The Canadian food processing sector was generally profitable in the first half of 2018, as we forecasted in January. The sector’s Gross Domestic Product (GDP) grew 4.5% between May 2017 and April 2018. This pace was slower than the growth recorded a year earlier but is still impressive. Strong GDP growth in food manufacturing should continue throughout the rest of the year, supporting profitability in the food processing sector for the remainder of the year.

Competition across several retail options continued to minimize inflation in domestic retail food prices in the first half of the year, as we expected. Many food products (pasta, fresh and frozen beef, ham, bacon, bread and butter, etc.) recorded price declines, helping to slow growth in overall food retail prices to 1.0% between May 2017 and May 2018.

While it helped to drive growth in consumer demand, weak food inflation also led retailers to pass the lower prices to processors, pressuring manufacturing margins between January and June. Lower year-over-year (YoY) prices in the first six months for raw materials such as livestock and certain grains and oilseeds, helped to ease those pressures.

Looking ahead, prices for livestock, grains and oilseeds, projected to generally remain lower in the second half of 2018, will continue to support processor profitability. Trade tensions between the U.S. and its major trading partners may bring downward pressure on commodity prices, as will the anticipated larger supply of both livestock and crops in the U.S. market throughout 2018.

Labour costs are perhaps the most significant inflationary pressure on processors’ costs. Canada’s labour market is currently robust. The national unemployment rate stayed at 5.8% from February to May, the lowest rate recorded since 2007. Wages paid by food manufacturers had not grown as quickly as overall wages on a YoY basis by early 2018, but their growth has picked up speed since then. This trend should hold through the second half of 2018 given the strength of the Canadian economy.

Overall GDP growth in the U.S. is estimated to have exceeded 4.0% during the second quarter in 2018. That pronounced economic performance should sustain the demand for Canadian food products and lift the current pace of Canada’s exports to the U.S. The record in exports that Canadian food processors set in 2017 fell a slight 0.7% YoY in June, but continued strong U.S. growth could spur exports in the second half of the year to make up for the slower pace recorded in the first six months of 2018.

Canada’s food processors could see further export opportunities expand beyond the U.S. market. Given ongoing trade tensions and tariffs applied to numerous U.S. products, foreign markets will look to source more competitively priced imports from non-U.S. suppliers. China, Mexico and the European Union are particularly enticing markets in the current global trade environment.
Interest rates slowly trend up while the loonie hovers at US$0.78

Global market forces played a big part in Canadian competitiveness and the profitability of our agricultural sectors in 2018-to-date. Several macro factors did too – and while we didn’t get everything right, our forecasts in January help explain those trends.

Our January forecast of a US$0.78 loonie was right on the money up to mid-June (see illustration). But the Canadian economy relies on the strength of export sectors. Trade tensions, currently pushing the CAD lower, could continue to pressure the loonie below the $0.78 projected 2018 average.

However, we underestimated the strength of the world economy and the resulting robustness in global oil demand: despite rising oil production in the U.S., the West Texas Intermediate (WTI) crude oil price averaged close to US$65, significantly more than our initial projection of US$55.

The Bank of Canada (BoC) has revised their projections of Canadian economic growth for 2018 since our January outlook. The Bank expects a slower rate of growth, but that the economy will operate close to full capacity this year. Inflationary pressures persist, trending higher than our forecast of 2.0%, the Bank’s mid-point target.

We also correctly anticipated the higher short-term rates in the U.S. and Canada that pushed bond yields higher. The average 5-year fixed rate on mortgages has climbed 35 basis points in the first six months of 2018 – in line with our forecast of an annual increase of around 75 basis points.

After hikes to the overnight rate in January and July (of 25 bps each), financial markets suggest one more increase is possible before the end of 2018. We believe however that the uncertain global trade and economic landscapes could make it difficult for the BoC to proceed with an additional rate hike.

In January, FCC Ag Economics forecasted 2018 ...

**Overnight rate increase**
Right on Target
FCC forecast: 50-75 bps
Actual Jan-Jun: 25 bps

**5-year fixed rate increase**
Right on Target
FCC forecast: 75 bps
Actual Jan-Jun: 35 bps

**USD/CAD exchange rate**
Right on Target
FCC forecast: US$0.78
Actual Jan-Jun avg.: US$0.78

**Inflation**
So close
FCC forecast: 2.0%
Actual Jan-Jun avg.: 2.5%

**Oil prices**
Miss
FCC forecast: US$55.00
Actual Jan-Jun avg.: US$64.88

Sources: Bank of Canada, Bloomberg
On the radar

- The loonie’s waning capacity to gain value in the last six months of the year. A lower loonie can help offset the impact of downward pressure on processors’ margins. That may be especially timely this year, as U.S. trade tensions bring uncertainty.
- The continued strength of the U.S. economy.
- An uncertain global trade environment to close out 2018
  - North American Free Trade Agreement (NAFTA) discussions will continue (with no determined end date).
  - Full ratification of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) agreement is ongoing.
  - The full implementation of the Comprehensive Economic and Trade Agreement (CETA) is conditional on ratification by the EU member states.

In this series:
- Crops East
- Crops West
- Food processing
- Hogs and pork
- Cattle and beef
- Dairy

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