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Consumers to Take on Higher Prices in the Meat Case This Summer

Brian Earnest

Lead Economist, Animal Protein

Inside…

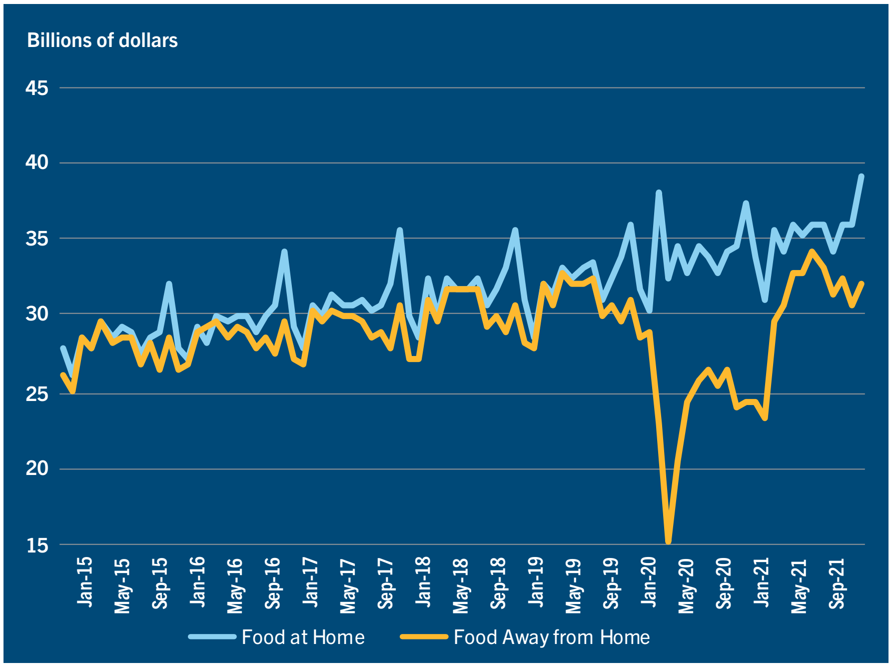
Key Points:

- In 2021 the market for proteins witnessed a new type of consumer, one who is less sensitive to higher retail meat prices and more interested in at-home food preparation.
- Demand for animal protein, particularly beef, has been exceptionally high since the onset of the pandemic, allowing producers to transfer the burden of higher input costs along to consumers.
- The factors that elevated meat prices will continue in 2022, including high production costs, declining livestock numbers, and unpredictable consumer behavior.
- Higher retail meat prices will continue through the rest of 2022. However, as U.S. consumers notice their dollar is not going as far as it used to, they are likely to "trade down" at the meat case, with chicken being the primary beneficiary.
- Although smaller herds and flocks mean growth opportunity is minimal in all protein sectors, chicken may again be best positioned for expansion, albeit not to the degree that occurred from 2015 to 2019.

Introduction

Over the past two years, ever-changing consumer behavior has buffeted the food sector. Initially consumers responded to the pandemic by stocking up on grocery shelf staples and avoiding sit down dining. As COVID outbreaks ebbed and flowed, so has consumer restaurant spending. But, during the entire time retail meat demand has remained steadfast. These unprecedented changes in spending patterns have proved extraordinarily difficult for livestock producers, meat processors, and consumer-facing channels.

EXHIBIT 1: Total Consumer Food Spending, Constant Dollars Retail vs. Food Service



Source: USDA ERS

The shift in spending was most notable during 2020 *(Exhibit 1).* Consumers, flush with cash from federal stimulus and facing ongoing dining restrictions, had more spare time and money to spend on cooking at home, and retail meat and poultry spending jumped nearly 20% in 2020. However, when dining restrictions did ease in the first half of 2021, retail meat spending defied expectations and held steady. And just as consumers were gaining optimism in the second half of 2021, the omicron variant spiked COVID-19 cases and curtailed restaurant spending yet again.

