Midstream: which "inning" of the midstream/energy recovery are we in? We take comfort that the "average investor" remains almost completely uninvolved in the recovery in midstream, instead choosing to catch falling knives in the post-peak tech market. We were surprised to discover that YTD money flows remain negative for actively-managed midstream (-2% of AUM), while ARKK – the tech ETF that soared during 2020's speculative frenzy and has since fallen 75% – has seen YTD net buying (+10% of AUM). We believe today's setup – where companies are the marginal buyer of their own stock in the absence of new investors – reflects an early-stage recovery.

Natural Resources: acute increases in gas prices in Europe and Asia vs. the US have re-sorted global cost structures. German refiners and Spanish aluminum facilities have all borne higher costs leading to curtailed production. Meanwhile, North American facilities enjoy lower-cost natural gas inputs and keeping them globally cost competitive. This highlights that marginal production economics in global industries are determined by local natural gas prices.

Access Recurrent's new White Paper on the rising "risk premium" in the oil market
Access Recurrent's latest video on the impact of Russia's invasion

MLP & Infrastructure

Performance review

During the month of May 2022, the Recurrent MLP & Infrastructure Strategy generated net returns of +10.72%, outpacing the +7.73% gross return of the Alerian MLP Index (AMZ) by +2.99%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +6.36% (annualized, net of fees). Please see the performance section at bottom for more detail.

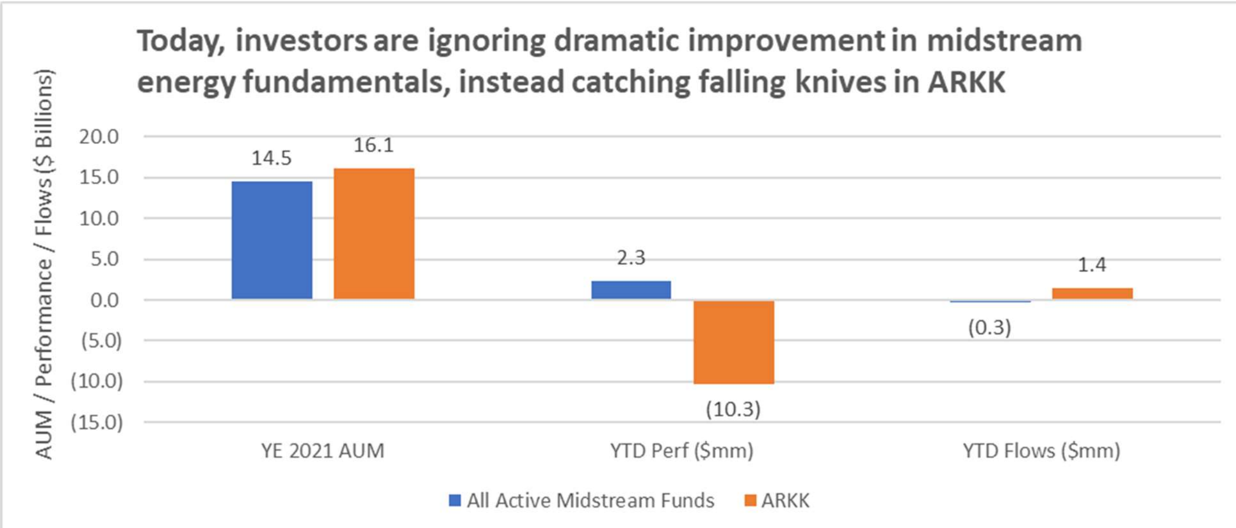
Which inning are we in today in the midstream/energy recovery?

After 6+ years of disheartening underperformance, midstream investors are perhaps understandably skittish after 18 months of outperformance vs the broader market. Our recent monthlies have focused on fundamental underpinnings of the midstream rally: the drivers of inflation (our finding: inflation is driven by energy capex, more than Fed policy), or the shift from free cash flow into record buybacks. But this month, we focus on a question that has come up in almost every recent investor meeting: "Did I miss the midstream rally?" We believe that today's market – almost **zero net buying** of midstream, with continued "knife catching" behavior, and long-term underperformance still in place – looks nothing like a typical overextended rally.

