Four Extraordinary Events Creating Opportunities in Real Assets

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Pandemic domino effects have led to unexpected consequences: sudden meat shortages, commercial buyers being paid to take possession of crude oil, ethanol plant closures, and sudden shut-ins of mines around the world. These dislocations are also creating investment opportunities. We examine four key events and their implications for commodities and the agriculture, energy and mining industries.

Disruptions, Implications and Opportunities

U.S. food supply at risk

Meatpacking plant closures and reduced slaughter have created a backlog of livestock, forcing farmers to cull animals in some cases, depressing farm prices, and driving up grocery store meat prices.

Stung by the lost income from plant closures and processing delays, farmers are expected to reduce their breeding stock.

In the near term, consumers will pay higher prices for protein, a boon for packaged goods producers. Reduced herd sizes should be supportive of livestock and protein prices in the future, especially given the multi-year impact of African swine fever on global protein availability.

Oil prices at historic lows and storage tanks full

Falling crude oil demand and a Saudi–Russia price war caused crude oil prices to briefly turn negative in April before rebounding above $20 per barrel.

Following the most aggressive producer supply response in history, we think oil prices could rise above $40 by year-end if demand stabilizes, if OPEC+ complies with production cuts, and if supply growth in the rest of the world remains negative.

Though an oil price recovery is not certain, incentives for stable global energy markets suggest to us higher prices are likely, which could be a positive catalyst for North American energy companies (although balance sheet concerns may persist).

Plummeting ethanol demand

With fewer drivers on the road, ethanol production has been shut in due to the plunge in gasoline demand, causing steep drops in the prices of key ethanol feedstocks corn and sugar.

The production slowdown is likely to result in massive surpluses in corn and sugar.

We expect the hole in demand to further pressure corn and sugar prices, while producers of animal protein and starch & sweeteners may benefit from lower feed and input costs.

Mining lockdowns

Social distancing policies have led to mine shut-ins and production slowdowns globally, materially reducing supply.

While supply reductions should be positive for metals prices, we believe they will not be large enough to offset the stark negative demand growth we anticipate in 2020.

We see attractive upside potential in platinum group metals and select mining companies due to a shrinking surplus of platinum and continuing deficit conditions for palladium.

1. U.S. Food Supply at Risk

Plant slowdowns and clogged supply chains

Headlines of COVID-19–related meatpacking plant closures and production slowdowns were an almost daily occurrence in late April and early May, raising concerns of beef, pork and poultry shortages nationwide. Coronavirus outbreaks, absenteeism and new social distancing measures have shuttered some processing plants and forced others to slow production. At the peak of the outages, the U.S. had seen cumulative processing plant closures representing about 25% of cattle slaughter capacity and 30% of hog slaughter capacity.

The lack of demand for animals to process through the supply chain is causing severe bottlenecks, significantly raising production costs and, increasingly, forcing farmers to cull herds (without sending them for processing). This has simultaneously pushed prices for cattle and hogs to extremely depressed levels and propelled beef and pork cutouts (carcass components) to unprecedented heights (Exhibit 1).

Meat shortage should be short lived

Tyson Foods' experience with a beef plant fire in 2019 bodes well for an eventual production recovery. Despite the fire wiping out 20% of Tyson's total processing capacity for two months, the company's volumes declined just 8%. Like so many other aspects of this surreal period, the situation remains fluid. But on April 28, 2020, President Trump signed an Executive Order under the Defense Production Act to allow that meat and poultry processing plants remain open during the pandemic. With the President's order and improved health and safety efforts in the plants, we anticipate production will return to more normal levels in the near future.