Weary of dining restrictions, consumers who wanted to replicate restaurant-like experiences have invested heavily in home cooking. According to the NPD group, U.S consumers spent $6.1 billion across the grilling segment in 2021, a 14% uptick from 2020, with peak (March-May) grill and smoker sales volume up 80% from pre-pandemic levels. Consumers' access to high-quality meat has been instrumental in retaining the consumer dollar at retail, specifically access to better-quality beef — more than 80% of beef was graded choice or higher during 2021.

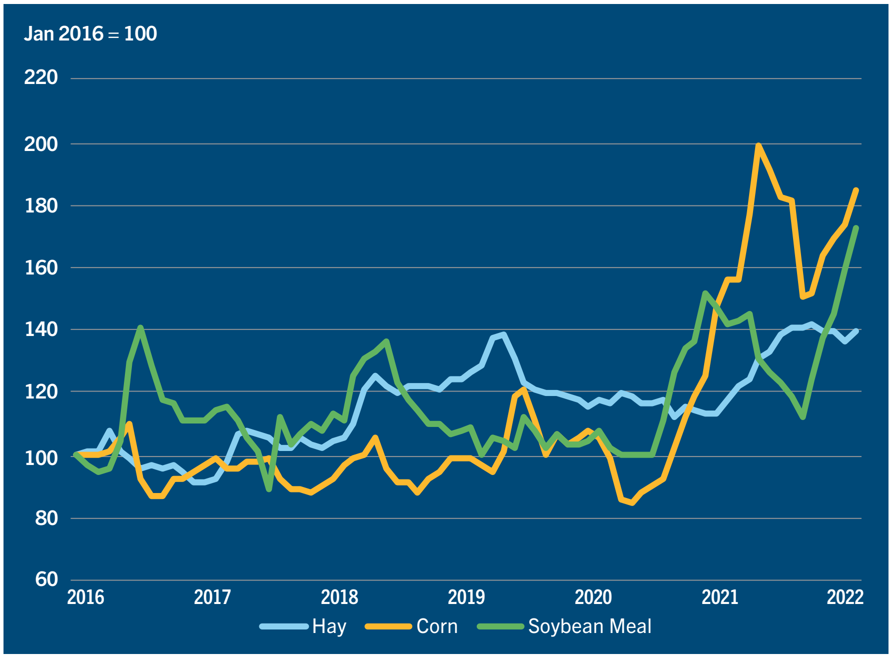
These shifting demand patterns and market uncertainties have played a major role in higher and more volatile meat and poultry prices, but that is only half of the story. Looking more in depth at the supply side, over the past decade the U.S. has added 14 billion pounds of animal protein production, a roughly 16% increase. Yet the past few years paint a different supply picture. The temporary closure of beef and pork plants in 2020 have led to backups in fed cattle supply that still linger today.

Combined with the ongoing severe drought conditions in the Western U.S. amid the backdrop of modest feeder calf prices, the nation's beef cattle inventory remains in decline. The combined cow and replacement heifer inventory has dropped by a whopping 12% since 2017. Likewise the nation's sow herd is contracting and is down nearly 6% over the past three years, primarily due to losses sustained in 2018-19, prior to the pandemic. USDA is forecasting a 2% decline in U.S. beef and pork production in 2022.

Given the broiler industry's ability to quickly ramp up production, we expected it to pick up the slack in terms of overall meat production, but that has not turned out to be the case. Broiler production expanded rapidly from 2013 to 2019, up some 2.4% annually on average. In contrast, during the most recent two years, (2020-21) annual broiler meat production growth averaged just 1.1%. Factors at play include uncertainties regarding the future of food service, high feed costs, ongoing chick survivability, and Highly Pathogenic Avian Influenza sweeping through U.S. commercial poultry. Overall, USDA expects minimal growth for chicken production, up just 0.7% in 2022.

The bottom line is that slightly higher poultry production and slightly higher red meat imports will leave the domestic meat and poultry supply essentially unchanged in 2022.

