Commodity Synchronicity

Synchronized Supply Rebalancing Amidst a Supportive Macro Backdrop

Ben Ross, Senior Vice President and Portfolio Manager
Nick Koutsoftas, Senior Vice President and Portfolio Manager
Brad Sanderson, Vice President and Research Analyst
Bennett Meier, Research Analyst

In our view, the narrative for commodities has changed dramatically over the last few years, from one in which the world is awash in supply to one where most commodity markets are now either balanced or in deficit. Prices have stabilized or risen in many instances and the demand picture continues to improve, supported by broad-based global expansion. We examine the fundamental prospects for the major sectors and the potential for commodities to sustain the positive returns delivered through the most recent rebalancing phase (2016–2017).

Highlights

Macro trend: Above-trend global growth, mounting inflation pressures and the transition to the late stages of the business cycle all point to a supportive macro environment for commodities.

Energy: The combination of strong compliance from OPEC and non-OPEC production cuts and subdued capital spending programs by global exploration and production companies has helped to support crude oil prices. Even with North American shale production forecasted to grow this year, we expect global demand will continue to exceed aggregate crude oil output, resulting in further inventory declines.

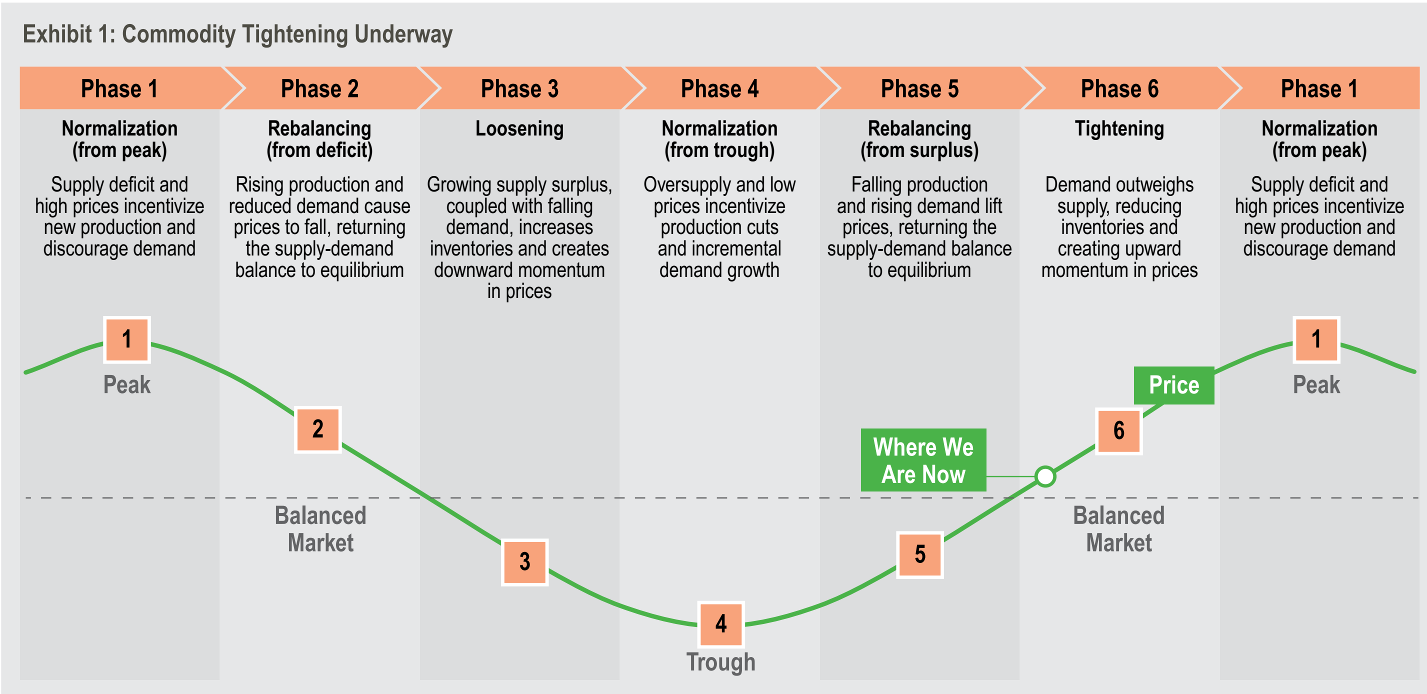
Metals: Many metal markets are in deficit at current global production levels, and lead times to build new mines often take years. We believe deficit conditions could persist across much of the metals group for the next several years.