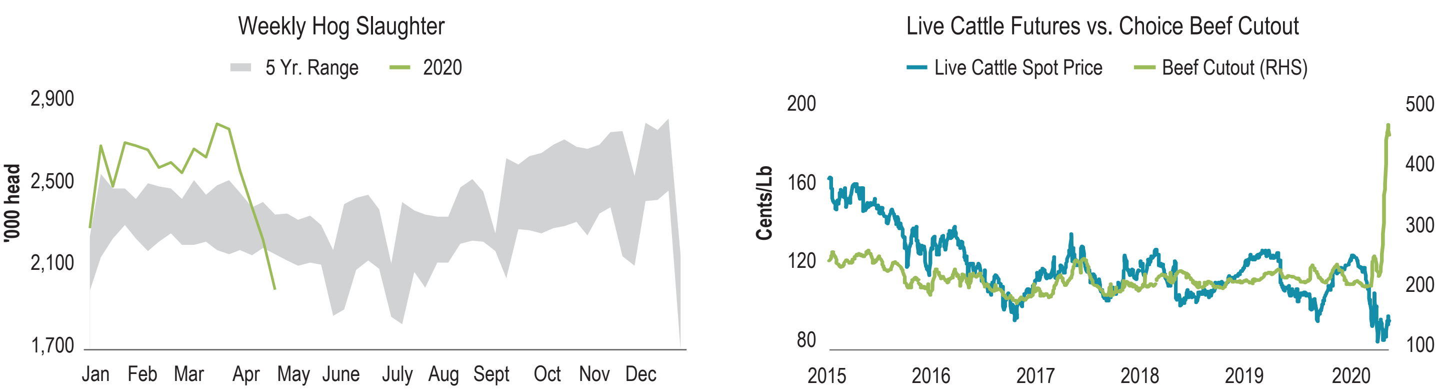
The longer-term impact of this situation will likely be smaller herds as producers stung by the plant closures reduce the size of their breeding stock. We also expect higher operating costs as processors invest further in the safety and well-being of frontline workers, and a ramp-up in capital spending for greater plant automation.

Higher livestock and producer prices to follow

Commodities: The reopening of processing plants should provide a near-term boost for cattle and hog futures, as demand for animals to process should be strong against a backdrop of record packer margins. Reduced herd sizes should be supportive of livestock prices further out on the futures curve—and all this at a time when the world is already contending with a protein shortage due to African swine fever (ASF) in China.

Exhibit 1: Producer and Consumer Protein Prices Moving in Opposite Directions

Herd liquidations due to supply chain disruptions set the stage for higher prices in the future



At May 15, 2020. Source: U.S. Department of Agriculture.

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Resource equities: Reduced livestock numbers may cause input costs to rise in the intermediate term, but demand should remain supportive given the multi-year impact of ASF on global protein availability. As a result, we believe leading global packaged food producers may benefit.

2. Negative Oil Prices and Full Storage Tanks

Too much oil, too little demand

The pandemic-driven demand shock, on the heels of a Saudi–Russia oil price war, has left the world awash in crude. The unsettling realization that storage tanks in Cushing, Oklahoma—where West Texas Intermediate crude oil (WTI) is priced—were essentially full sparked an unprecedented event on April 20, 2020, one day before the May futures would expire: The front-month contract collapsed by a seemingly impossible 300%—plunging from around $20/per barrel (bbl) to –$40/bbl (Exhibit 2). While fundamentals explain why oil prices have traded significantly lower in recent months, the move into negative territory was financially driven.

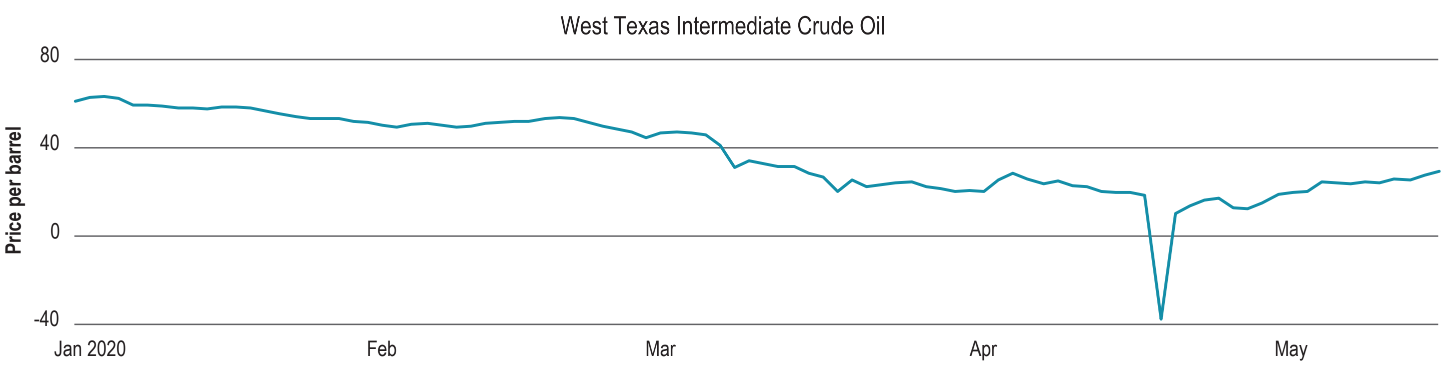
Since WTI oil futures only settle by physical delivery, and Cushing's remaining 20 million barrels of capacity was reserved through the end of May, speculative long investors with no ability to take delivery were forced to sell their expiring contracts, in effect "paying" commercial buyers to offload their soon-to-be physical barrels. Prices rebounded into positive territory the next day and were back into the teens once the front-month contract switched over to June.