Lack of active net buying of midstream is one piece of evidence that the rally is in early innings

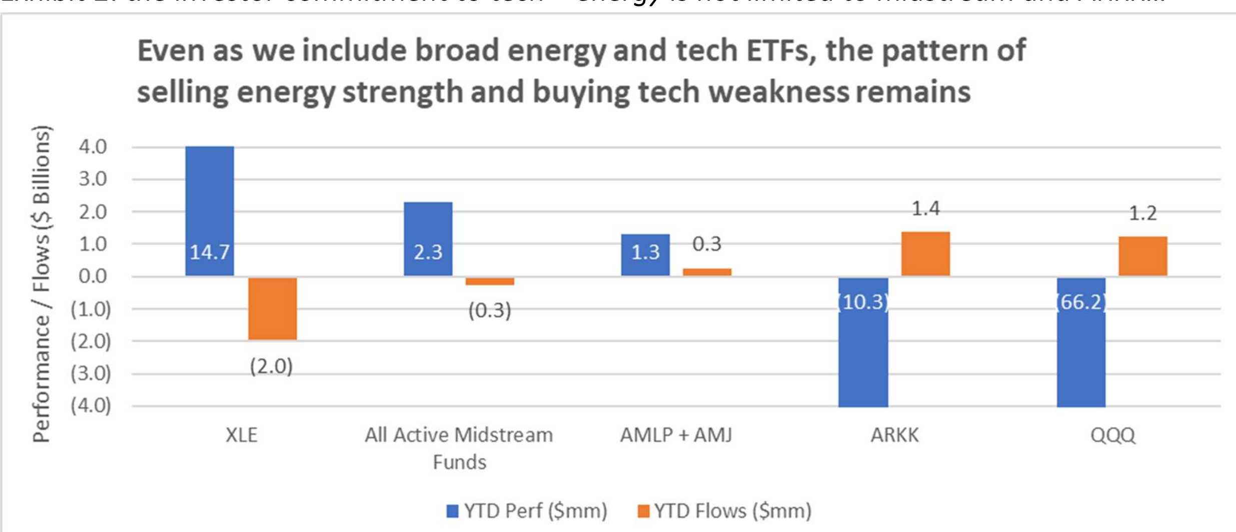
The actively-managed midstream funds/ETF space – with aggregate AUM of roughly $15bn at the beginning of 2022 – has seen net selling in YTD 2022 as the sector has massively outperformed. By contrast, investors continue to put money to work in the collapsing speculative growth space, most notably ARKK. A powerful anecdotal indicator of "where we are" in the current market is the fact that ARKK – the poster child of COVID-era speculation in largely unprofitable tech companies – has continued to see investor buying in 2022, despite the fact that ARKK has declined over -60% YTD as of time of writing (and down -75% from its 2021 peak). Is it possible that the midstream/energy rally could end without any new buyers, and before investors even give up on the growth bull market?

Exhibit 1: can a rally run out of steam without any investor buying?



