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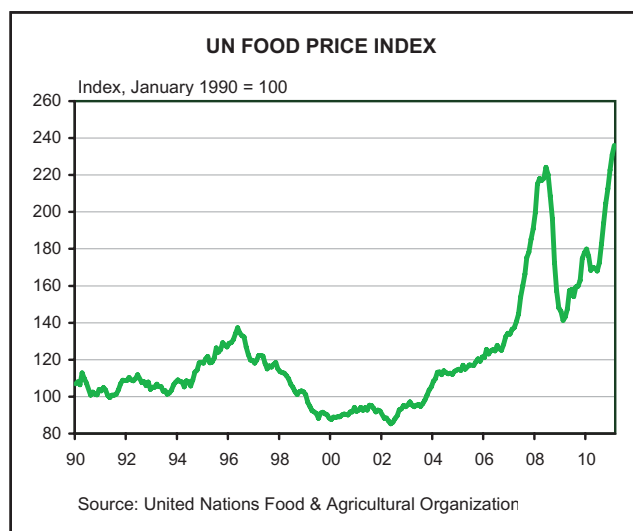
HIGHLIGHTS

- Severe weather over the past two years have impacted global supplies of key food commodities and generated substantial upward pressure on food prices.
- Food inflation has been elevated in emerging markets since last year, but has yet to impact advanced economies fully.
- For Canada, rising global food prices take one year before producers pass increased costs onto consumers. This is likely to occur in the coming months.
- Canadian food inflation, as measured by the food component of the CPI, could rise to as high as 7-8% on a year-over-year basis over the next 9-12 months.
- Fortunately, these kinds of shocks do not tend to last. A similar run-up in global food prices was recorded in 2007 and 2008 when severe weather was also to blame. However, prices did eventually fall back to their pre-crisis level once growing conditions improved and Canadian food inflation fell back toward its long-term average of about 2% by 2009.
- We're expecting a similar story to play out going forward. We are already beginning to see this occur as the prices of several key food commodities have recently begun to fall.

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WEATHERING THE STORM OF FOOD PRICES

Food inflation has been a serious issue in a number of emerging markets since the middle of last year. A string of severe weather systems over the past two years that have spanned the globe have wreaked havoc on crops and destroyed supplies of critical food commodities, driving up prices in the process. In response, governments around the world have turned to protectionist trade policies and mass hoarding in a bid to curb domestic inflationary pressures and improve food security. However, this has only put further pressure on already strained supplies and exacerbated the upward price momentum. In contrast, food price inflation – as measured by the food component of CPI – has remained subdued in Canada and other advanced economies thus far, but that story is soon likely to change as retailers begin to pass on the cost of higher prices for grains and other food commodities to consumers. From a Canadian perspective, food price inflation will likely peak at roughly 7-8%. However, this should prove temporary, lasting for about 8-9 months. Canadians can take some comfort in the fact that these kinds of shocks to food supplies and prices generally ease as weather conditions normalize and global supplies rebound, as was the case in 2007-08.



The Astronomic Rise of Food Prices

According to the food price index released by the United Nation's Food & Agricultural Organization, average food prices have increased by more than 67% since February 2009. However, prices have been rising particularly rapidly since June 2010, increasing by 40% since then. The index is now at its highest level since the UN began tracking prices in 1990. While demand for food is indeed growing, particularly in emerging markets, this would support only moderate price gains over long periods of time. The recent experience is much too rapid to be sustainable and is likely cyclical in nature.

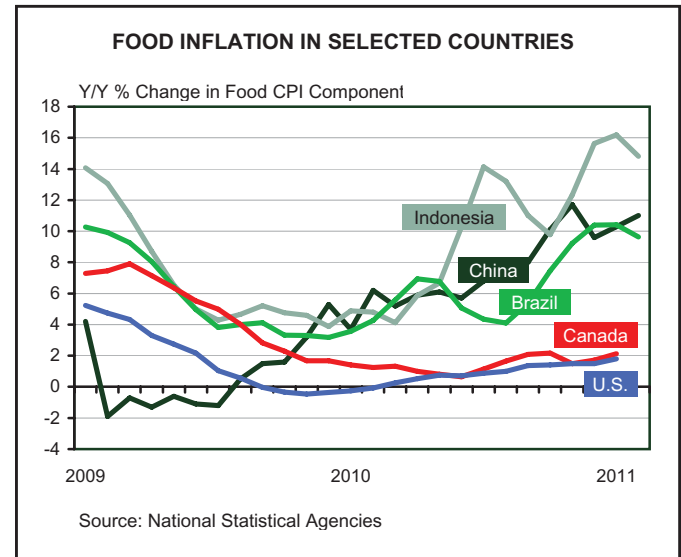
There are three major factors behind the food price boom. First, a series of devastating weather events around the globe have either dramatically reduced yields or have outright destroyed crops of a number of critical food commodities since the beginning of 2010. The El Niño and La Niña phenomena, which were last seen in 2008, are largely credited and the effects have ranged from extreme dry conditions in Russia and Argentina; and severe droughts in China, to floods in Australia,

Pakistan, Southern Africa, Brazil, and the Canadian Prairies; and cold snaps all across North America. Global supplies have tightened considerably, as a result.