Agriculture: Grains and other agriculture commodities have taken longer to rebalance, but should enter deficits later this year due to a deceleration in global acreage growth and recent weather-related production disruptions in North and South America.

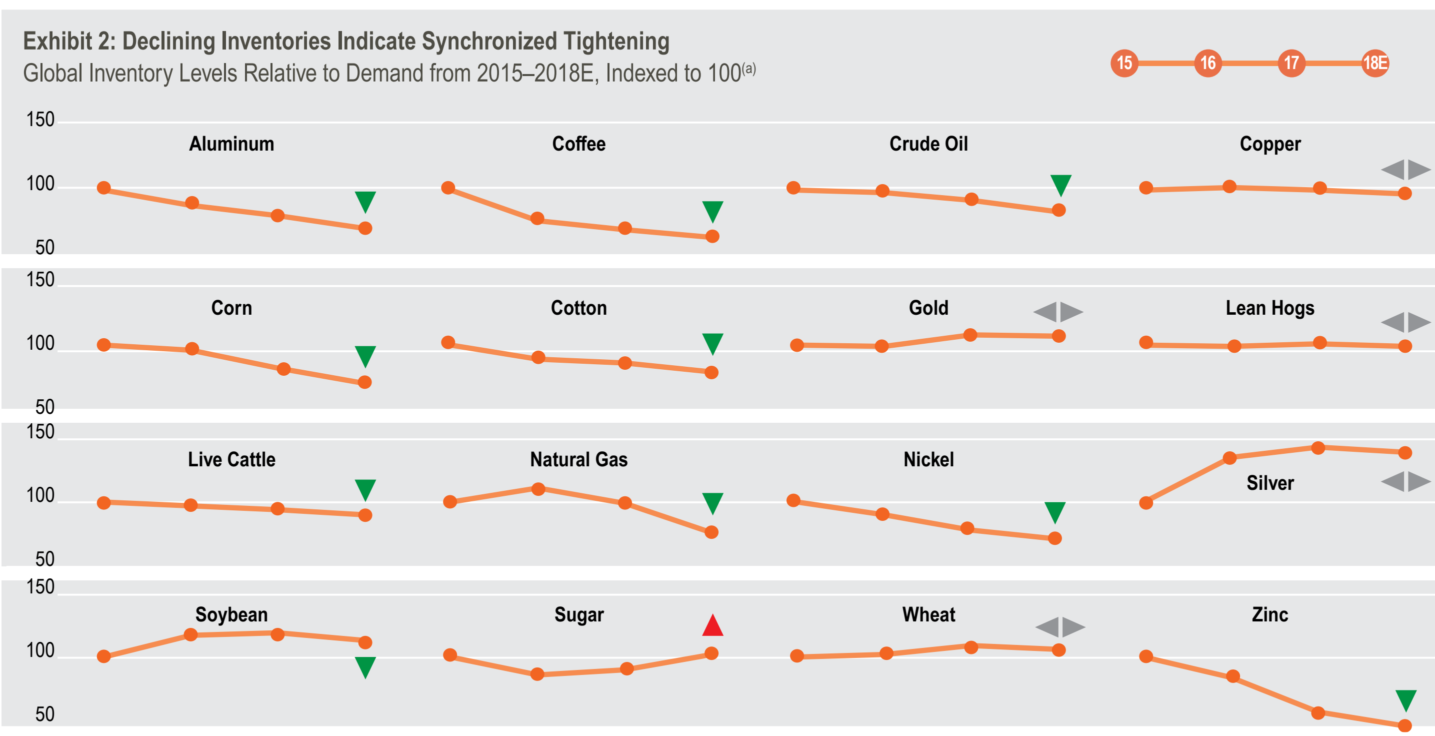
Trade: Since mid-June, strengthening commodity fundamentals have largely taken a back seat to trade fears and related global growth concerns. However, our analysis indicates that outside of a few specific cases where tariffs have or will begin to impact trade flow, commodity fundamentals haven't changed materially.