Source: Recurrent research, Bloomberg data

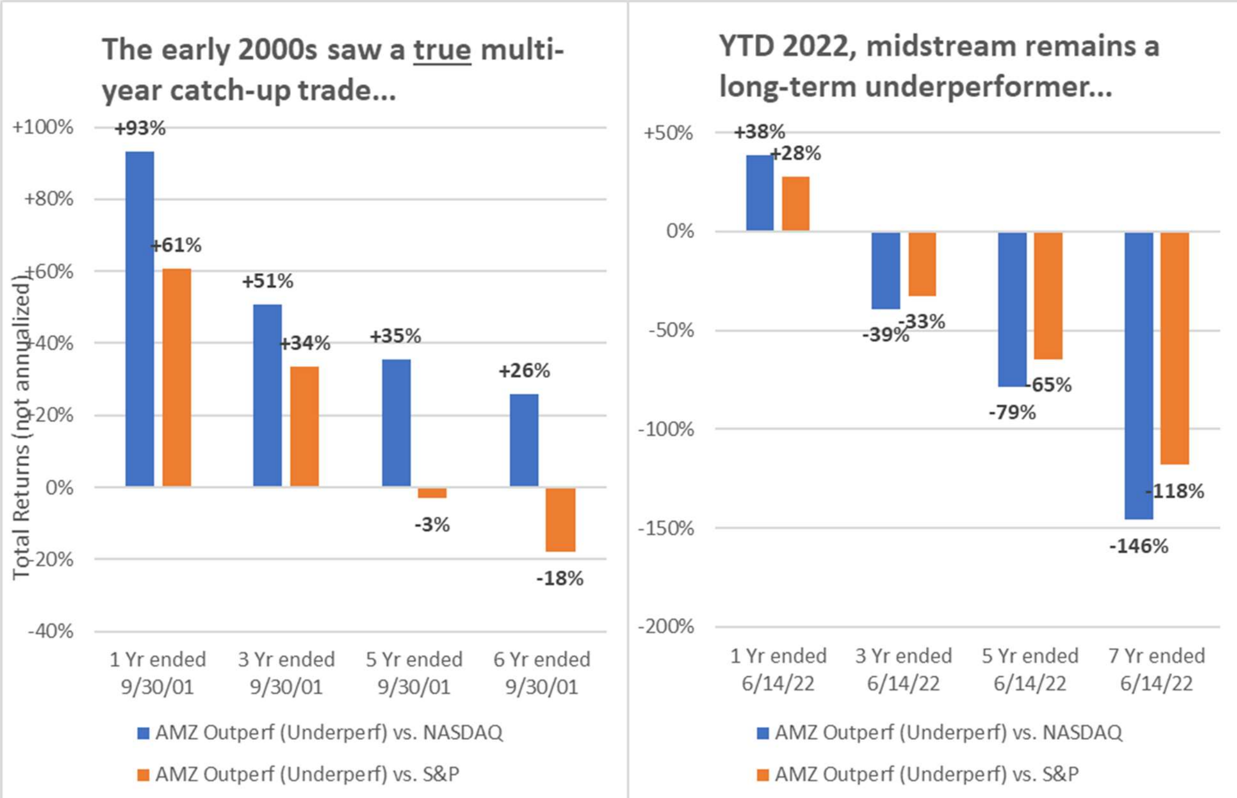
Exhibit 2: the investor commitment to tech > energy is not limited to midstream and ARKK…



Source: Recurrent research, Bloomberg data

As we've noted in last month's note, in the absence of significant investor buying, midstream companies themselves have become the marginal buyer of their own stocks. This reflects midstream's fundamental improvements, but also midstream's continued performance lag, seen in Exhibit 3 below.

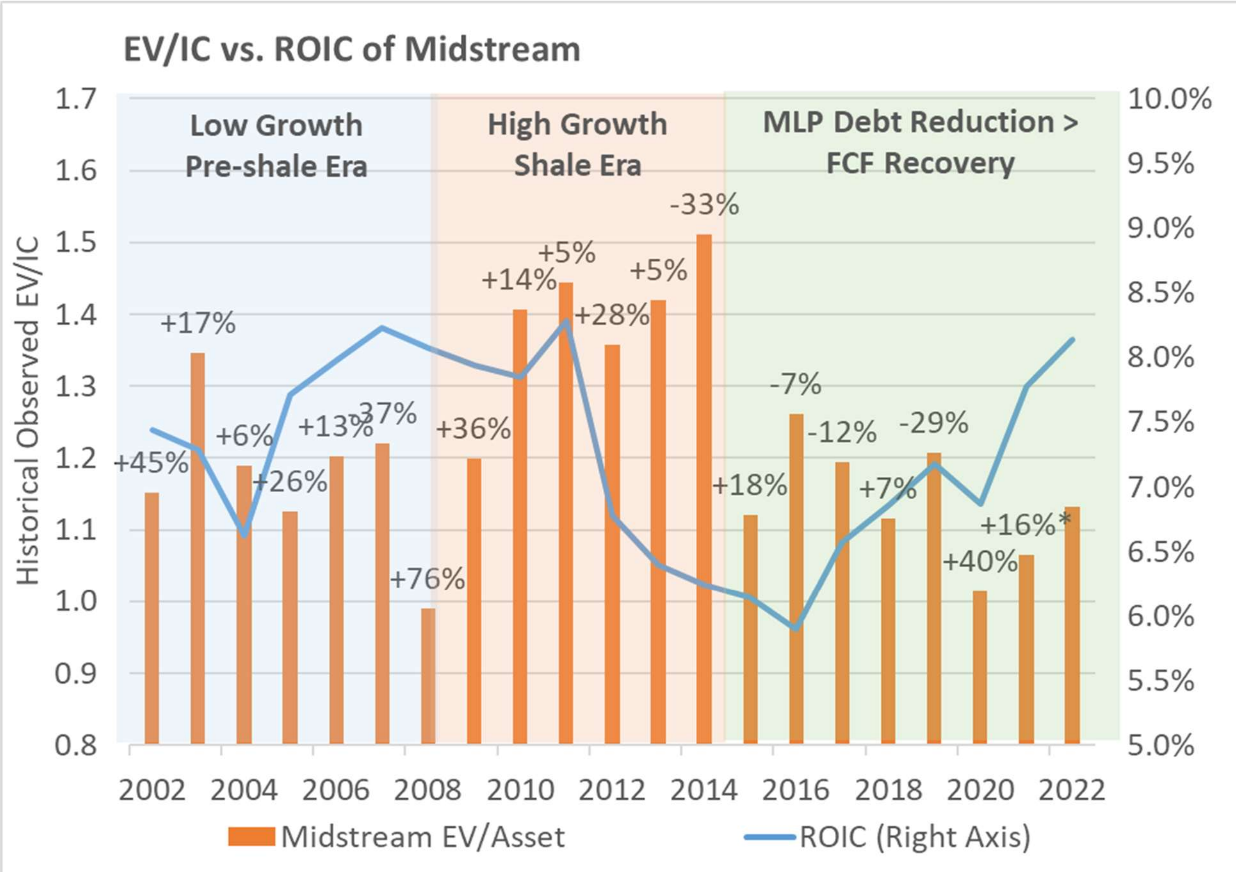
Exhibit 3: long-term underperformance remains significant



