Understanding Oil and the Impact on Real Assets

The decline in oil prices has raised many questions among investors about what it means for the global economy and how different investments might be affected. This report offers our insights on potential scenarios for the oil price cycle and the opportunities and risks in real asset classes, including real estate securities, commodities, natural resource equities and global listed infrastructure.

Falling Oil Prices Are a Double-Edged Sword

With oil prices down more than 50% from their peak in mid-2014, oil consumers have received a significant financial windfall. Lower oil prices serve as a “tax cut” through lower gasoline and heating fuel prices, giving consumers more money to spend and reducing input costs for many businesses. However, if the oil price falls too far, it can negatively impact oil-producing countries and businesses, leading to less spending on future projects, fewer energy jobs and reduced economic activity in energy-related businesses. Low oil prices can also trigger credit stress, which can cause a ripple effect across global markets and ultimately dampen economic growth.

The graph below offers a visual representation of this dynamic. Declining oil prices provide an increasing benefit to economic growth up to point A, at which point the benefit begins to diminish. At some price—point B—low oil prices would be a detriment to growth and would present heightened stress in global credit markets. In our view, we are currently beyond point A, but above point B: the positive impact of lower energy costs is outweighing the negative impact from credit stress. However, risks to the global economy could increase if oil prices continue to drop or remain low for a prolonged period, which leads us to our next topic: where do oil prices go from here?

![Stylized Relationship Between Oil and Global Growth](image-url)

Source: Cohen & Steers.
Two Scenarios for Oil Prices

Forecasting the direction of oil prices is a challenging task, particularly after a decline of this magnitude and the continued uncertainty surrounding the policy of the Organization of Petroleum Exporting Countries (OPEC). Not since the mid-1980s has OPEC completely stepped away from balancing the supply-and-demand dynamics of the oil market. In response to the oil-price decline, many North American oil producers have already announced spending cuts for next year. However, near-term production continues to increase. As a result, we believe oversupply will continue to pressure global oil markets.

As of this writing on January 14, 2015, Brent crude was $49 per barrel and WTI crude was $46. We see potential price support slightly below current levels, as we are approaching a pivotal pressure point where operating expenses begin to exceed revenues, and producers are forced to shut in production. Over time, this reduced activity could lead to a recovery in prices. How quickly this recovery occurs may hinge on the willingness of OPEC to cut production, leading to two scenarios.

Scenario 1: If OPEC agrees to cut production to drive prices higher, we would expect a relatively quick recovery in oil prices, reaching equilibrium around $70 for Brent and $65 for WTI potentially by the end of this year. We believe this is a price OPEC would be comfortable trying to stabilize—high enough for most members to balance their budgets, but low enough not to encourage significant new production from North America that could push global prices lower again.

Scenario 2: If OPEC allows the market to balance itself, prices could remain below $60 well into 2016, potentially reaching equilibrium at $70 for Brent and $65 for WTI by the end of 2016 as production growth is gradually scaled back.

Implications for Real Assets

We believe the shifting dynamics of the oil market presents opportunities for active management, as some regions and sectors are likely to fare better than others depending on the expected trajectory of oil prices. Below are our views of how low oil prices may affect core real asset classes based on current market conditions.

Real Estate Securities

Demand for commercial real estate is driven by local economic conditions. To the extent that lower oil prices affect a country's economic backdrop, we would expect to see a corresponding impact on the demand for commercial real estate. As such, companies with assets in oil-producing markets could see a negative economic effect, whereas those in regions driven more by domestic consumption should benefit from lower energy expenses.

- Sustained low oil prices should allow interest rates to remain lower for longer, which we expect to be beneficial for real estate securities.
- For some oil-exporting nations, lower oil revenues could impact current accounts, drive fiscal spending lower, weaken currencies and lead to less foreign direct investment. Countries affected could include Canada, Norway, Russia, Mexico and Brazil, and to a lesser extent, the United Arab Emirates, Indonesia and Malaysia.
- Oil importers and consumption-driven economies should benefit from lower oil prices, as consumers have more to spend as a result of lower gasoline and heating expenses. These include the U.S., Japan and Europe, as well as emerging markets such as the Philippines, India and Thailand.
- Among property sectors, we expect low oil prices to provide the largest benefit to consumer-oriented sectors, including regional malls, shopping centers, self storage, apartments and logistics. However, other property sectors such as offices and industrial could also benefit, depending on the impact to local economic growth.
Commodities

Energy represents a significant component of the major commodity indexes. As a result, volatility in the price of oil can have a dramatic effect on any diversified commodities strategy.

- We are currently underweight the petroleum complex, which includes WTI crude, Brent crude, unleaded gasoline and distillates (heating oil, diesel).
- We believe the oil futures curve will steepen from current levels, a phenomenon called contango, where a futures contract price is above the current spot price. We are expressing this view by selling “time spreads”—selling a contract in the front of the futures curve and buying a contract farther out on the curve to capture the price difference between the two months.
- Within our diversified universe of commodities, we are currently finding more attractive long opportunities in certain base and precious metals, as well as agriculture commodities, which we believe are largely insulated from the impact of oil prices.

