Midstream: The US has not seen rising inflation in a recession since the deficit-spending "guns and butter" era of the 1970s. Today, inflation indicators are rising, amid high unemployment and weak GDP growth. In our conversations, we find that inflation remains far from a priority for investors after a 6-year commodity bear market. "Real asset" allocations have shied away from commodities, in favor of "tangible assets": real estate, utilities, telecom infrastructure. Tangible assets have not historically hedged against rising rates, leaving many portfolios vulnerable to inflation. The largest stimulus in US history is still to come.

Natural Resources: Despite commodity inputs accounting for a smaller percentage of the US economy than in previous economic cycles, accelerating signs of commodity inflation are appearing in certain subsectors of the economy, even as broader inflationary pressures remain muted. One example is in the home construction industry, where lumber prices have risen over 100% in the last 12 months, single-handedly increasing the cost to build a new home by almost 5%.

Download our latest white paper here: Why midstream should become the "next tobacco".
Download our white paper on the "dispatch curve" that governs the oil market here.

Other white papers are available at www.recurrentadvisors.com.

February 2021 Performance Summary and Market Commentaries

Please find below performance and market commentary for our two strategies – MLP & Infrastructure and Natural Resources. Performance follows at the bottom of the commentary. For additional information, please contact us at (832) 241-6400 or info@recurrentadvisors.com.

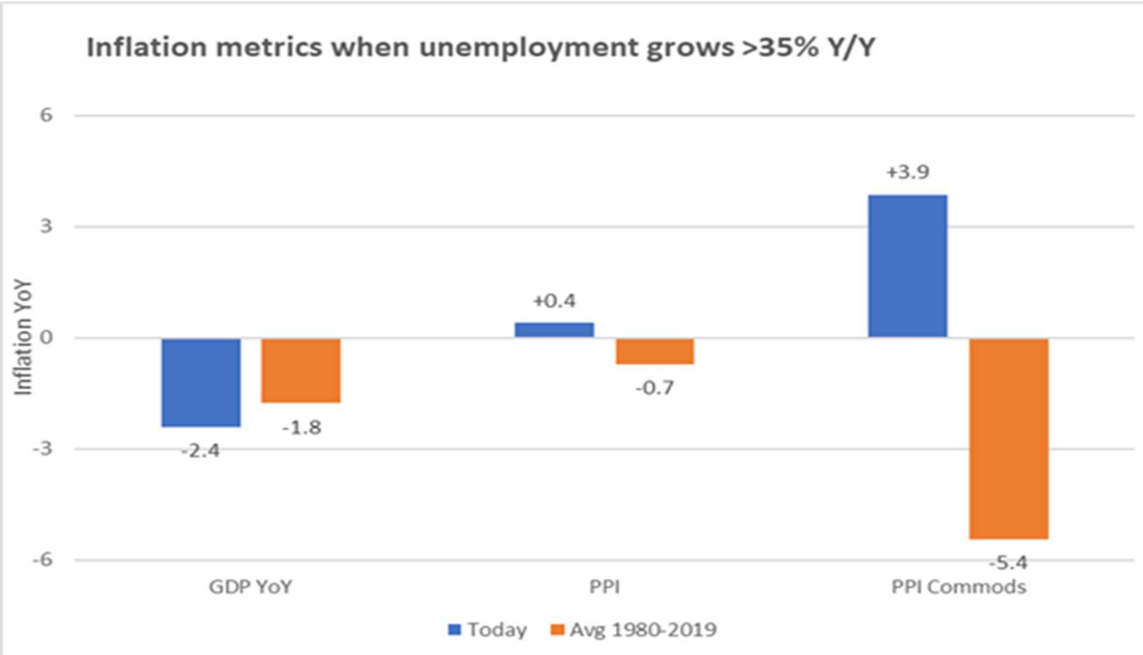
MLP & Infrastructure

Performance review

During the month of February 2021, the Recurrent MLP & Infrastructure Strategy generated net returns of +10.02%, outperforming the +7.77% return of the Alerian MLP Index (AMZ) by +2.25%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.91% (annualized, net of fees). Please see the performance section at bottom for more detail.

