Midstream: a year ago, we asked "have investors forgotten how to hedge inflation?" Our question highlighted the fact that commodity-levered equities (nat res, energy, midstream) had historically offered superior inflation protection vs. "consensus" inflation hedges like gold and TIPS, or "real assets" like utilities and REITs. Better yet, midstream offers high yield, while more common yield vehicles (bonds) have delivered negative returns in times of inflation. Why haven't commodity equities become "must own" assets? Perhaps investors believe Fed policy will slow GDP growth and rapidly tame inflation. Below, we show that commodity-driven inflation has historically been more responsive to supply-side investment, and less responsive to broad GDP growth. This study should give pause to anyone who believes Fed tightening will quickly solve the current bout of commodity-driven inflation.

Natural Resources: Headlines of withdrawals from oil strategic petroleum reserves, combined with already low private company inventories, have raised broad questions of oil scarcity and possible energy insecurity in light of geopolitical tensions heightened by the Russia/Ukraine conflict. However, in the case of the United States, the combination of increasing domestic production and pipeline-bound Canadian imports minimizes dependence on waterborne oil imports and greatly reduces the need for elevated strategic petroleum reserves to preserve energy security.

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

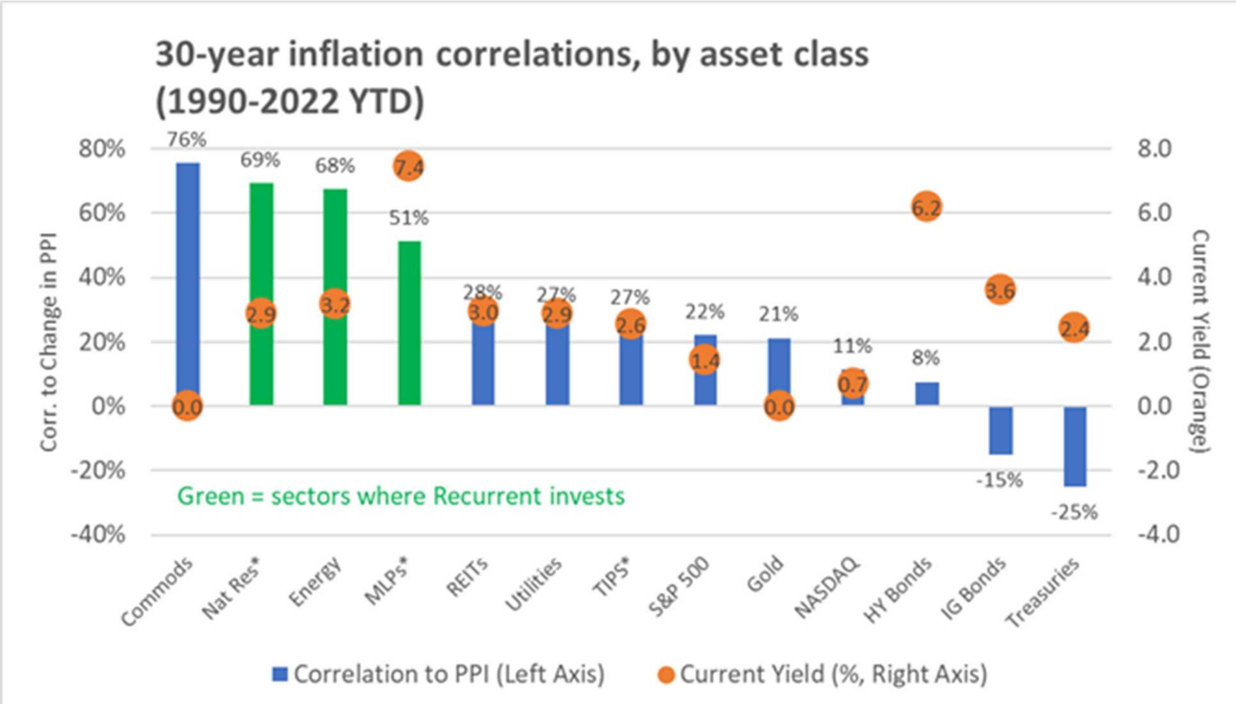
MLP & Infrastructure

Performance review

During the month of March 2022, the Recurrent MLP & Infrastructure Strategy generated net returns of +7.11%, outpacing the +2.05% gross return of the Alerian MLP Index (AMZ). Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +5.52% (annualized, net of fees). Please see the performance section at bottom for more detail.