The second factor relates to the response by governments to the supply shock. Some, like Russia and India, have turned to export bans or quotas, while others have opted to outright stockpile commodities to secure their own supply and, hopefully, curb inflationary pressures. Neither response is prudent from a long-term perspective. Large-scale purchases and mass hoarding has simply caused supply to contract further, while protectionism is more likely to inhibit the supply response (ie. greater agricultural output) that would typically help normalize these cyclical price movements.

Third, speculators appear to be playing a role in driving up prices. While fundamentals ultimately drive long-term movements in commodity prices, a consensus is building that investors chasing short-term returns can add to short-term price volatility. Low returns on fixed-income investments and rising risk appetite appear to be the main driver of investor demand. In addition, investors are likely keying off of the structural impact on food and other commodity demand coming from the growth in emerging economies. According to the Commodity Futures Trading Commission, there has been a considerable increase since last June in the number of traders purchasing futures with the expectation that prices will increase.

Fourth, an increasing share of North American agricultural production is being earmarked for biofuel production rather than consumption, particularly in commodities like corn and oilseeds. The food versus fuel trade-off is becoming increasingly relevant as additional countries implement

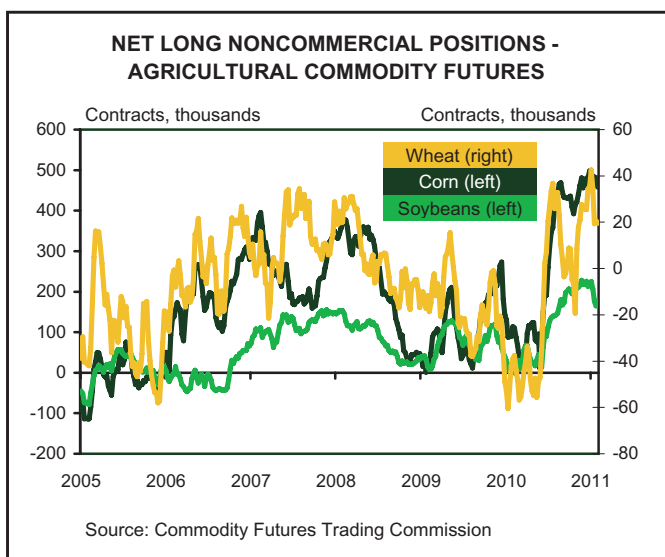


policies to increase the share of renewable energy in transport fuel. Agriculture and Agri-food Canada has estimated that annual world biofuel production could double to 220 billion liters by 2020.

Food Inflation is on its way to Canada

Retail food price inflation has not yet emerged fully among advanced economies. Both in Canada and the U.S., food inflation has increased since last June, but remains in the 1.5%-2.0% range on a year-over-year basis – far from worrisome levels. However, food prices have been a serious issue for emerging markets for almost a full year now. In some of the most populous countries in the world, such as Indonesia and Brazil, food inflation has risen from 3-4% on a year-over-year basis in mid-2010, to between 10-15% currently.

The lagged impact on Canada and the U.S. is likely due to fierce competition amongst producers and retailers inhibiting their ability to pass on increased costs to consumers. In Canada, changes in global food prices typically take about one year before they fully pass through to final goods prices. In addition, food inflation is unlikely to reach the same level as in emerging markets. Raw agricultural inputs represent only a small fraction of the prices paid at grocery stores. The remainder is accounted for by processing, packaging, transportation, storage, retailing, and other business inputs. It has been estimated by the Canadian Wheat Board that raw wheat accounts for just 15 cents of the price of a loaf of bread that consumers pay¹. On the same token, however, energy prices can then influence food prices as the aforementioned inputs are more affected by energy costs. It has been estimated that about one-fifth of all energy used in the U.S. is accounted for by the supply chain of food². Energy



price gains have been slightly less remarkable than those recorded by global food prices, however.