Source: Recurrent research, Bloomberg data

Finally, we would note that valuations, using the cyclically appropriate metric of enterprise value vs. book value of invested capital (EV/IC), remain at roughly the 30th percentile of a 20+ year range, while ROICs have returned to the top quartile - providing a continued opportunity for companies to buy their own stock.

Exhibit 4: bottom 30% valuation vs. top 25% ROICs = continued opportunity for buybacks (and outside investors, eventually!)



Source: Recurrent research, Bloomberg data.
Note: % values reflect the following year return. 16% reflects YTD return through 6/15/22.*

Natural Resources

Performance Review

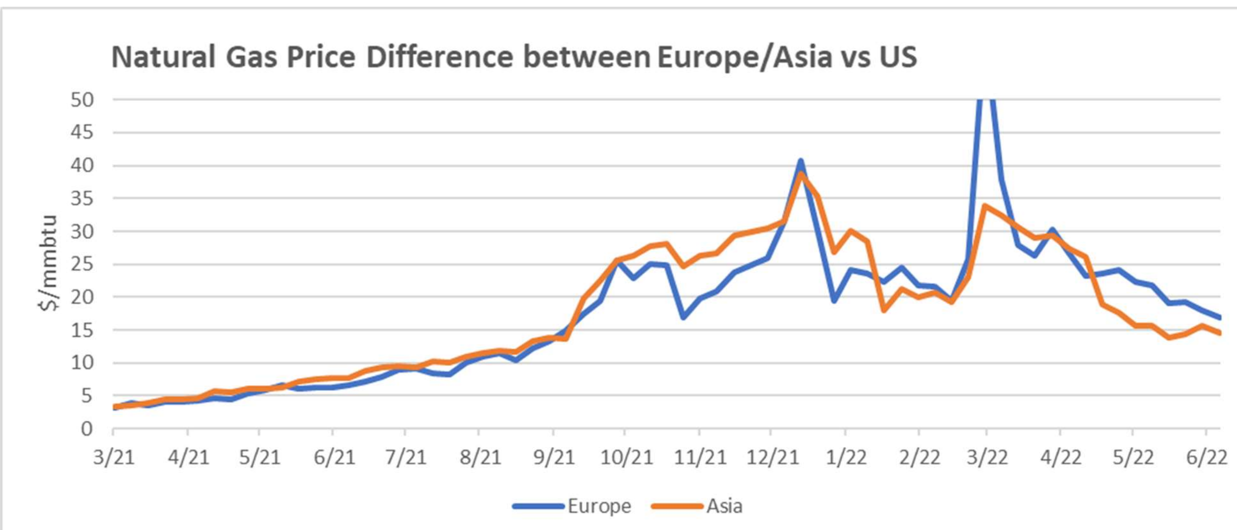
In the month of May 2022, the Alma Recurrent Global Natural Resources Fund rose by 5.36%, outpacing the S&P Global Natural Resources Index's 4.65% return. Overweights in the refining sector, and stock selection in other sectors of the energy industry, significantly added to performance as the Russia/Ukraine conflict exacerbated supply/demand dislocations in a number of commodity markets. Alcoa Corp detracted from performance, falling 8.82% in the month, as Chinese demand fell as a result of COVID lockdowns..