The current inflationary environment suggests that midstream, energy, resource sectors are "must own" assets

Here we briefly revisit a study we discussed a year ago, showing the relative effectiveness of different asset classes in hedging against inflation. We measured the correlation of rolling 12mo returns over 30 years compared to the 12mo change in PPI. The last 12 months have only further bolstered last year's study: commodities, as well as commodity-levered sectors like natural resources, energy and midstream, provide returns that are substantially more correlated to PPI inflation. Of these 3 commodity-levered equity sectors, midstream offers the highest yield.

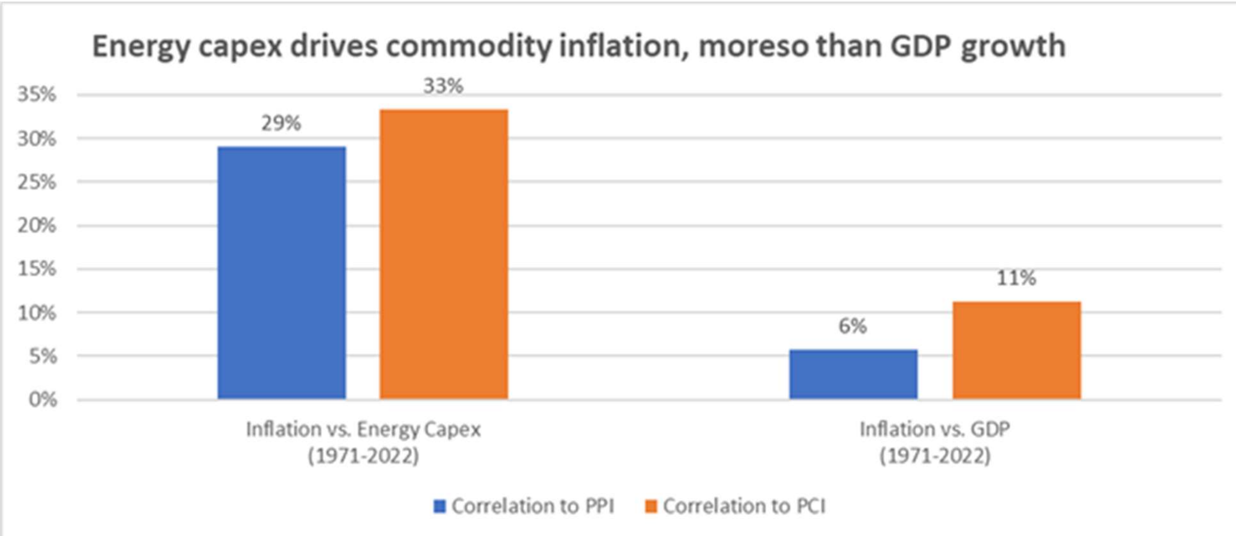


Data through March 31, 2022. Source: Bloomberg data, Bureau of Labor Statistics, Recurrent research.
Notes: Commods = Bloomberg Commodity Index; REITs = Dow Jones REIT Index; Utilities = S&P Utilities; MLPs = Alerian MLP Index; TIPS/Treasuries = Bloomberg Barclays Indices. Asterisk indicates data series beginning in 1997 (24 years instead of 31).

Should tighter monetary policy change our attitude about commodity sectors? In short: No.

Despite measures of inflation hitting multi-decade highs in the last 12 months, commodity-related sectors remain near historic lows as a % of broad equity indices (as discussed in last month's NR writeup). Why have investors and allocators largely remained underweight? As the "transitory inflation" argument has faded, the new argument is that inflation is high, it is dangerous to the economy, and the Fed is laser-focused on taming it. Therefore, the sectors which have benefitted from inflation are unlikely to deliver superior returns in a time of Fed monetary tightening and potentially slowing economic growth.

History shows it's not so simple. Over a 50-year dataset, **energy-specific capex is a much more important driver of commodity-driven inflation than broad GDP growth**. PPI and PCI (PCI being the commodity portion of PPI) is not especially responsive to broad GDP growth and Fed policy; commodity prices are responsive to commodity-specific supply dynamics. This is not surprising; one only needs to consider the economic malaise in the 1970s and 1980s as oil prices soared, or the economic boom that continued from 2014-2019 even as oil prices collapsed. In both cases, supply outweighed broad economic growth as a driver of commodity price inflation.