Commodities Nearing a Sweet Spot

Our outlook for commodities has become increasingly bullish as market forces align on both sides of the supply-demand equation, nearing a "sweet spot" for the asset class. Based on our fundamental analysis, we believe the market has shifted from rebalancing to tightening for the majority of commodities (Exhibit 1). As the cycle has progressed, many commodity markets have experienced meaningful declines in the levels of existing stock available to cover current demand—evidence that markets are in deficit and inventories are falling (Exhibit 2).



At May 31, 2018. Source: Cohen & Steers. See page 8 for additional disclosures.



At May 31, 2018. Sources: Aluminum, copper, nickel, zinc: Wood Mackenzie, Cohen & Steers days of consumption, global. Corn, cotton, soybeans, sugar, wheat: United States Department of Agriculture (USDA) global stocks-to-use, Cohen & Steers. Coffee: USDA global stocks-to-use. Crude oil: International Energy Agency (IEA) and Organization for Economic Co-operation and Development (OCED) days forward cover. Gold: Global Council World Official Gold Reserves days of consumption, Global, Cohen & Steers. Lean hogs and live cattle: USDA U.S. beginning stocks ex-sow/U.S. ex-cow slaughter. Natural gas: Bentek U.S. days forward cover annual average. Silver: Gold Fields Mineral Services (GFMS) BMO Capital Markets global months of demand, Cohen & Steers.

(a) Based on days of supply to meet current demand. See page 8 for additional disclosures.

Macro Environment Turning More Supportive

We believe the convergence of several macroeconomic factors has created a very supportive environment in which commodities have traditionally thrived.

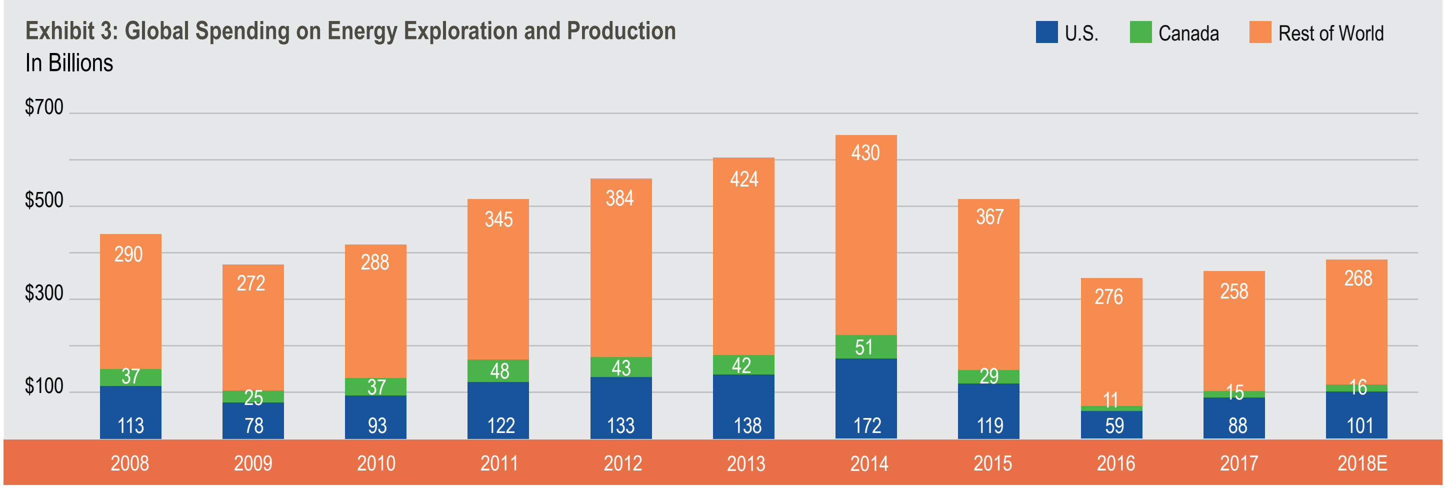
The evolution to the late stage of the business cycle should bode well for commodities.