EXHIBIT 2: Animal Feed Cost Index



Source: USDA ERS - Feed Grains: Yearbook Tables

Input Inflation Rolling Down to Consumers

Animal feed prices have skyrocketed from where they sat in 2020 as global grain balance sheets tightened amid smaller global harvests in 2021 and now by the Russian invasion of Ukraine *(Exhibit 2).* The invasion shocked grain markets and sent grain and oilseed crop prices up 20%-30% in a matter of days. Although feed is the largest variable cost to livestock production, it is not the only cost: Labor and energy also represent major expenses and both of those have been rising steadily as well. The sharply higher costs for feed, and energy in particular, have yet to fully impact wholesale and retail meat prices.

Thus far, the consumer has been assuming more of the burden of higher production costs as they've shown up in prices on shelves and menus. The intense media coverage of food inflation in recent months has prepared consumers, in a somewhat perverse manner, for higher food prices, which is minimizing "sticker shock" in 2022. In previous times of real income reductions, consumers have traded down to "value" options such as chicken breast and pork chops. However, until proven otherwise, we expect that meat consumption will remain strong throughout 2022 despite the effects of reduced government stimulus payments and higher gas prices on shoppers' budgets.

Higher Wholesale Meat Prices Add to Uncertainty in Retail Shopper Behavior

Price volatility across the animal protein sector has become a daily headache for procurement teams to manage. While prices started 2022 in post-holiday doldrums, wholesale values were still elevated compared with pre-pandemic levels. Volatility in wholesale markets remains an obstacle for promotional planning. With combined cutout values of beef, pork, and chicken climbing 22% YoY for the first quarter of 2022, the consumer is all but certain to see higher prices in the meat case.

Current dynamics playing out in whole turkey and ham segments may signal what to expect for on-shelf prices for the rest of the year. Turkey, and specifically whole turkey prices early in the year, can indicate retailer price expectations for the year because they contract and take delivery early in the year for the fourth quarter holiday period. To start 2022, wholesale turkey prices were up more than 20% from a year earlier, and 30% above the three-year average.

A major factor tightening ham availability is reduced labor availability. COVID-19 exacerbated an already tight labor market hampering pork processors' ability to de-bone hams, forcing larger bone-in ham volume into export markets. While bone-in ham prices have fallen to 10-year lows, boneless ham values have risen to levels not seen since 2015, doubling the spread between the two cuts, to about $160/cwt. With no end in sight to the industry's labor woes, we can expect the premium for domestic boneless ham supply will remain elevated for the rest of the year.

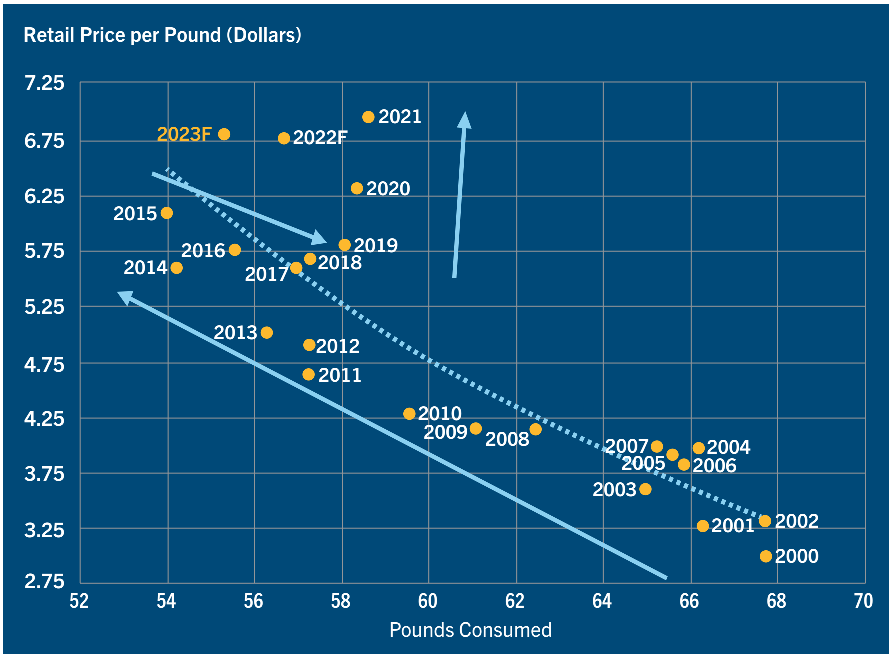
Beef Demand Defies Price Pressure

Typically during inflationary periods or when real disposable income declines, consumers buy fewer luxury items. For example, as retail beef prices rose during 2000-2010, beef consumption eroded. Specifically, from 2009 to 2015, retail beef prices rose 7% on average per year while per capita beef consumption declined more than 11% (from 61 pounds to 54 pounds). Retail beef prices then rolled back in 2015-17, and rose just 2% annually from 2017 to 2019.