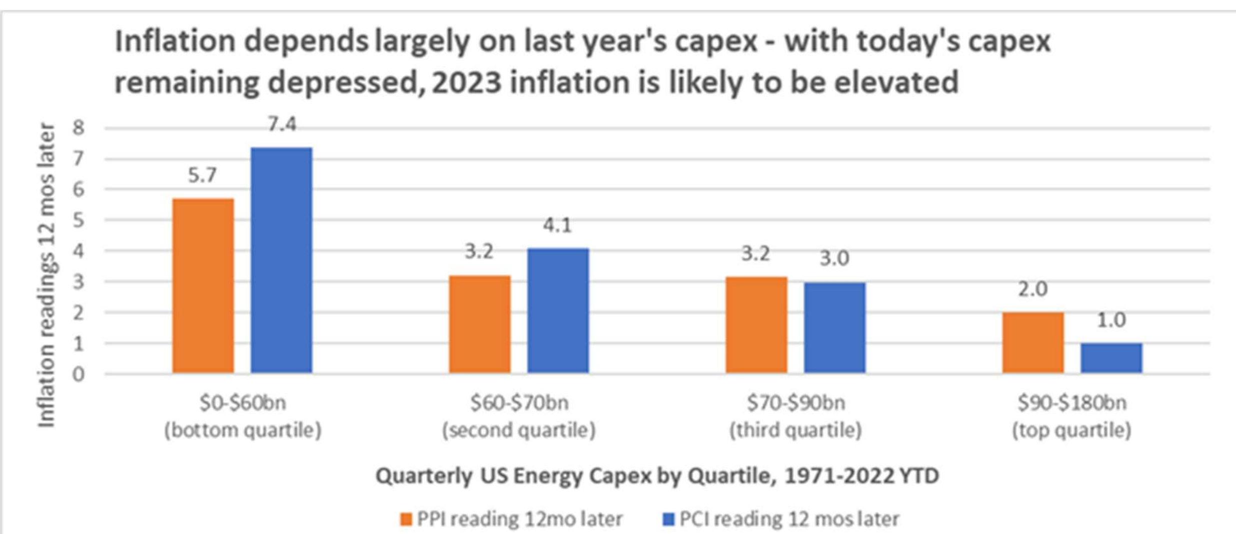


Data through March 31, 2021. Source: Bloomberg data, Bureau of Labor Statistics, Bureau of Economic Analysis, Recurrent research.

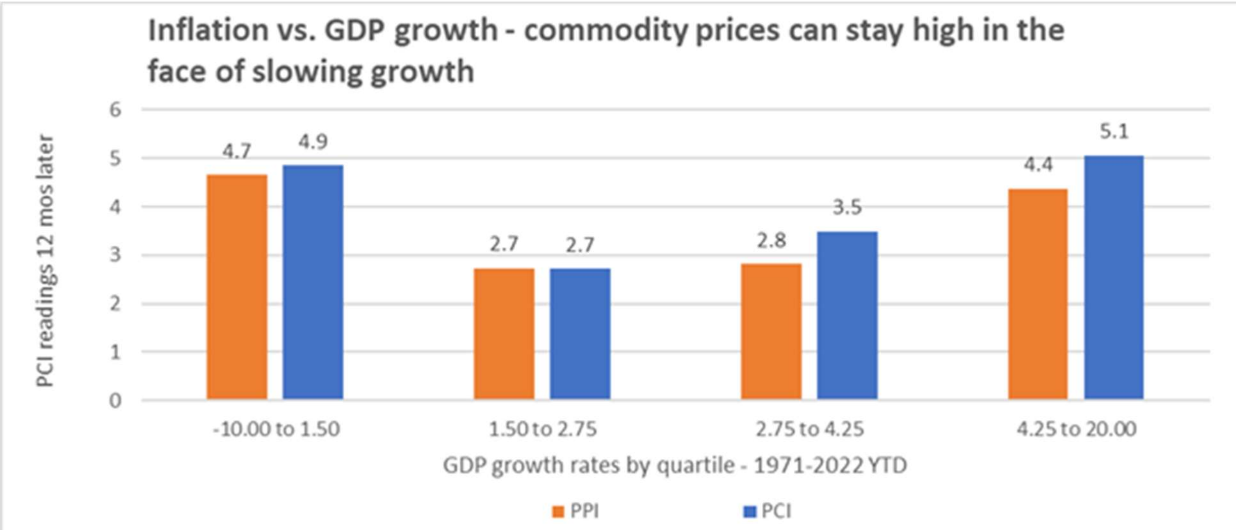
Energy capex drives commodity prices; economic growth is less impactful for commodity prices

