Midstream: Last month, we discussed how midstream has historically provided inflation-resistant income in a way that REITs, utilities, and TIPS have not. Q1 earnings provided a strong case-in-point for this relationship, as midstream profited from commodity bottlenecks, while other sectors absorbed higher costs. This week's Colonial Pipeline outage is another example of how underinvestment has created less infrastructure redundancy. The fundamental arguments for midstream – benefitting operationally from inflation, while reducing capital employed at a time of rising rates – continue to strengthen, especially compared to capital-intensive sectors like utilities and Cleantech.

Natural Resources: As current inflationary pressures mount, the topic of 1970s inflation has grown in prominence. Our analysis of the 1970s highlights the stronger role commodities played in the early 1970s inflationary period, compared to the broader based inflation of the late 1970s. With commodity inflation increasing today in the relative absence of broad-based inflation, at this point, the early 1970s appears to be a more appropriate comparison than the late 1970s and could foreshadow an extended period of inflation.

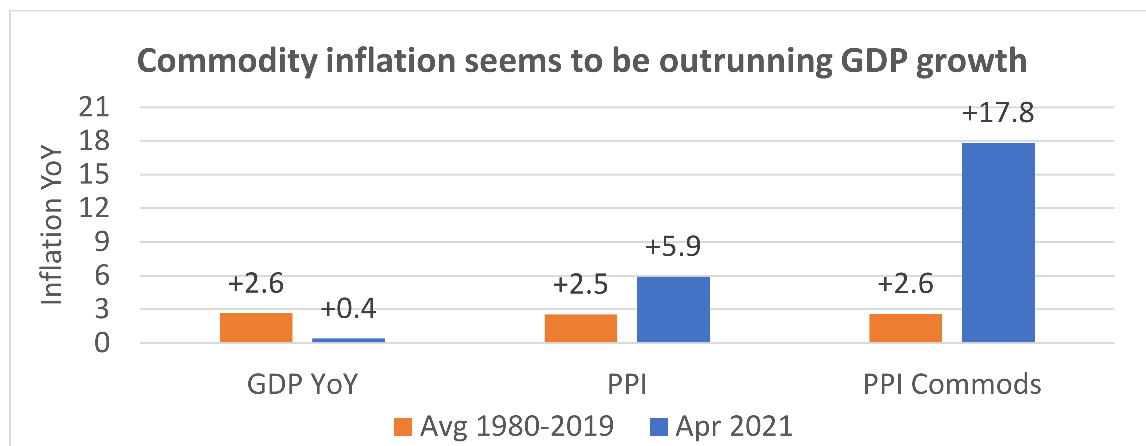
MLP & Infrastructure

Performance review

During the month of April 2021, the Recurrent MLP & Infrastructure Strategy generated net returns of +5.62%, underperforming the +7.15% return of the Alerian MLP Index (AMZ) by (1.53%). Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +3.74% (annualized, net of fees). Please see the performance section at bottom for more detail.

One year since WTI oil prices went negative, commodity bottlenecks are increasingly frequent

From oil and gas, to lumber, copper, steel and aluminum – commodity tightness is making itself felt across the global economy. Given the increasing strain associated with providing raw materials for the post-COVID economy, "shortages," "bottlenecks," and "inflation" have all been cited by many Fortune 500 executives on recent earnings calls.



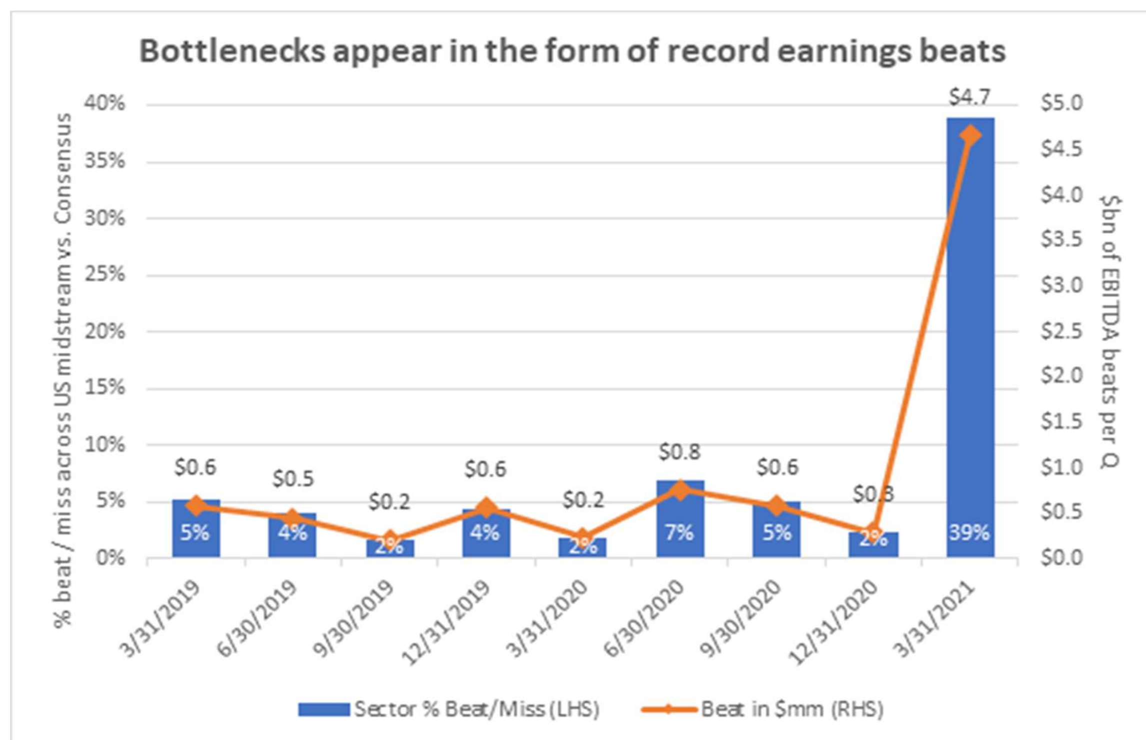
Data through 4/30/2021. Source: Bloomberg data, Bureau of Labor Statistics, Recurrent research.