Oil balances nearing an inflection point

We estimate that global inventories of crude and refined products will reach historic surpluses in the second quarter of 2020 (Exhibit 3). During this environment of weak demand and record surpluses, we expect oil prices to remain low enough to force production shut-ins and induce significant capital spending reductions globally, in efforts to ease the strain on storage and pipeline infrastructure. The market has already seen the fastest and most aggressive producer supply response in history. In addition to record OPEC+ supply cuts in April, there has been a significant curtailment in development and production from almost all non-OPEC producers, including national, integrated, and independent oil companies worldwide. Reduced output and an upswing in demand should result in inventory draws beginning in the second half of the year, with a return to more balanced conditions expected in 2021.

Exhibit 2: Excessive Supply Sent Oil Prices Into Negative Territory

Oil prices turned negative when financial sellers had to "pay" commercial buyers to exit expiring contracts



At May 15, 2020. Source: Bloomberg.

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Equities (which are a discounting mechanism in contrast to the spot nature of commodities), have responded positively. The gains have occurred on the belief that oil prices have bottomed, the longer-term competitive landscape has improved, and demand is showing early signs of returning as economies begin to loosen lockdown orders. Energy companies that have taken appropriate measures to protect their balance sheets and support business continuity have generally outperformed during this period.

Among midstream energy companies, improving fundamentals for natural gas helped fuel the considerable gains in April and May. While some investors first think of crude oil in the context of midstream energy, more than half of midstream company revenues come from natural gas–related activities. Natural gas prices have moved higher since March amid resilient demand, and as supply has begun to slow significantly—primarily driven by declines in "associated gas" (i.e., gas that comes as a byproduct of crude oil drilling). The result is natural gas fundamentals that look much healthier now than they did earlier in the year.

Energy prices poised to rebound to pre-crisis levels

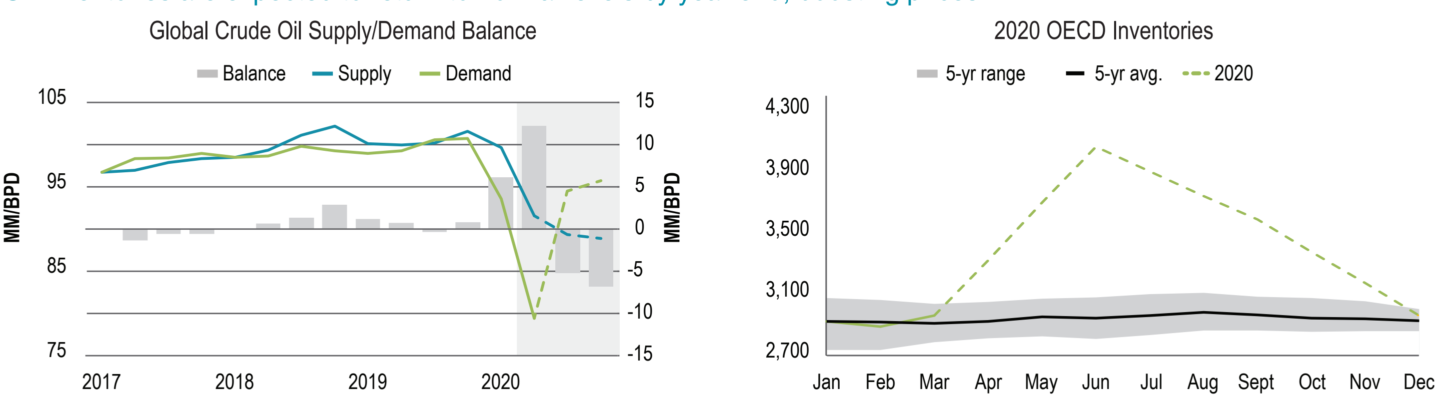
Commodities: We expect oil prices to rebound above $40 per barrel by year-end 2020 if demand stabilizes by the fourth quarter, if the Organization of the Petroleum Exporting Countries and its partners (OPEC+) complies with their historic production cuts, and if supply growth in the rest of the world remains negative.

