels that could exceed the overall inflation rate (currently at 1.7%). Higher income and shifting inflationary pressures could trigger shifts in food consumption habits.

Weaker loonie will help offset pressures on processing margins

The loonie declined steadily in 2018. We forecast it to average US$0.75 for 2019 – a good news story for food processors.

- Challenged 2019 oil prices, as production increases and demand slows.
- Rate increases on both sides of the border. Enjoying its second-longest economic expansion period ever, the U.S. will break the record if that growth extends into summer. Watch for the Federal Reserve to hike interest rates possibly three times in 2019. Here at home, the Bank of Canada expects inflation to hit its 2.0% mid-point target, with an economy near full-capacity. Financial markets currently expect no more than two overnight rate increases of 25 basis points this year, with the first rate hike coming in the second half of the year.

On the radar

- Expansion of different food retail channels such as online shopping, and their impact on food preferences and purchases.
- The next chapter in U.S.-China trade tensions that will weaken or sustain the volatility in commodity prices observed in 2018.

- Ratification and implementation of the new Canada-U.S.-Mexico Agreement (CUSMA). Canadian access to U.S. agri-food markets will be preserved while U.S. dairy gains access to the Canadian market.
- Potential for the global economy's weaker growth in 2019, driven in part by uncertainty around China's ability to sustain its debt-fuelled economic expansion without triggering inflation. Chinese debt is a growing financial risk for the health of the world economy.
- Elevated probability of an El Nino event with more rainfall in the southern part of the U.S. and drier conditions in the northern part of the U.S. and Canada. Drier conditions are expected to prevail as well in Asia and Africa. Disruptions in production of agricultural commodities can lead to large swings in commodity prices.

Curious about the 2019 outlooks for other Canadian sectors? Here's what is available:

- Agribusiness
- Broilers
- Dairy
- Grains, oilseeds and pulses
- Horticulture (new for 2019)
- Red meat

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