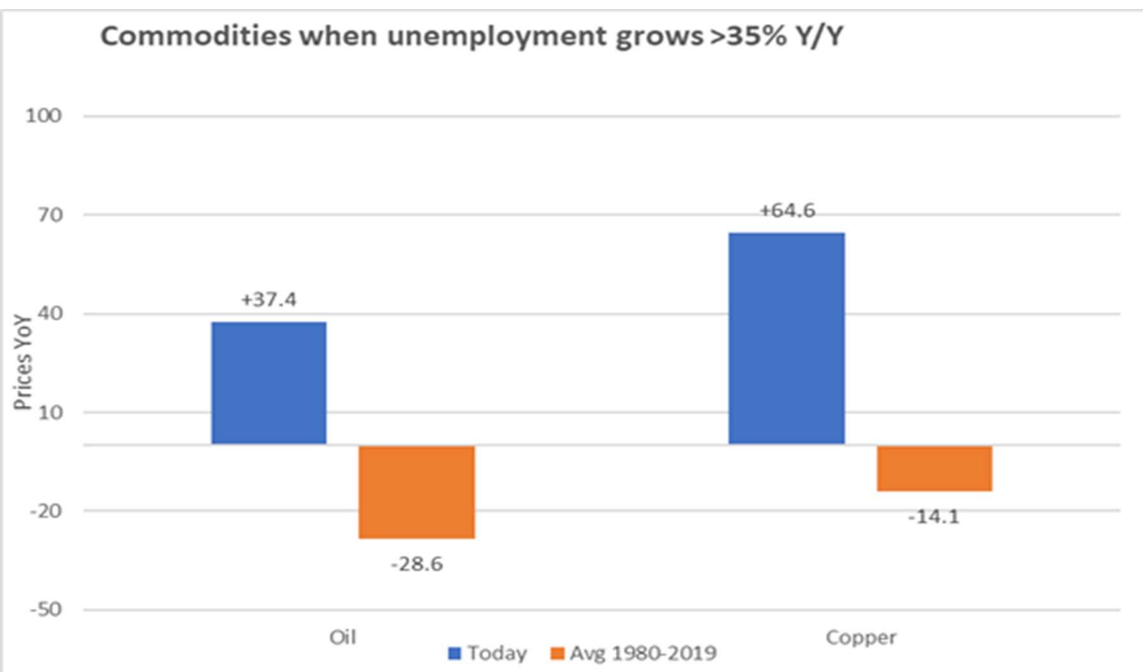
Unemployment and inflation almost never go together, but they coexist today – why?

Historical periods of weak/negative GDP growth and elevated unemployment have generally coincided with low inflation and negative commodity price performance. This relationship is well established: During the 40 years from 1979 to 2019, periods of rising unemployment and falling GDP have generated negative average producer price index (PPI) inflation readings and typically more strongly negative PPI Commodity Index (PCI) readings. Today, both of those metrics are in positive territory, as shown in the charts below. Given the lagged nature of these datasets, these metrics are all but certain to continue their increase in coming months.



Data through February 28, 2021. Source: Bloomberg data, Recurrent research.

Within the PPI Commodity Index, oil and copper, as well as their derivatives, are significant components – we see below that those commodities are also unusually strong given the current macro environment, compared with the historically very negative commodity performance in recessionary environments over the last 40 years.



Data through February 28, 2021. Source: Bloomberg data, Recurrent research.

Inflation today looks restrained… but only if we assume today's COVID-impacted economy is already "back to normal" – which it clearly is not

Today, these leading indicators of inflation remain restrained, by the standards of a "normal, healthy" economy. But as shown above, when we restrict the data to include only recessionary periods (when unemployment has grown >35% Y/Y, when GDP growth is almost always negative), we see that today's environment is highly anomalous. Given the painful memories of commodity performance in 2020 during the depths of COVID, it is understandable that allocators are hesitant to add commodity-levered assets early in the post-COVID recovery – but as inflation continues to accelerate and fiscal stimulus impacts the real economy, out-of-favor asset classes like midstream and natural resources may once again become core holdings as investors from current positioning – which seems to be overweight in assets like growth equities and bonds, which benefit from low rates – into a more inflation-resilient posture.

Natural Resources

Performance Review

Natural resources markets outpaced broader markets as improving economic prospects and increased inflation expectations supported the sector. The Recurrent Natural Resources Strategy rose 13.03% net of fees, in line with the S&P North American Natural Resources Index's 12.99% return. During the month, portfolio holdings Valero Energy, Alcoa, and Marathon Petroleum rose by 38.5%, 36.4%, and 28.0% respectively. The gold sector fell 12.2%, which further benefited relative performance given the portfolio's underweight position.

Investment Discussion – inflation begins to appear in the "real economy"

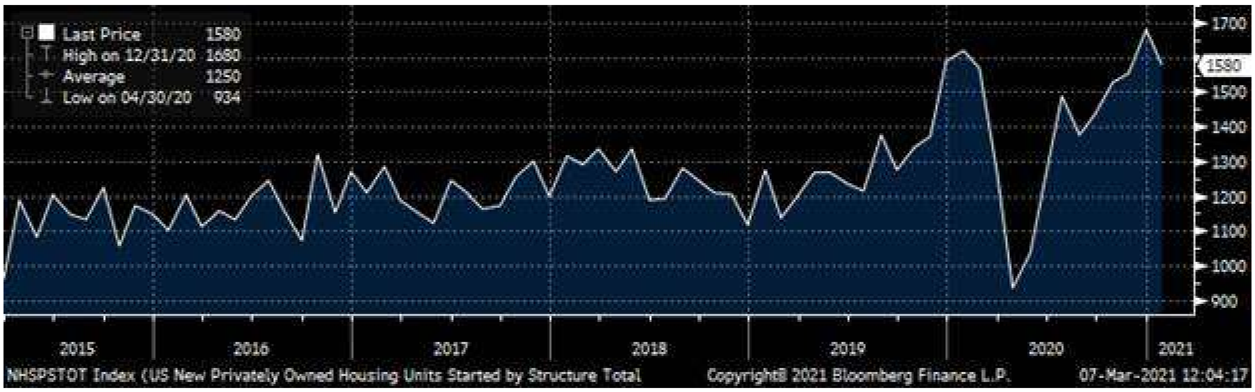
While traditionally a relatively small consideration in global commodity markets, the lumber industry has recently attracted increased interest. Since the beginning of 2020, the lumber price has risen from $400 to more than $1,000, as seen below.