- **Synchronized global growth.** The global economy has been in a period of broad-based above-trend growth—the broadest since the IMF began collecting data in 1980—driven largely by capital expenditures, tight global labor markets, increased business and consumer confidence globally, and the lagged effect of easy financial conditions. This environment could continue to provide the stimulus needed for increased commodities consumption, even though we may have seen the peak in growth.
- **Rising inflation pressures.** Following one of the slowest expansions in history, the global economy is heating up and inflation pressures are building. This could place a premium on commodities, which historically have been among the best inflation hedging vehicles.
- **Aging business cycle.** Commodities have historically outperformed equities toward the end of expansion cycles and in the early stages of recessions. In general, this is because equity valuations are forward-looking and tend to contract in anticipation of slower earnings growth. By contrast, commodity spot prices typically reflect the relative tightness of supply and demand at that moment, when demand growth is usually peaking. While not a predictor of future returns, we believe the evolution of the current business cycle bodes well for commodities as the U.S. enters its ninth year of expansion.

Petroleum: Continued Production Discipline

The collapse in oil prices in late 2014 forced significant spending cuts, better operational discipline and reduced production across the entire energy complex. After falling dramatically in 2015 and 2016, capital spending in North America ramped up in 2017 and is expected to continue higher this year, though only getting back to 2010 levels, with a majority of the spending taking place in U.S. shale (Exhibit 3). Globally, spending is forecast to increase only modestly in 2018. Even with the recent rise in oil prices to the $70–80 per barrel range, we see global oil and gas companies are allocating excess cash flow more toward strengthening balance sheets and returning cash to shareholders rather than aggressively investing in growing production.

Exhibit 3: Global Spending on Energy Exploration and Production
In Billions



At May 31, 2018. Source: U.S. Energy Information Administration (EIA), Cohen & Steers. See page 8 for additional disclosures.

With oil consumption poised to rise in the coming years, we believe oil deficits could persist for the foreseeable future, supporting higher prices.

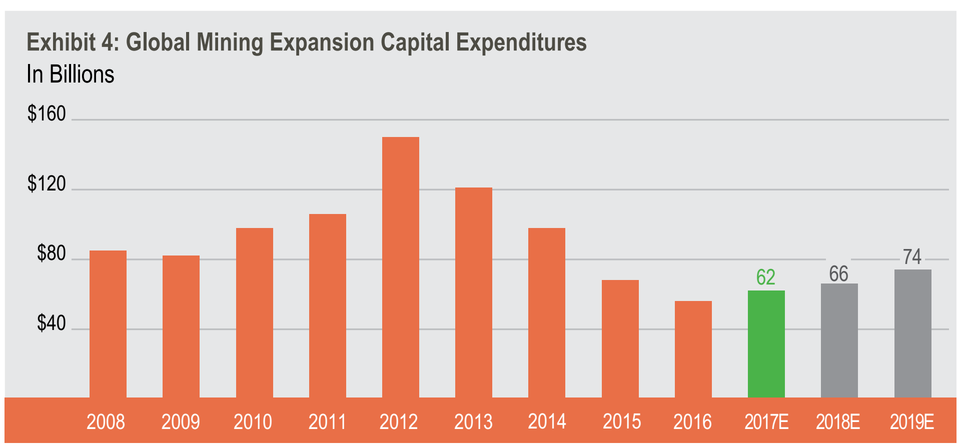
OPEC's role. Since the November 2016 announcement of production cuts by OPEC and non-OPEC members, OPEC and Russia have curtailed a combined 2.5 million barrels per day, which has helped to normalize global inventories. At their most recent meeting on June 22, 2018, OPEC and non-OPEC members agreed to increase production by 600,000 to 800,000 barrels per day to offset massive structural declines in Venezuela and potential losses in Iran due to U.S. sanctions. While the group remained mindful of not letting oil prices get too high, which could erode demand, we expect the global supply/demand balance to remain in deficit over the next six to eight quarters, further reducing inventories.