Resource equities: The recovery for integrated energy producers may continue as oil balances turn more positive. However, share prices are likely to be volatile, providing attractive opportunities for active investors to increase exposure in the coming months.

Midstream energy: Storage and refinery-linked midstream businesses should benefit from low energy prices. For the sector as a whole, an abundance of pipeline assets in some areas may pressure the cash flows of certain companies in the next few years, but we believe the medium- to long-term fundamental case for midstream is compelling based on a resilient long-term outlook for hydrocarbon demand.

Exhibit 3: Oil Demand May Outstrip Supply Beginning in The Third Quarter

Oil inventories are expected to return to normal levels by year-end, boosting prices



At May 15, 2020. Source: U.S. Energy Information Administration, Bloomberg, Cohen & Steers.

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3. Shuttered Ethanol Production's Impact on Corn and Sugar

Ethanol demand has collapsed with fewer cars on the road

With many commuters staying home, global demand for biofuels has plunged. The sharp decline in gasoline consumption has been especially hard on demand for ethanol, which experienced year-to-date price drops of 15% and 27% through late May, respectively, in the U.S. and Brazil (the world's largest ethanol producers). Responding to negative margins, the U.S. corn ethanol industry—which accounts for roughly 40% of U.S. corn demand—idled nearly 50% of its production capacity (Exhibit 4). Though Brazil's ethanol production is more seasonal, and is dependent on the pace of the sugarcane harvest to determine actual production volumes, poor ethanol economics have shifted the early-season share of sugarcane/sugar ratio to its highest level in more than a decade.

A reduced call on corn and sugar

The ethanol production slowdown will likely lift the U.S. corn stocks-to-use ratio to the highest level in 14 years. Should the current production economics continue through the Brazilian sugarcane crushing season, it would boost Brazil's sugar production by 29%, or nearly 9 million metric tons (MT), and would push the global market from balanced conditions to a nearly 9 million MT surplus in the process.

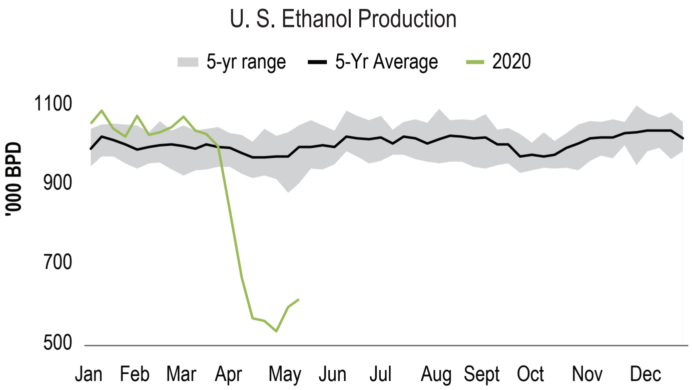
Weak prices mean higher margins for producers

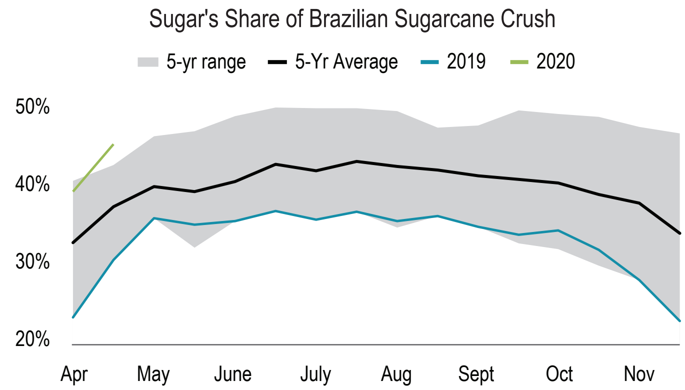
Commodities: Corn and sugar prices are expected to remain under pressure in the coming months.

Resource equities: Producers of animal protein, starch and sweeteners should benefit from lower feed and input costs. We believe certain agribusiness equities stand to benefit from lower corn prices, less competition for soymeal (from distiller dried grains) in the near to intermediate term, and the potential for ethanol headwinds to fade from here.

Exhibit 4: Weak Ethanol Prices Should Continue to Pressure Corn and Sugar

Surplus conditions should weigh on corn and sugar





At May 15, 2020. Source: U.S. Energy Information Administration, Bloomberg, Cohen & Steers estimates.