Energy demand is relatively inelastic (i.e. demand for commodities does not meaningfully decline when GDP growth slows), while energy supply has potential to be highly elastic when capex increases meaningfully (i.e. drastic changes in energy capex can influence supply by +/- 10% over the next 12 mos; 1% change in GDP growth has historically driven roughly ~0.5% change in oil demand).

As shown below, periods of high spending (>$90bn per quarter in US energy capex) have been consistent with very low PPI and PCI readings. For reference, today's energy capex sits at $58bn, just inside the bottom quartile of the 50-year range. Meanwhile, inflation readings are well into the top decile.



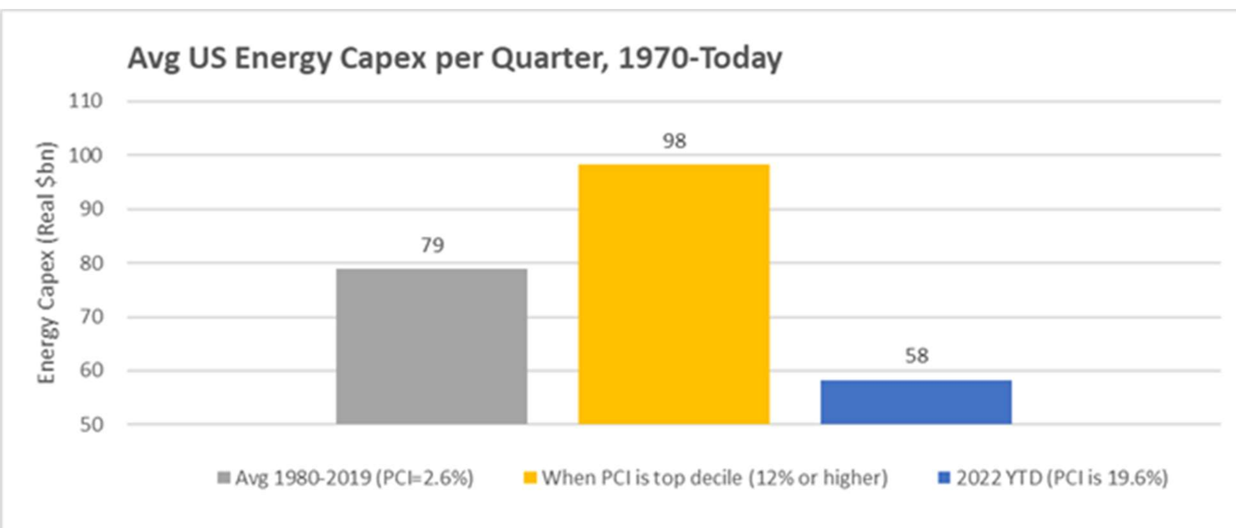
Data through March 31, 2021. Source: Bloomberg data, Bureau of Labor Statistics, Bureau of Economic Analysis, Recurrent research.



Data through March 31, 2021. Source: Bloomberg data, Bureau of Labor Statistics, Bureau of Economic Analysis, Recurrent research.

Cheap company valuations, a lack of political support, and high levels of steel/labor inflation are preventing capex from rising

As shown below, today's energy capex is in the bottom quartile of the last 50 years, despite PCI readings which are well into the top decile (12% has historically defined top decile PCI readings vs. today's 19.8% reading). Plenty of political finger pointing surrounds the low levels of capex, but one clear obstacle is a steeply backwardated commodity curve making it difficult for producers to lock in future profits, while steel and labor costs soar, squeezing forward margins even as spot markets support record profits. Of course, increased political interference in commodity markets potentially dampens companies' desire to grow production.



Data through March 31, 2021. Source: Bloomberg data, Bureau of Labor Statistics, Bureau of Economic Analysis, Recurrent research.