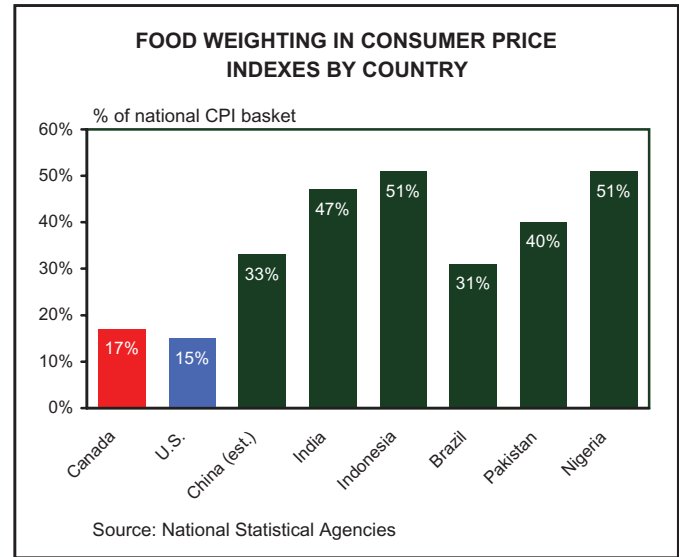
The elevated Canadian dollar likely also plays a role through lowering the price of imported food. Canadians spent more than \$85 billion on food in 2010, while imports of food products amounted to more than \$25 billion. A significant portion of those imports would have been used in the production of processed foods, but it provides some insight as to how much a high Loonie can have on food prices given the substantial size of imports.

So, roughly one year has now passed since global prices began their ascent and, true to form, prices at the consumer level are beginning to respond in Canada. A major Canadian food producer recently announced a 5% price hike in its products, and a major grocery chain has warned that food prices will begin to rise soon, as producers continue to face higher input costs. Going forward, price pressures will continue to mount as the prior year's gain in global food prices feed into prices paid at grocery stores.

Fortunately, the impact on overall headline inflation will remain moderate. In emerging markets, food inflation is a critical issue as food plays a much larger role in an average household's expenditures. In the world's six most populous countries (not including the U.S.), representing almost half of the world's population, food constitutes between one-third and one-half of a household's consumption basket. In Canada and the U.S., however, food accounts for just 17% and 15%, respectively.

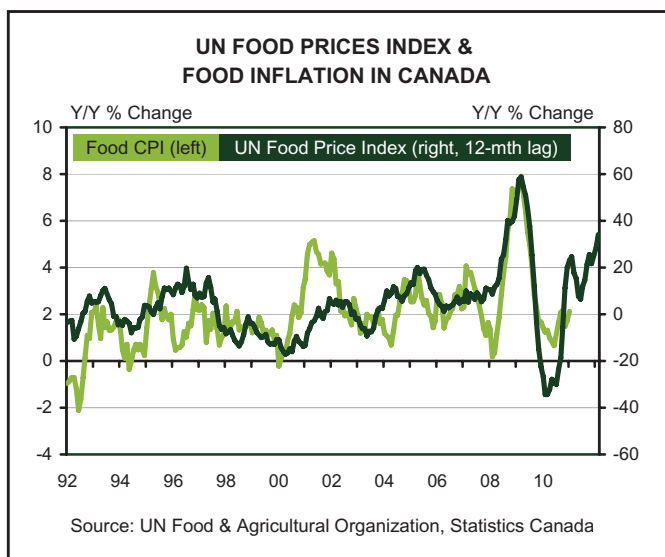
How high and how long? A comparison with the 2007-08 cycle

So, food inflation is on its way to Canada. The big ques-



tions that remain are: how rapidly could food prices rise and how long could inflation remain above its 2.2% long-term average? This will ultimately depend on the lagged impact of the past year's rise in global food prices and where they head from here. Unfortunately, this is difficult to predict given the uncertain nature of things like weather, growing conditions, and political developments. To that end, we look to recent history for some insight. The current food price cycle is uncannily similar to one that Canadians went through just a few years ago. The last El Niño and La Niña cycle came in 2007 and 2008. At the time, severe weather systems had destroyed crops of critical commodities, supplies of foodstuffs around the world had contracted, both agricultural and energy prices had soared, governments had instituted protectionist policies, and food prices in emerging markets were reaching critical levels. The UN's price index rose by 67% over 18 months, while in Canada, food inflation increased dramatically from 0.2% in February 2008 to a high of 7.9% in March 2009, one full year after food prices began rising.

However, by the end of 2008, weather and growing conditions had improved and supply rebounded as farmers increased both acreage and yields, mostly through the usage of better fertilizers. As a result, global food prices recorded price declines in excess of one-third in less than a year and fell back to slightly above their pre-crisis levels. In Canada, food inflation fell to just 1.25% by December 2009. Thus, given the similarities in circumstances, we expect both prices and supplies to follow a similar trend as it is most likely the case that such weather-related supply shocks will not persist. This is not the first El Niño and La Niña cycle the world has gone through, nor will it be the

