Active Commodities

The commodities market had a 1.6% return in the first quarter in Australian dollars, as measured by the Bloomberg Commodity Index Total Return.

Investment Review

The first quarter was a challenging and volatile period for fixed income and equities, while commodities had a slightly overall positive return. Initially, interest rates rose sharply, credit spreads widened and market volatility spiked as investors assessed mounting inflationary pressures from continued economic growth. Later in the period, new tariff announcements from the U.S. and an in-kind response from China sparked concerns of a budding trade war, further pressuring equity, fixed income and certain commodity markets.

The yield on the 10-year U.S. Treasury rose from 2.4% to more than 2.9%, before settling around 2.7%. The Federal Reserve raised its short-term lending rate by 0.25%, to a range of 1.50% to 1.75%. The Fed also maintained its forecast for a total of three rate hikes in 2018. Investors had been anticipating a more hawkish outlook for Fed policy in light of tight labor market conditions and an expected boost from recently enacted tax cuts. In Europe, the Bank of England left its benchmark rate unchanged at 0.5%, while the U.K. economy remained resilient in the face of Brexit. On the continent, government bond yields were mixed as trade war fears were coupled with somewhat disappointing Eurozone economic data.

Index Performance (A$)

	Bloomberg Commodity Index Total Return
Q1 2018	1.56%
1 Year	3.14%
3 Year	-3.33%
5 Year	-2.51%
10 Year	-6.10%

Data quoted represents past performance, which is no guarantee of future results.

This information is not representative of any Cohen & Steers account and no such account will seek to replicate an index. You cannot invest directly in an index and index performance does not reflect the deduction of fees, expenses or taxes.

Periods greater than 12 months are annualized.

Sector Highlights

- West Texas Intermediate crude oil (8.4%[1]) benefited from continued draws in total U.S. crude inventories and a weaker U.S. dollar. On the demand side, refinery utilization has emerged from winter maintenance at a much quicker-than-normal pace and exports have stabilized at a very high 1.5 million barrels-per-day level. Additionally, a constructive oil market report from the International Energy Agency (IEA) showed slightly lower production from the Organization of the Petroleum Exporting Countries (OPEC) in February, helping to support Brent crude (5.0%).
- Natural gas (–7.2%) fell on surging U.S. production and rising rig counts, which more than offset generally constructive demand trends and a sizeable inventory deficit (–20%) relative to its five-year average at the close of the winter heating season.
- Industrial metals (–6.6%) were broadly lower with the exception of nickel (3.8%), which outperformed as stainless steel demand in China remained strong and inventories continued to draw. Aluminum (–12.4%) fell on rising exchange inventories pointing to a well-supplied market, while copper (–8.9%) seemed to be pressured by fears of an escalating trade war between the U.S. and China and its potential negative effects on global growth. However, aluminum began to recover late in the period following the Trump Administration's decision to sanction seven Russian oligarchs and the 12 companies they own/control. This suggests concern that Russian aluminum production could potentially get "trapped" in Russia, resulting in less available global supply.
- Gold (0.6%) rose modestly amid general risk-off sentiment during the period. Gold ETFs continued to see inflows as investors appeared to be comfortable with an allocation in the metal for diversification purposes.
- Unfavorable weather conditions across a broad swath of the western hemisphere helped sustain a rally in the grain complex (7.1%). Soybean (7.5%) and soybean meal prices (20.2%) continued to benefit from a worsening of drought conditions in Argentina, which resulted in reduced soy production estimates and increased the potential risk of limited soybean meal exports. Kansas City wheat (6.0%) rose, as a new round of crop condition reports confirmed that the ongoing drought in the U.S. southern plains was having an adverse impact on the Hard Red Winter wheat crop. Corn prices (8.3%) also moved higher as continued dryness in Argentina and

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planting delays in Brazil once again elicited cuts to yield estimates.

- Sugar (–18.2%) declined on upward production surprises across Asia, as the India Sugar Mills Association increased their forecast for the country's production by 13% to 29.5 million tons, while Thailand's government increased their forecast from 11-12 million tons to 12-13 million tons. India's decision to force mills to export at least 2 million metric tons of excess production, despite deeply unfavorable economics at present, also weighed on the global raw sugar market.
- Live cattle (–10.8%) and lean hogs (–11.1%) declined after China announced a new tariff package that included a 25% tax on U.S. beef and pork imports. While the U.S. exported only $30.9 million in beef and beef variety meats to China in 2017, China is the fourth largest destination for U.S. pork and pork variety meats. Continued worries that a NAFTA breakdown could harm demand for U.S. pork and beef exports also weighed on the space.