Regardless of the reason why, energy capex remains constrained

With energy company valuations remaining very cheap (and cost of capital remaining very expensive), new investment is also being discouraged by investors, who have been unwilling to ascribe long-term value to commodity-derived cash flows. We see two ways out of the current underinvestment environment: 1) investors and capital support higher valuations (and easier access to capital) for out-of-favor commodity-related equities, allowing investment to increase without penalizing management teams; or 2) revenues grow to a point where companies can afford to reinvest in production while providing ample cash returns to a finite investor base. Either outcome points to attractive returns for commodity-related sectors. #1 requires a broadening investor base, leading to multiple expansion; #2 entails much higher commodity prices and inflation going forward, benefitting a finite group of natural resources and energy investors, with buybacks and dividends as key drivers of returns. We see #2 as the likely paradigm as long as multiples remain well below pre-COVID levels.

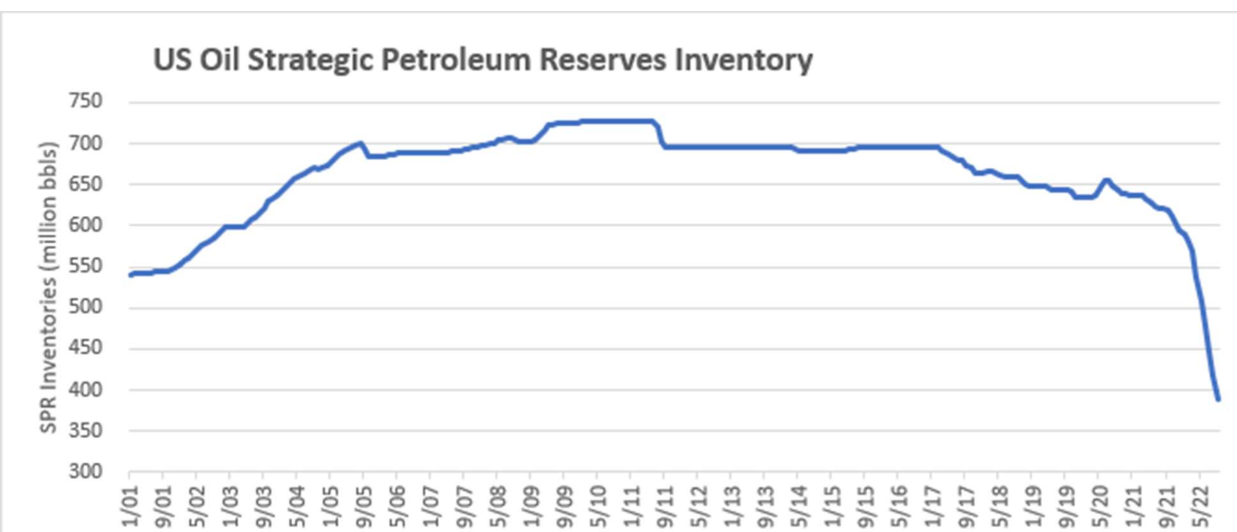
Natural Resources

Performance Review

In the month of March 2022, the Recurrent Global Natural Resources Strategy rose 8.51% net of fees, outpacing the S&P Global Natural Resources Index's 7.38% return. Alcoa, one of the portfolio's top 10 holdings, rose by 19.64% in the month, significantly added to performance. Stock selection in the paper products sector detracted from performance, as the sector fell by 3.90% within the portfolio.