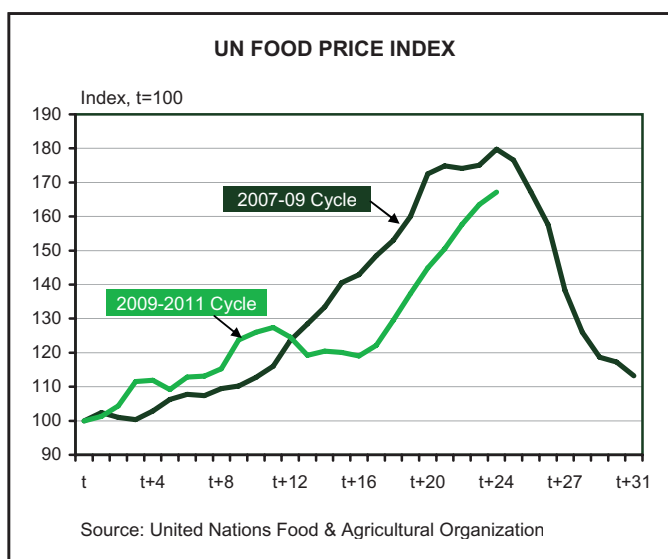


last, and supply conditions do tend to normalize once the cycle ends. This should help normalize prices and we are already beginning to see this happen. China, the world's largest producer of wheat, was struggling with its worst drought in two centuries since April 2010, but thanks to a few weeks of heavy precipitation and a heroic irrigation effort, China was able to avoid much of the calamity faced by more than one-third of its wheat fields. As a result, prices of wheat futures have declined by more than 20% over the past 5 weeks. Moreover, reports are beginning to filter out of South America and Australia of better-than-expected harvests for other commodities. Prices of corn and soybean futures are both down by between 5-10% since earlier this month. All price declines are prior to the Earthquake that struck the north-eastern coast of Japan.

Thus, we are provided with a reasonably good indication as to what we can expect for Canadian food inflation. Our analysis suggests that food inflation could rise to as high as 7%-8%, while an elevated rate of inflation could last for at least the next 8-9 months. Beyond that, price pressures should moderate to a level in-line with the historical average. In turn, we are anticipating a relatively muted increase in headline inflation as the elevated Loonie should continue to hold down price pressures. In addition, food represents 17% of the average household's consumption basket and an 8% increase in food prices translates roughly to a 0.2 percentage point increase in headline inflation. Overall, we anticipate headline inflation to peak in the second quarter of 2011 at 2.6% on a year-over-year basis, before falling back to 2.2% by yearend.

Risks to the Outlook

Our baseline forecast for food inflation assumes a similar



storyline as that recorded in 2007 and 2008. However, there are significant risks. Admittedly, Mother Nature is unpredictable, and we remain cautious regarding our expectation of improving growing conditions. Another determining factor will be how long protectionist policies remain in place. Such protectionism prevents domestic farmers from reaping the huge fiscal benefit that could be gained from exporting at elevated prices. That income could then be used to increase acreage which, given better growing conditions, would help stabilize both global supplies and prices. Under an export ban or quota, farmers have neither the ability nor the impetus to do so. As such, prices could remain elevated overall for a prolonged period of time. By the same token, however, substitution between commodities and suppliers can take place as protectionism is not so widespread as to restrict a worldwide supply response.

Third, governments in emerging markets are now on high alert as inflationary pressures mount and countries such as China, India, and Brazil have begun hiking interest rates in response. Their success, or lack thereof, in moderating both growth and inflation could have substantial influence on the both the bullish sentiment of commodity investors and fundamental demand for commodities. Lastly, the outlook for energy prices also plays a critical role. Geopolitical risks in the Middle East and Northern Africa have generated sufficient supply concerns as to be a material upside risk to our outlook as elevated energy prices implies elevated producer input costs and consumer food prices.

Conclusion

Thus, Canadians need to be prepared for rising food prices. The evidence suggests that food inflation could rise to as high as 7-8%. And how long those increases persist will be determined by a host of supply and demand factors. We anticipate that these weather systems will eventually fade, as they have in past cycles. As such, the supply response to these elevated prices should help normalize markets for these commodities and bring price levels back down to manageable levels. In turn, this will feed into more moderate food price inflation here in Canada. However, even if every agricultural commodity price were to begin falling right now, high food inflation would still persist for at least the next 8-9 months. And, as highlighted above, there remain a host of risks that could potentially help support an elevated level of commodity prices and, thus, food prices. Prolonged protectionism, additional poor weather, and stronger-than-expected emerging market growth will all factor into the direction and momentum of global food prices in the coming months.



Endnotes

1. <http://www.theglobeandmail.com/globe-investor/personal-finance/household-finances/price-of-food-in-canada-could-jump-7-per-cent-in-2011-economist/article1934763/>
2. Pimentel, D., and Patzek, T. (2007). Ethanol Production Using Corn, Switchgrass, and Wood and Biodiesel Production Using Soybean. Plants for Renewable Energy. Haworth Press, Binghamton, NY in press.

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