Investment Discussion

Since the beginning of the Russia/Ukraine conflict, many commodities have experienced higher prices. As one of the largest commodity-producing regions in the world, the combination of significantly reduced supply from Ukraine and embargoes on Russian goods have caused imbalances between supply and demand which has driven prices higher.

Few commodities have attracted more global attention than natural gas. With large natural gas supplies and necessary infrastructure to deliver natural gas to Western Europe, Russian exports totaled approximately 40% of Western European natural gas consumption in 2021. As a result of the Russia/Ukraine conflict, the EU has announced intentions to reduce their reliance on Russian natural gas by 2/3 by the end of 2022.

Global prices reflect the current regional supply demand dynamics. With ample domestic natural gas supply in the US, the cost of nat gas remains significantly lower than other global regions, despite a nearly tripling in price to $9/mmcf in the last 12 months. In contrast, Russia's invasion has caused European and Asian natural gas prices to rise to approximately $25/mmcf today.



Source: Bloomberg, Recurrent Research

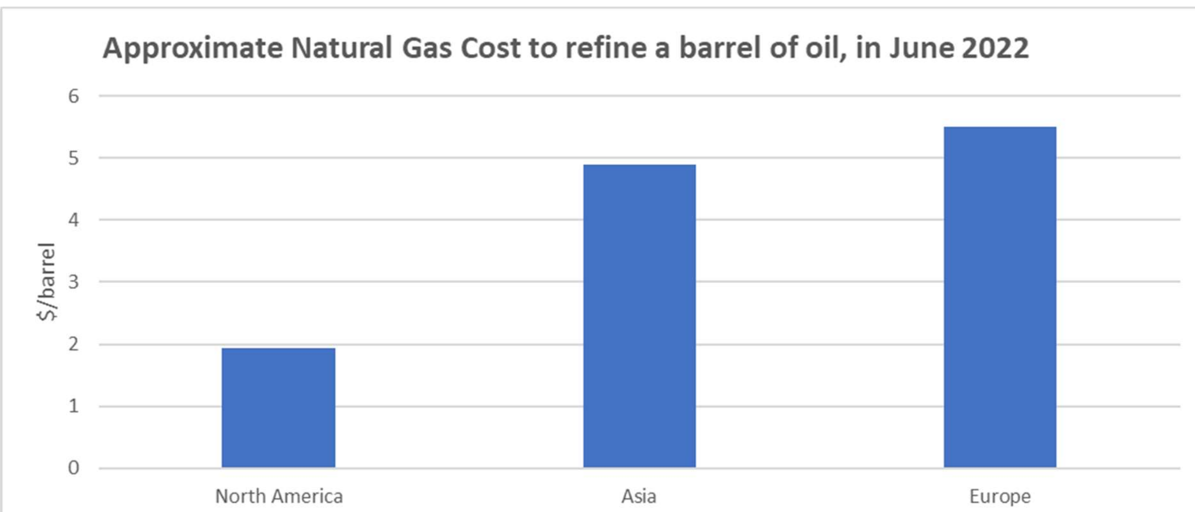
Many investors rightly identify the need for additional natural gas supplies in Europe and look to invest in liquified natural gas projects in the US for Europe/Asia consumption. While clearly a large beneficiary of reduced Russian natural gas supplies to Europe, liquified natural gas companies do not currently have enough capacity to meet localized undersupplies.