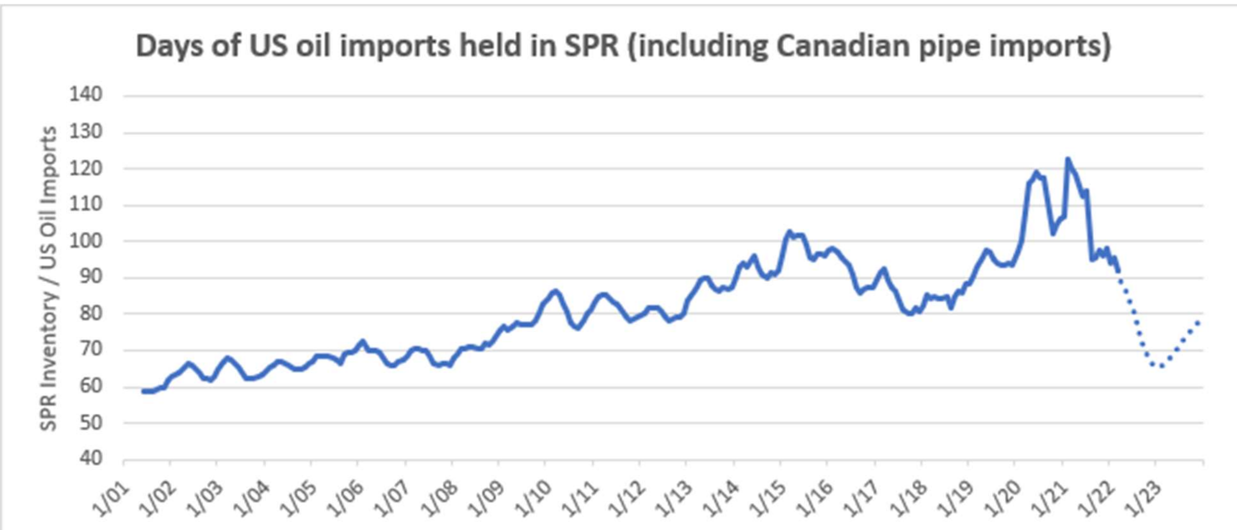
Investment Discussion

On March 31, President Biden announced plans to sell 1 million barrels of oil daily for 180 days from the Strategic Petroleum Reserve (SPR). We have received many questions regarding the impact on American (and Western) energy security. The proposed SPR release will reduce US strategic inventories by nearly 1/3rd, from 560 million to 380 million barrels. With private industry inventories also well below average levels, the proposed 180-million-barrel SPR release will reduce inventories well below previous multi-decade lows, bringing concerns around energy security to the fore.



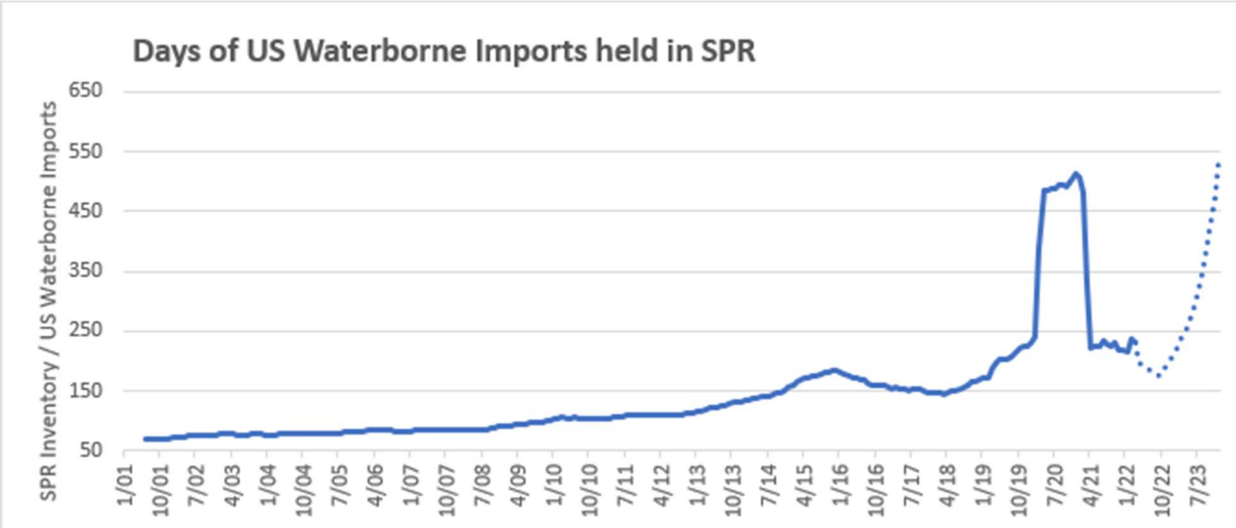
Source: Bloomberg, Recurrent research

However, over the course of the last 20 years, the United States has increased its domestic oil production, growing from less than 5 million barrels/day in 2004 to more than 13 million barrels/day in 1Q 2020. With demand ranging from 18-20 million barrels/day depending on the season, the need for external oil is lessened, and the SPR could provide longer periods of market support. Additionally, the largest importer of oil to the United States is Canada. Notably, almost all of Canada's oil shipments to the US are pipe-bound, without access to alternative (non-US) markets. Over the last 20 years, Canadian oil imports to the United States have increased from 1.3 to roughly 4.0 million barrels/day. If we were to consider the highly unlikely loss of Canadian pipeline barrels, then SPR inventories, even after the proposed drawdown, would "fill" the supply/demand gap for roughly 70-80 days – providing the same cushion as the 20-year average, despite the fact that absolute barrels in storage are nearly 50% lower.