Lumber price: Last 12 months

Source: Bloomberg, Recurrent research

One of the largest uses of lumber is the housing market, where lumber is frequently used to build housing frames. The impacts of COVID have caught the lumber market off guard from both a supply and demand perspective. Demand for lumber has been much higher than expected, particularly when seasonal patterns are considered. COVID has increased savings rates for many first-time home buyers, because of stay-at-home orders and reduced travel opportunities. Additionally, COVID concerns have incentivized more buyers to move to single-family homes for health reasons. As a result of these two factors, new home starts, after a brief dip in 2Q 2020, have rebounded much more strongly than many expected, to levels not seen since 2005.

New Home Starts: 2015 through Today

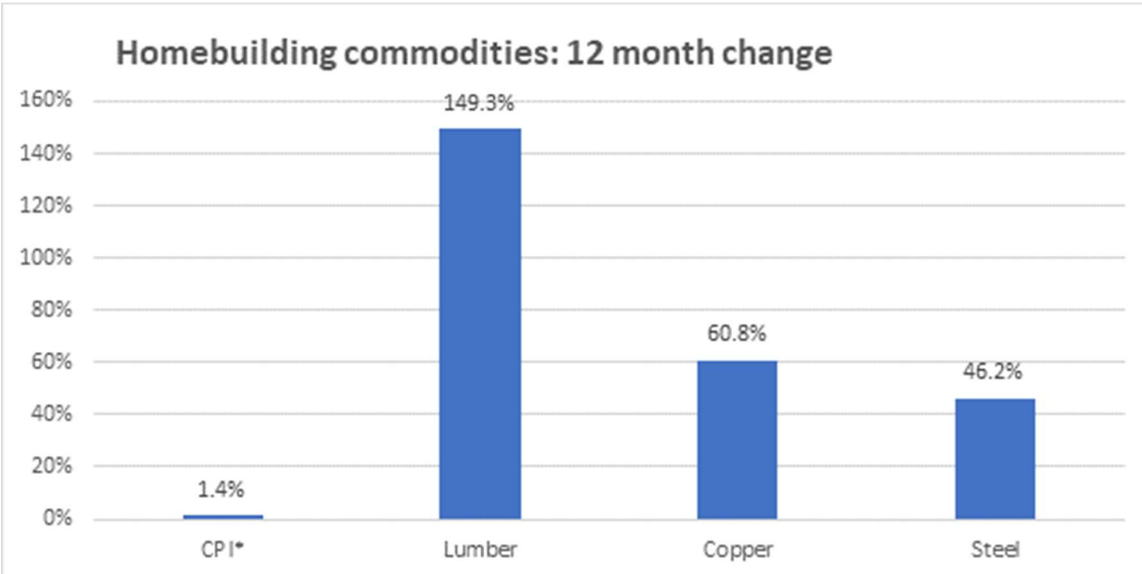


Source: Bloomberg, Recurrent research

From a supply perspective, while ample timber supplies exist, US sawmill capacity has been rationalized after years of oversupply. Additionally, temporary supply outages due to recent weather events in the Southern half of the US furthered the undersupply of milling capacity. Lastly, 4Q and early 1Q are generally lower volume seasons, so COVID-derived increases in demand took the sawmill market by surprise. As a result, many analysts believe insufficient milling capacity will take many quarters to de-bottleneck and lumber prices will remain elevated during this period.

Impact on home building costs

While lumber costs comprise a small percentage of mindshare in commodity markets, in certain specific industries, the impact of rising lumber costs have had a material impact on costs. A prime example is the housing market. In a January 2020 study by the National Association of Home Builders (NAHB), the average home of 2600 square feet of living space cost approximately $300,000 to build. Of that cost, approximately 16,000 board feet, and 6000 square feet of lumber are needed. A year ago, in 1Q 2020, the cost of that lumber was approximately $8,000, only a few percent of the total cost to build a typical home. However, at spot prices today, the cost has risen to $20,000, an increase of $12,000. While in the context of a $300,000 home, the increase may not sound like much, the increasing cost of one small line item increases the cost of the entire home by 4%. Commodities such as copper and steel have also increased by more than 50%, further increasing the cost of materials to build a house, despite comprising a smaller percentage of the total cost.



Source: Bloomberg, Recurrent research

Note: 12 Month change in lumber, copper and steel are measured through February 28; the CPI is measured through January 31, 2021

Over the last several weeks, investor discussions surrounding inflation have increased, from institutional analysts to mass media. We felt it important to highlight how a relatively tangible example of strong commodity inflation of a small line item (<5%) can drive total costs to build a house to increase by 4%. This example highlights our perspective that rapid commodity inflation can continue for some time before crippling the broader economy.