Inventories normalizing. Following more than two years of a global market surplus brought on by $100 per barrel oil, demand began exceeding supply in 2017 and could continue to do so into the foreseeable future. This persistent market deficit has helped to cause inventories to normalize on an absolute and relative basis, and triggered an inflection in the crude oil price trajectory. As of March 2018, total OECD inventories have fallen by over 230 million barrels in the previous 12 months and are now below the five-year average.

Metals: Underinvestment Driving Long-Term Deficits

Metals and mining commodities generally remain the furthest along among the sectors in terms of rebalancing supply and demand. In our view, this is due to a combination of stronger-than-expected global demand and, more importantly, a lack of capital investment in new projects.

Base, bulk and precious metals prices bottomed by early 2016 due mainly to a combination of slowing global demand (namely from China), strong growth from projects greenlighted during the famed commodity "super-cycle," a rising U.S. dollar, and deflationary pressures globally. These drastic peak-to-trough price declines (ranging from 40–75%) generally caused extreme balance sheet stress across the industry and resulted in massive capital expenditure cuts. Global mining expansion capex fell over 60% from the peak in 2012 to the trough in 2016 (Exhibit 4).



At May 31, 2018. Source: Macquarie Capital Markets and Cohen & Steers. See page 8 for additional disclosures.

Going forward, we expect capex to recover, but to nowhere near the peaks seen during the last cycle. Despite strong price appreciation over the last two years, we have yet to see meaningful investment for many of these commodities, which are already at or near the price needed to incentivize new development. The mining industry continues to display capital discipline, with many companies prioritizing shareholder returns through dividends and buybacks over investing in new production.

Even if prices were to rally further in the short to medium term, which could further encourage the development of new mines, we believe deficits will persist for the next several years across much of the sector. This is due to the long lead times of mining projects: for example, a new greenfield copper mine can take over five years to complete.

Agriculture: Delayed Rebalancing Slowly Unfolding

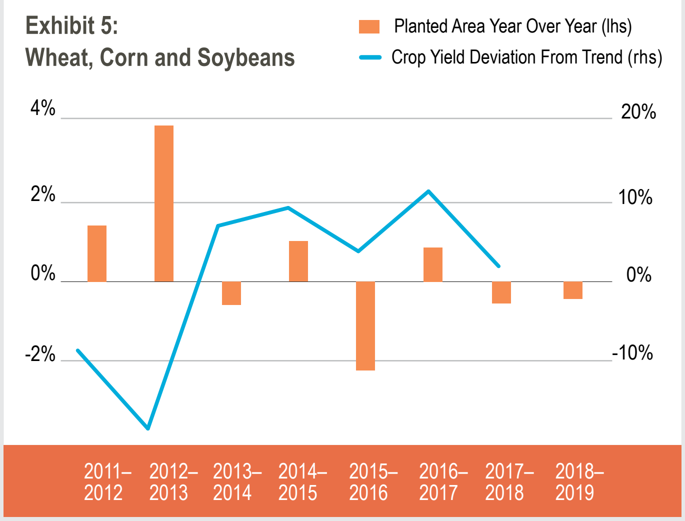
Agriculture commodities, specifically U.S. grains such as corn, soybeans and wheat, have taken longer than other commodities to rebalance for myriad reasons. These include a sustained period of above-trend yields, a well-capitalized U.S. farming community and the inability of agriculture producers to organize a collective production curtailment as in other commodity markets. Despite these challenges, we have begun to see stabilization in global acreage. When combined with recent weather issues in North and South America, as well as in the Black Sea region, we see potential for market deficits across the grain complex in 2018—a development that may be met with higher prices.

A Look Back at Why Grain Markets Have Taken So Long

The five consecutive years following the historic 2011–2013 U.S. drought were all bumper crops, resulting in a five-year run of above-trend yields in wheat, corn and soybeans (Exhibit 5). This impressive trend was the product of beneficial weather, good crop husbandry, precision farming and advances in seed technology, which together resulted in record production and elevated ending stocks despite a modest decline in combined grain and oilseed acreage over the same period.