Source: Bloomberg, Recurrent research

Lastly, when considering the relationship between the SPR and net waterborne imports (i.e., assuming that Canadian imports are highly unlikely to be disrupted), the SPR "inventory cover" is even larger relative to historical levels, enough to replace waterborne imports for nearly a year. As US production is expected to rise during 2022 and 2023, required waterborne imports will continue to fall, making SPR "inventory cover" close to 2 years by the end of 2023. This assumes that the US will continue to export oil in the current quantity of ~3 million barrels per day.



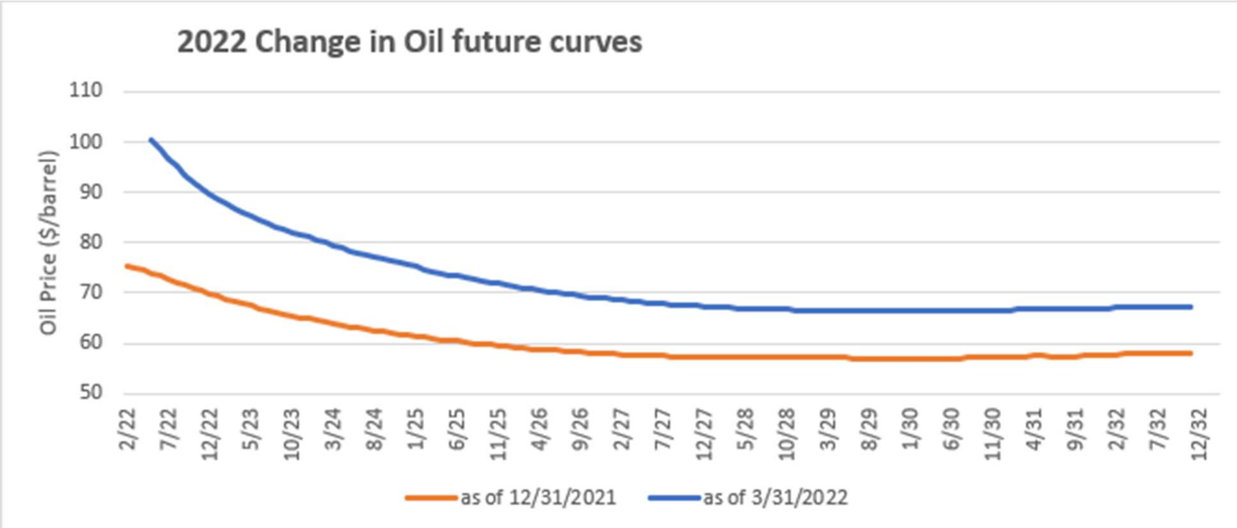
Source: Bloomberg, Recurrent research

We see above, that despite the reduced absolute levels of SPR inventories, the SPR remains more than adequate to protect the US (and Canada) from any supply disruption in the global oil markets, given the reduced import needs of the US (and North America broadly).

<u>Market Reaction</u>

From an oil market perspective, an additional 1 million barrels of oil/day will help to alleviate global undersupplies caused by OPEC's inability to produce at quota levels and US E&P companies' adherence to capital discipline. Global demand continues to recover from 2020 COVID lows, with the recovery in jet fuel accounting for the largest demand increase in recent months. Despite the SPR release, demand will still outpace supply since the summer months are the highest demand period of the calendar year.

The market reaction to the SPR release provides further insight. While near-term oil futures have risen most due to short-term supply disruptions, longer-term futures have remained at lower levels (in a condition known as backwardation), and have risen by roughly 50% as much as near-term futures. This reflects a continued sanguine attitude toward the long-term availability of oil supply. The higher price along all time periods highlights the increased cost to deliver barrels for a variety of reasons, but does not reflect a long-term energy shortage, exacerbated by depleted strategic oil inventories.



Source: Bloomberg, Recurrent research

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