Natural Resource Equities

Energy-related natural resource equities are just one portion of the asset class, which also includes metals & mining and agribusiness.

- We are underweight the energy sector, particularly exploration and production (E&P) companies, as well as higher-risk emerging-market energy producers.
- We are balancing this underweight with a large overweight in agribusiness, which has no negative direct exposure to falling energy prices.
- Mining companies should see a short-term tailwind to margins and cash flows as energy expenses represent a large portion of their cost of goods sold (COGS). Lower input costs should help to offset some of the pressure on revenues resulting from declines in metals prices.

Global Listed Infrastructure and MLPs(1)

Lower oil prices can have both positive and negative effects on infrastructure business operations, depending on whether an asset’s users are oil consumers or oil producers. To the extent that oil-price volatility creates market uncertainty, we would note that global listed infrastructure has historically outperformed broad equities during market downturns.

- Pipelines will likely be the infrastructure subsector most negatively affected by rapidly declining and sustained low crude oil and natural gas liquids (NGL) prices. Most pipeline company assets operate under fee-based contract structures and therefore have minimal direct commodity price risk. However, some businesses, such as processing, may have direct exposure to prices. Pipeline companies may also be affected indirectly, as reduced capital expenditures from E&P companies could lead to slowing production growth for crude oil and NGLs, impacting volumes transported through pipelines. We expect the slowdown in North American energy production to reduce medium-term capital investment opportunities for midstream energy companies. However, the long-term imperative for energy infrastructure investment remains, given the growing importance of energy independence. We believe that attractive investment opportunities will arise during the current “sorting-out” period for midstream energy stocks.
- Transportation infrastructure businesses have the potential to benefit from sustained low oil prices, as lower fuel costs tend to lead to higher throughput (e.g., higher traffic on toll roads).
- If a lower commodity price environment coincides with a more defensive and risk-averse market sentiment, defensive subsectors such as utilities and satellites may perform well.
- We have reduced our allocations to energy infrastructure in favor of businesses with less direct and indirect exposure to lower energy commodity prices, including European regulated utilities, U.S. freight rails and U.S. integrated utilities.

(1) MLPs: master limited partnerships
Closing Perspective

As we have seen in the early days of 2015, oil prices remain highly volatile. The biggest near-term risk is that pockets of credit stress could spread to other parts of the global financial market. So far, the more severe stresses have been contained to specific oil-dependent countries such as Russia and Venezuela. However, we are closely monitoring cross correlations in foreign-exchange markets for indications that credit risk is spreading.

As the oil cycle plays out—as production and capacity are cut and markets rebalance—we anticipate major buying opportunities. At Cohen & Steers, our cross-disciplinary approach to active management combines our specialized knowledge across real asset classes, including the extensive experience of our commodities team, to identify and act on opportunities as they emerge.

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Understanding the Risks of Investing. A real assets strategy is subject to the risk that its asset allocations may not achieve the desired risk-return characteristic, underperform other similar investment strategies or cause an investor to lose money. The risks of investing in REITs are similar to those associated with direct investments in real estate securities. Property values may fall due to increasing vacancies, declining rents resulting from economic, legal, tax, political or technological developments, lack of liquidity, limited diversification and sensitivity to certain economic factors such as interest rate changes and market recessions. An investment in commodity-linked derivative instruments may be subject to greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. The use of derivatives presents risks different from, and possibly greater than, the risks associated with investing directly in traditional securities. Among the risks presented are market risk, credit risk, counterparty risk, leverage risk and liquidity risk. The use of derivatives can lead to losses because of adverse movements in the price or value of the underlying asset, index or rate, which may be magnified by certain features of the derivatives. Infrastructure issuers may be subject to adverse economic occurrences, government regulation, operational or other mishaps, tariffs and changes in tax laws and accounting standards. Foreign securities involve special risks, including currency fluctuation and lower liquidity. The market value of securities of natural resource companies may be affected by numerous factors, including events occurring in nature, inflationary pressures and international politics. Because the strategy invests significantly in natural resource companies, there is the risk that the strategy will perform poorly during a downturn in the natural resource sector.

Futures Trading Is Volatile, Highly Leveraged and May Be Illiquid. Investments in commodity futures contracts and options on commodity futures contracts have a high degree of price variability and are subject to rapid and substantial price changes. Such investments could incur significant losses. There can be no assurance that the options strategy will be successful. The use of options on commodity futures contracts is to enhance risk-adjusted total returns. The use of options, however, may not provide any, or only partial, protection for market declines. The return performance of the commodity futures contracts may not parallel the performance of the commodities or indexes that serve as the basis for the options it buys or sells; this basis risk may reduce overall returns.

About Cohen & Steers

Founded in 1986, Cohen & Steers is a leading global investment manager with a long history of innovation and a focus on real assets, including real estate, infrastructure and commodities, along with preferred securities and other income solutions. Headquartered in New York City, with offices in London, Hong Kong, Tokyo and Seattle, Cohen & Steers serves institutional and individual investors around the world.

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