It's one thing to use natural gas for residential demand; it's entirely different when natural gas is used as an input for industrial products. Fertilizer, chemical, and many heavy industrial companies require significant amounts of natural gas as a major input.

North American companies using materially lower-cost natural gas have become significantly more competitive on a global basis than their European/Asian counterparts. Take the refining sector for example.

Global refining cost structures impacted by global natural gas price differences

The refining industry requires natural gas to heat oil to turn it into refined products like diesel and gasoline. Before the Russia/Ukraine conflict, the natural gas portion of global refiners' cost structure was fairly small, causing little difference in regional cost structures. However, as regional natural gas prices between the US, Europe and Asia widened, the differentials between the continents have widened. As seen in the chart below, today North American refiners have a $3-4/barrel cost advantage due simply to its natural gas input advantage. As a result, US refineries are running at high capacity utilizations to supply global markets.

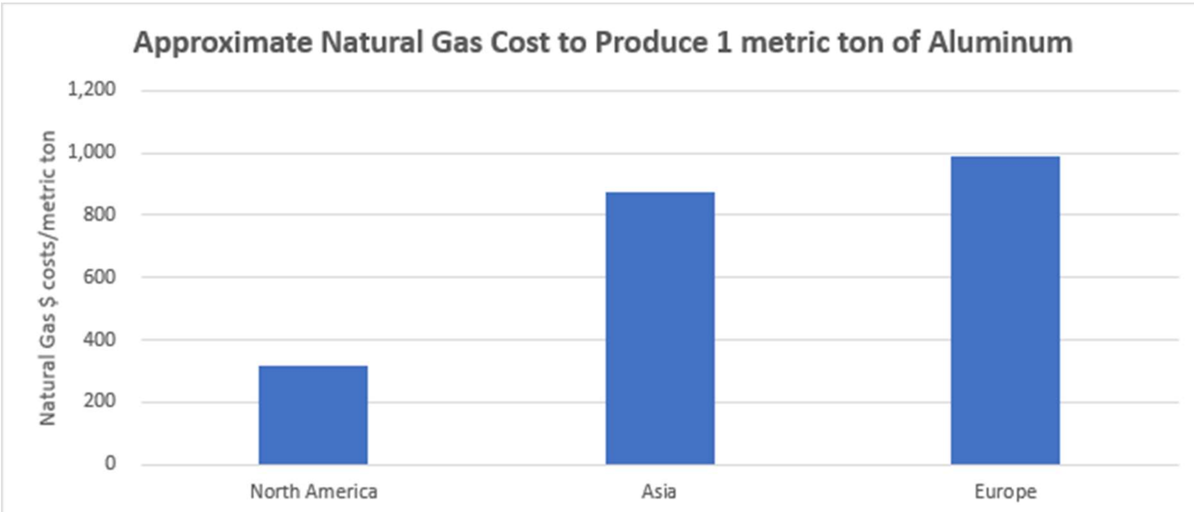


Source: Stratas Advisors, Bloomberg, Recurrent Research

Regional natural gas prices have even more impact on aluminum production costs

In many ways, the conversation is similar in the aluminum industry. In previous monthly commentaries, we have discussed the large role natural gas plays in the aluminum production process (as an approximate 30-40% of operating costs). Lower North American natural gas prices have created a $500-700/metric ton cost differential. **With spot aluminum prices approximating $2600/metric ton, the cost difference alone comprises 25% of revenues.** Similar to the refining market, North American producers' significant cost advantages warrant higher than usual capacity utilization, and small changes in demand will be borne by marginal high-cost producers outside of North America. To the degree supply in the US exceeds demand, given cost differentials, US producers are able to export finished goods at cheaper prices than local European or Asian producers.

Lastly, the high cost of natural gas explains why European aluminum smelters were being closed as aluminum prices were at multi-decade highs earlier this year – the cost structure was simply too high due to high natural gas prices.



Source: Alcoa, Bloomberg, Recurrent Research

From a portfolio perspective, one way to gain exposure to profit opportunities is through companies which produce and transport natural gas. An additional opportunity has emerged with North American advantaged industrial exposure. As the low cost "baseload" producers, even in weak economic environments, low cost North American producers will produce locally and ship globally so long as this phenomenon continues.

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