However, since 2020, beef consumption has not declined in the face of higher prices *(Exhibit 3)*. Combined retail prices have grown to all-time highs, increasing by more than 20% from 2019 to 2021 – yet consumption still increased by 1.4%. Since 2015, annual beef consumption is up 8.6% to 58.6 pounds per capita in 2021. For 2022 and 2023, USDA is forecasting a slight decline in beef pounds consumed, as domestic supplies shrink amid a contracting cattle herd and growing exports.

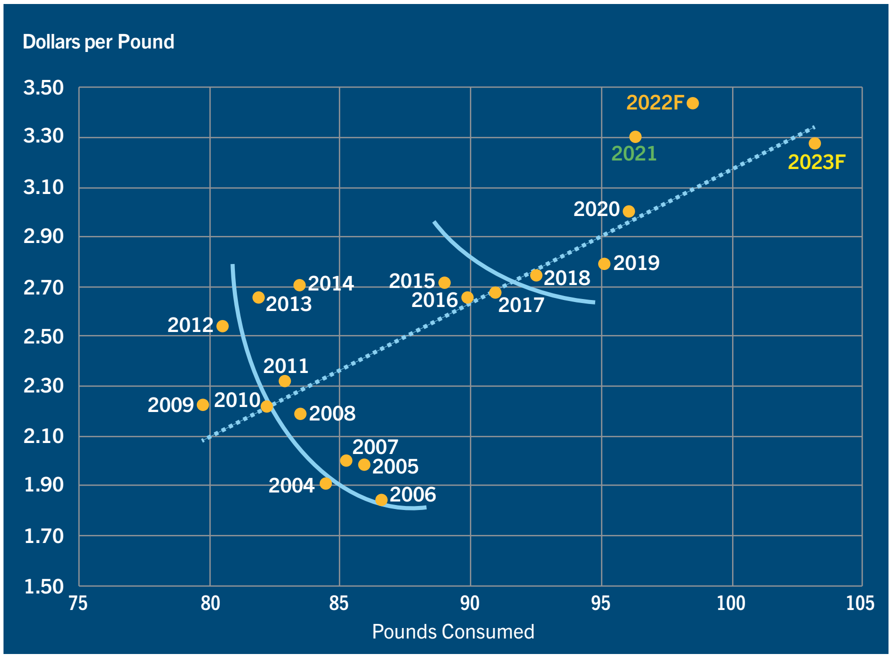
Demand for chicken has also increased as prices have risen. The relationship between change in prices paid and change in quantity consumed is consistent and fairly strong *(Exhibit 4)*. Both consumption and prices rose to record high levels in 2021, up 8.2% from 2015. Both retail