Investment Outlook

The commodity rebalance is well underway with many markets now in deficit and inventories across sectors normalizing. We expect sound global economic growth to persist throughout 2018 with improving employment and rising personal incomes spurring consumer spending and business investment alike. Such conditions should prove broadly favorable for commodity demand, in our opinion.

A preference for sugar and Arabica coffee in softs. We maintain a favorable outlook toward sugar with record short speculative positioning and fundamental price support likely to come from favorable Brazilian ethanol economics heading into that country's crushing season. We have a positive view on Arabica coffee with tepid exports from key producers signaling tighter than expected supplies and weather issues developing in key producing regions.

In base metals, we favor copper, nickel and zinc. We are projecting the copper market to be balanced this year, with the assumption it swings into deficit on supply outages and/or demand upgrades. In addition, we believe the copper market will move into deficit in 2019 on insufficient supply growth from a lack of investment over the previous five years. Despite nickel's recent price appreciation, the metal is still trading well below the global cost curve and we project deficit markets through 2020. However, rising nickel pig iron production in Indonesia tempers our short-term outlook. The zinc market should continue to tighten for the next 3-6 months on stable demand in China. But the price increase to 10-year highs will eventually result in a supply response, which should begin to flow through in the back half of the year.

Aluminum outlook mixed. On the bear side of the ledger, government mandated supply cuts in #1 producer China have come in lower than previously expected. This, combined with rising exchange inventories on both the London Metal Exchange and Shanghai Futures Exchange, point to a well-supplied market. However, the Trump administration's sanctions on Russian state-owned firms, including UC Rusal, a top-three aluminum producer, may result in supply being artificially withheld from the global market.

Oil's steady rebalancing forecast to continue. The global crude oil market remains fundamentally and structurally constructive amid strong global demand growth (based on strong GDP growth especially non-OECD), high compliance to the OPEC/non-OPEC production cut agreement and normalizing OECD inventory levels, despite record U.S. supply. In this environment, we believe oil prices should be supported in a $60 to $75 per barrel range.

Surging U.S. production a headwind for natural gas. Despite a somewhat constructive demand profile, natural gas prices appear to have limited upside to around $3.00 per million BTU—a level at which producers are hedging 2017-2019 production and where shale plays outside of the Marcellus and Utica, such as the Haynesville, potentially become profitable.

Green shoots in grains. While global inventory overhangs persist across most of the grains complex in the 2017-2018 marketing year, a slow rebalancing is underway, as corn and wheat prices have reached levels that are incentivizing lower planted acreage across the northern hemisphere in 2018. Weather may also be a more bullish feature in the coming year, as the continued existence of a La Niña climate pattern has heightened drought conditions in the U.S. southern plains and parts of South America. Dryness and severe cold earlier this winter has already harmed conditions in the U.S. hard red winter wheat crop, which underlies the Kansas City wheat contract. Dry weather in Argentina has also harmed yield prospects for that country's corn and soybean crops.

Gold looks fairly valued at current levels. Inflationary pressures appear to be building, which should somewhat offset rising interest rates and prevent real rates from increasing materially. In addition, heightened geopolitical risks should continue, and we would not be surprised to see incremental buying of gold for diversification against very long (and historically expensive) equity portfolios.

Underweight livestock. The U.S. protein sector continues its broad-based expansion phase, evidenced by record all-meat

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production (combined chicken, pork, beef and turkey) and elevated cold-storage stocks. Robust export sales of beef and pork in 2017 helped absorb the increased supply, and this trend will need to continue into 2018, in the face of policy headwinds, in order to compensate for the expected production increases. Substitution may play a larger role in 2018, as meats compete for shelf space.

Weaker outlook for cotton fundamentals. We believe a large recovery in global cotton supplies will exert downward pressure on prices in the first half of 2018, especially as we complete the ginning of the large northern hemisphere crop. Current prices of cotton are incentivizing additional acres in 2018 in key producing regions, including the U.S., which could add to the burgeoning global supplies. While not our base case at present, the threat of Chinese tariffs on U.S. cotton also poses a negative tail risk for U.S.-based contracts.

(1) Sector returns are in U.S. dollars. Sector classification of securities in the index are determined by investment advisor.

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The Bloomberg Commodity Index Total Return is a broadly diversified index that tracks the commodity markets through commodity futures contracts. The index is made up of exchange-traded futures on physical commodities, which are weighted to account for economic significance and market liquidity.

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