Following the 2011–2013 drought, U.S. net farm income hit a record high in 2013 due to elevated crop prices and insurance indemnity payouts. This allowed farmers to withstand lower crop receipts during the grains bust in the years that followed without markedly reducing their planted area. Additionally, low interest rates and the relative strength in farmland values provided a stable credit environment that helped to support farmers' financial stance.

Exhibit 5:
Wheat, Corn and Soybeans



At May 31, 2018. Source: USDA, Cohen & Steers estimates. See page 8 for additional disclosures.

Weather risks could accelerate rebalancing. Unlike many commodity sectors, where greater market concentration invites the possibility of coordinated production cuts that can have an immediate and meaningful impact on supplies, the agriculture industry remains comparatively fragmented. With an estimated 2.2 million farmers in the U.S. alone, and over 500 million farms around the globe, a coordinated production response to low prices is generally unfeasible, which can make a boom-bust cycle in agriculture more prolonged than in other markets.

However, weather-related production disruptions can unilaterally curtail supply and accelerate market rebalancing. We are currently monitoring several weather hot-spots across the Western Hemisphere:

- **Argentina.** A top-three exporter of soybeans and soybean products, the country recently had their driest summer (December–February) in 30 years, which dented yield prospects. Soybean and corn production are now forecasted to see year-over-year declines of more than 35% and 15%, respectively.
- **Brazil**. Excessive rainfall in December and January delayed the planting of the nation's "safrinha" (late planted) corn crop—a move that is estimated to have reduced the country's safrinha corn acreage by 4.5% year over year, and production by over 7%.
- **Southern Great Plains.** The drought in the southern plains of the U.S. has left Hard Red Winter Wheat condition ratings in the bottom quintile of years dating back to the initiation of the rating system in the late 1980s. With U.S. winter wheat area near 100-year lows, even marginally below-average yields could lead to the lowest U.S. wheat production since 2002.

We believe the weather risks in three of the largest grain producing and exporting nations have a strong likelihood of helping to accelerate the rebalancing process. We currently forecast global stocks-to-use across the three major grains (soy, wheat and corn) and cotton to decline in the upcoming 2018–2019 marketing year—the first such coordinated inventory draw over in 20 years.

How Commodity Rebalancing May Benefit Other Real Asset Categories

Midstream Energy. Rising and stable energy prices have largely resulted in increased energy production, particularly in North America, benefiting midstream energy companies that generate fee-based cash flows to gather, process and transport energy commodities. We expect continued global growth to benefit developing economies, which account for the vast majority of global energy demand growth. U.S. shale's production cost advantage and speed to market have made it one of the world's key resources for new supply, with a significant portion of crude oil exports going to developing countries.

Natural Resource Equities. The turnaround in commodity prices is providing a meaningful boost to many companies in natural resource industries. After a challenging few years, these companies have generally become leaner and more disciplined with capital allocation. Many mining and energy companies are now cash flow positive, while others are working to reduce their rate of cash burn. We believe a continued recovery in commodity prices should bring improved profitability and higher returns to natural resource equities.

A Trade War's Possible Impact on Commodities

Since the U.S. implemented tariffs on steel and aluminum imports in June, commodity fundamentals have taken a back seat to trade war fears and related global growth concerns, generally driving commodity prices lower. However, outside of a few specific cases where tariffs have or will begin to impact trade flow, there has been little change in underlying commodity fundamentals.

We view the recent across-the-board correction in commodity prices as an overreaction and believe supportive macro factors and fundamentals will prevail. Barring a significant escalation into a global trade war, we expect the synchronized rebalancing of commodity supply and demand to continue, potentially driving strong returns for the broader commodity market over the next year.

Oil prices could see volatility. Though China has threatened tariffs on U.S. crude oil, no action has been taken to date. China represents 17% of U.S. crude exports, so we see this as an important area to monitor given the potential impact on the U.S. crude oil balance sheet. Globally, a broader trade war could cause oil demand to slow significantly, which may put downward pressure on oil prices and potentially prompt OPEC to reconsider its recent decision to increase production.