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4. Mining Industry Hit by Global Lockdowns

Metals impacted to varying degrees

Since mid-March, government-mandated stay-at-home orders have led to reduced or suspended mining activity in important jurisdictions worldwide, including Mexico, Peru, Chile and parts of Canada. Some nations have since extended the measures, while others have either relaxed the orders or reclassified mining as an essential business to jumpstart economic activity. These supply shuts are material, but in our estimation are not large enough to offset the stark negative demand growth we expect for industrial metals in 2020.

Mine location a factor for platinum

Supply shuts in precious metals mining only add to what was already a constructive outlook (Exhibit 5). The platinum group metals (PGMs) are of particular interest due to the concentration of mine supply. South Africa (which accounts for about 75% of annual platinum and 40% of annual palladium supply) recently reopened mining—but at a government-mandated 50% reduction in employees, significantly reducing production relative to full capacity. An explosion at one of Anglo American's processing plants in March, which will be offline for a year, will further tighten the PGM market. This lower capacity utilization may result in a tighter supply/demand situation (and, therefore, potentially higher prices).

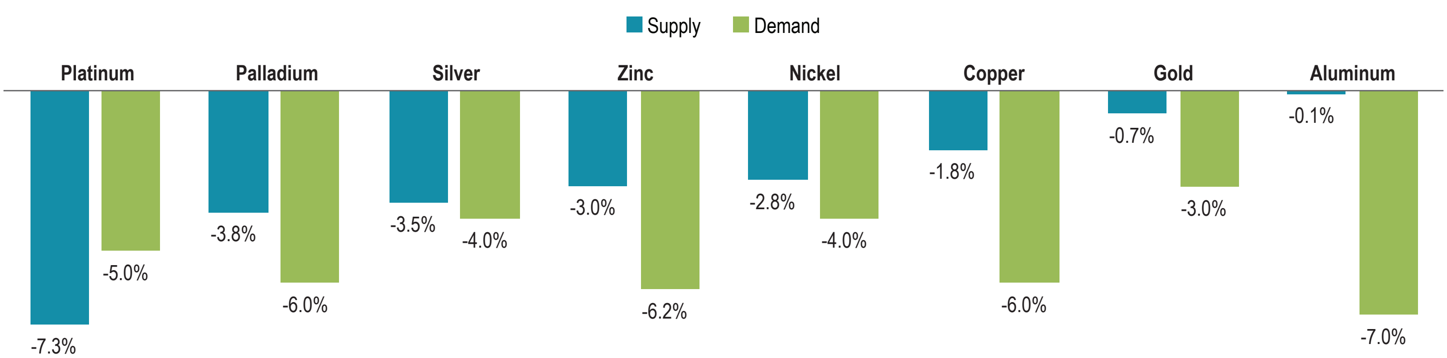
Bullish precious metals backdrop

Commodities: Platinum group metals are expected to be the top-performing precious metals, with platinum supply cuts outweighing lost demand and resulting in a smaller surplus than 2019's, and with the palladium market remaining in a deficit. Base metals will require time to work off inventory builds due to recent demand destruction in our view.

Resource equities: Companies with exposure to PGMs look attractive, in our view. Some producers with low-cost, long-lived mines generate substantial cash flow at current commodity prices and offer attractive dividend yields. They may also benefit from significant operational and capital expenditure tailwinds on weak currency and oil prices.

Exhibit 5: 2020 Supply Disruption vs. Estimated Demand Contraction

Platinum is likely the biggest beneficiary from mine closures



At May 15, 2020. Source: Cohen & Steers and Macquarie Group.

This chart is for illustrative purposes only and does not reflect information about any fund or other account managed or serviced by Cohen & Steers. Total outages based on 2019 annual mine supply and based on current announcement by countries and individual companies. Estimates do not include forecasted losses going forward. Demand estimates per Cohen & Steers based on consensus estimate of 2020 world GDP contraction of ~2-3%. Gold and silver demand not including ETF/investor demand projections. See page 7 for additional disclosures.

Conclusion

Even as economies begin phased reopenings, we expect to see further short-term disruptions in commodity and equity markets in the months ahead. As a specialist manager focused exclusively on listed real assets and alternative income, we continue to concentrate our resources on finding attractive return opportunities across the real assets investment universe.

We believe accessing investment opportunities around the world requires local knowledge and insight into specialized and regional markets. Cohen & Steers maintains a global presence through the following offices:

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