EXHIBIT 3: Retail Beef Prices vs. Per Capita Disappearance



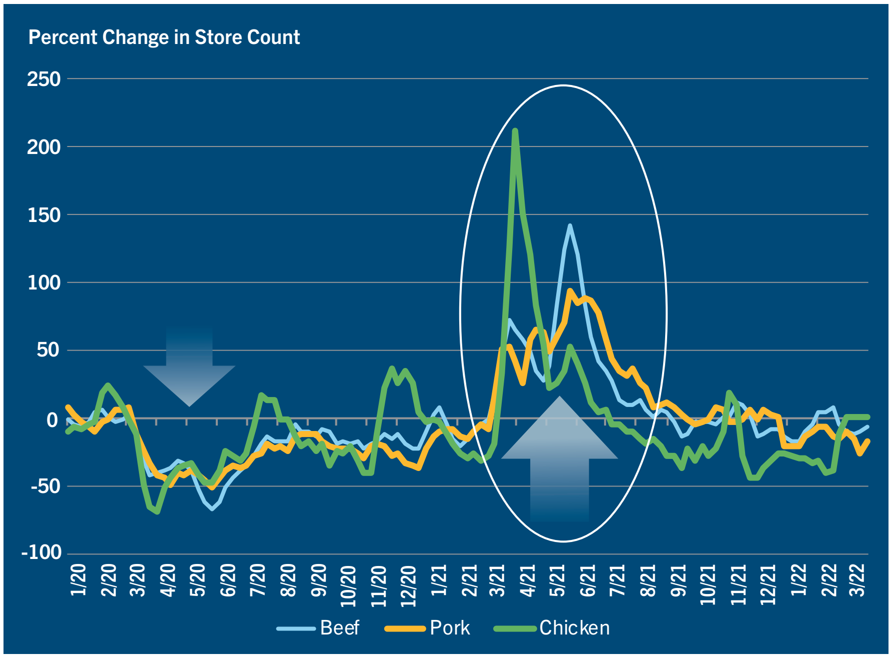
Source: CoBank, USDA

EXHIBIT 4: Real Retail Chicken Prices vs. Per Capita Disappearance



Source: CoBank, USDA

EXHIBIT 5: Retail Feature Activity YoY Change by Protein



Source: USDA AMS, CoBank

prices paid by consumers and consumption are forecast higher during 2022. While stronger beef demand has been getting attention lately, chicken continues to enjoy strong consumer demand as well.

Elevated Wholesale Values Have Implications for Promotions As Well

Grocery meat department managers generally plan featured products and pricing 3-6 months ahead and food service managers set promotional strategies at the beginning and mid-year for a 6-12 month basis. Meat procurers' current promotional plans show they expect that consumers will continue to absorb the forthcoming rise in prices and that the increased cost volatility is affecting retail featuring.

Increased volatility in spot markets and supply instability handcuffed retail marketing of proteins during the 2020 grilling season *(Exhibit 5).* Featuring activity rebounded substantially in 2021 as grocers sought to hold onto the sales they gained during the pandemic. For 2022, a flight to safety from higher meat prices may be to feature value items like ground beef, hot dogs, and sausage items.

Will Consumers' Savings Run Out?

Wages are increasing but they are not keeping pace with inflation, meaning that real purchasing power is declining. As U.S. consumers notice their dollar does not go as far as it used to, they may "trade down" in their protein purchases, favoring chicken more often than was the case in 2021. However, we do not anticipate that the trade-off will be as severe as what happened in 2006-15 when chicken rapidly became a major presence on quick-service restaurant menus.

Although government stimulus payments successfully encouraged economic recovery through 2020 and 2021, Americans put a large portion of stimulus towards paying down debt and into savings. Consumers' savings ballooned by an estimated $2.5 trillion by April 2021 and most of that savings remains in consumer bank accounts. How soon and how deep consumers need to dip into those savings to pay for higher gas, housing, and grocery bills will be a factor in how long meat prices can be sustained.

Conclusion

Given the strength in the markets during the first quarter of 2022, there is a high probability that wholesale prices will remain supported through the balance of 2022. USDA is currently forecasting livestock prices up 10% YoY for 2022 overall. Surprisingly, as dining restrictions have eased over the last 12 months, retail channel support has seen minimal contraction. With grilling season in mind, it is likely that retail meat department's focus will shift to profit margins over sales volumes this year, meaning we will see increased creativity in the meat case. Rather than vying for consumer dollars through aggressive price points, "no price" features will be an attractive solution.

Additionally, while prices for end cuts have been elevated, grinds show moderate price support, suggesting we could see burgers and all-beef franks more frequently featured during grilling season.

If consumers' real incomes continue to decline along with higher meat prices, we may finally see a significant change in consumer's willingness to pay for red meat. If that turns out to be the case, the U.S. broiler industry may yet again be well positioned for modest growth and strong margins. Even here, however, we do not expect that the opportunity will likely rival the expansive growth that occurred from 2017-20 when eight new broiler plants were built.

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