Soybeans and pork among the biggest losers. Agriculture commodities, which are produced largely in Republican-dominated states, have been the primary targets for retaliatory tariffs in an effort to exert political pressure on the Trump administration. Soybeans have been the hardest hit, as China is the world's largest importer of soybeans (used in making animal feed and cooking oil), accounting for 54% of U.S. exports year to date. However, we believe China cannot fully eliminate the U.S. as a supplier, given that alternative sources such as Brazil do not have the production capacity to meet China's entire demand.

Multiple rounds of tariffs on pork have also started to affect demand, with U.S. exports to China falling precipitously in May of 2018. Pork tariffs were also recently imposed by Mexico, the largest U.S. pork customer, which threatens to weaken demand for U.S. pork further.

Counter-currents for metals. The biggest risk facing base metals is that further tariff escalations could lead to slower global growth, leading to lower global demand—specifically from China, the largest consumer of metals. We believe the recent decline in metals pricing reflects an overly pessimistic demand outlook, although this is a fluid situation. On the other hand, we believe the global 10% import tax on aluminum could have a positive impact on prices, as there are no significant plans for the U.S. to restart idle capacity.

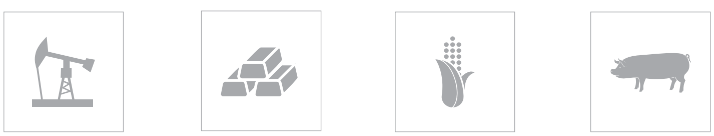
A Compelling Opportunity for Allocating to Commodities

In the coming years, we expect commodity supplies to tighten further as the synchronized supply rebalancing persists. In addition, supportive macroeconomic factors could continue to provide the stimulus needed for increased commodities consumption and trade. With many commodity markets already in or near supply deficits, we believe an allocation to commodities represents a compelling opportunity for investors.

COHEN & STEERS
REAL ASSETS. REAL RETURNS.

Cohen & Steers

COMMODITIES • The Essential Real Asset



Index Definitions

Investors cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

The Barclays Capital U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds. The Bloomberg Commodity Index is composed of exchange-traded futures on physical commodities, which are weighted to account for economic significance and market liquidity. The S&P 500 Index is an unmanaged index of 500 large-capitalization stocks that is frequently used as a general measure of U.S. stock market performance.

Important Disclosures

These materials are provided for informational purposes only and reflect the views of Cohen & Steers, Inc. and sources believed by us to be reliable as of the date hereof. No representation or warranty is made concerning the accuracy of any data compiled herein, and there can be no guarantee that any forecast or opinion in these materials will be realized.

This is not investment advice and may not be construed as sales or marketing material for any financial product or service sponsored or provided by Cohen & Steers, Inc. or any of its affiliates or agents. This is not an inducement to buy or sell commodity interests. Trading in commodity interests involves a risk of loss. Past results are not indicative of future results. Investors should consider whether commodity interests are suitable investments.

Cohen & Steers Capital Management, Inc. (Cohen & Steers) is a registered investment advisory firm that provides investment management services to corporate retirement, public and union retirement plans, endowments, foundations and mutual funds.

Cohen & Steers UK Limited is authorized and regulated by the Financial Conduct Authority (FRN458459). Cohen & Steers Japan, LLC is a registered financial instruments operator (investment advisory and agency business with the Financial Services Agency of Japan and the Kanto Local Finance Bureau No. 2857) and is a member of the Japan Investment Advisers Association.

About Cohen & Steers

Cohen & Steers is a global investment manager specializing in liquid real assets, including real estate securities, listed infrastructure, commodities and natural resource equities, as well as preferred securities and other income solutions. Founded in 1986, the firm is headquartered in New York City, with offices in London, Hong Kong, Tokyo and Seattle.

cohenandsteers.com

Advisors & Investors: **800 330 7348**
Institutions & Consultants: **212 822 1620**