Bottlenecks create opportunities for asset-rich midstream infrastructure companies

On the other side of these "bottlenecks" are midstream companies. After years of reduced investment, constraints are appearing – most notably, in February's deep freeze which afflicted much of the southern United States. Bellwethers, Kinder Morgan (KMI) and Energy Transfer (ET) reported excess freeze-related earnings from their gas operations that that reached $1bn for KMI and $2.4bn for ET. In line with our long-term debt reduction thesis, ET permanently retired $3.7bn of debt outstanding in Q1 – that's compared to a market cap of roughly $25bn!

More recently, a cyberattack on Colonial Pipeline, the source of nearly 50% of all East Coast motor fuels and petroleum products, found its operations halted after a cyberattack. In Michigan, politicians are seeking to dig up a pipeline that has operated safely for 60+ years – despite the fact that it supplies most of the state's propane supply for winter heating. What ties these seemingly random events together is the realization that the US – a country with more miles of pipelines than any other – still has fairly low levels of redundancy in its commodity value chains.

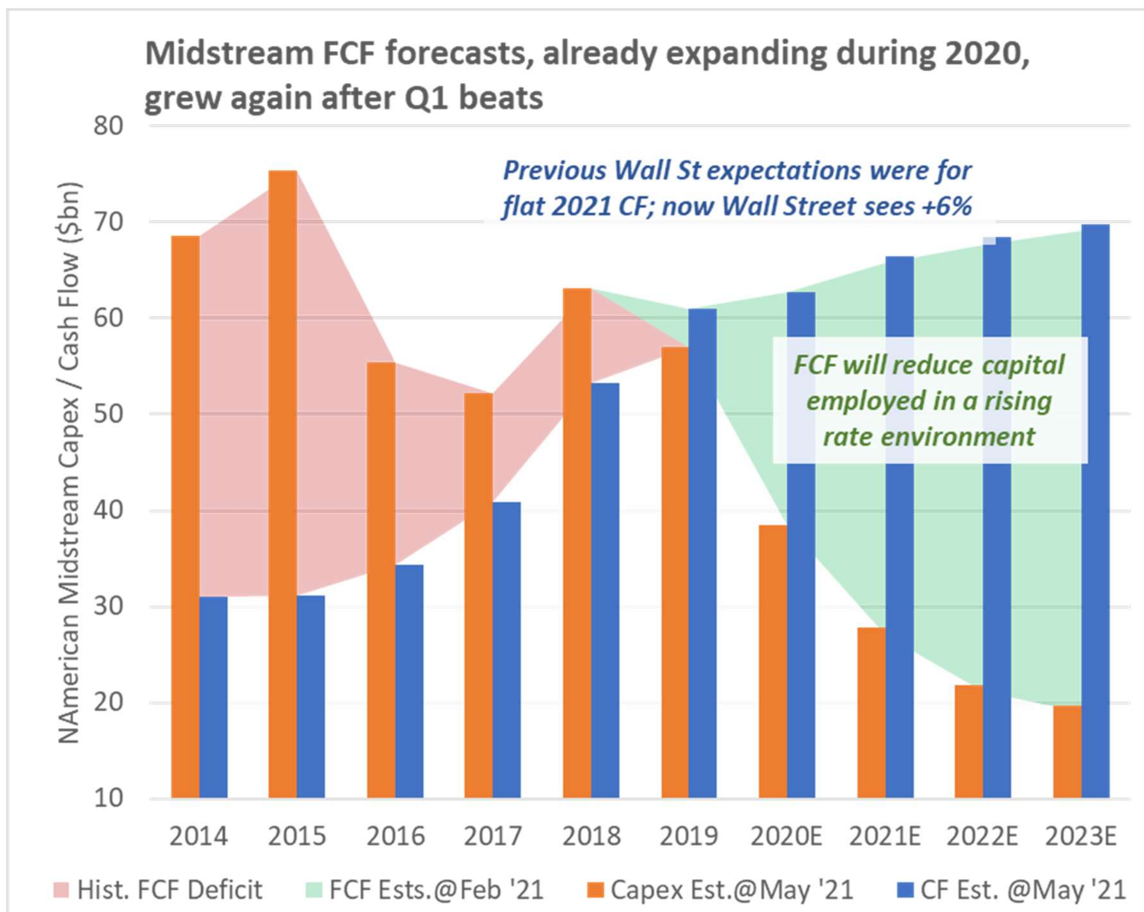
While the polar vortex was responsible for billions of dollars of excess midstream profits derived from natural gas assets, improving outlooks reflect an array of other factors. Prices of gas liquids used in plastics production – mainly extracted by midstream companies – are now +50 to +100% higher than 2019 levels. Global gas demand has drained non-US storage to multi-year lows and driven global gas prices +50% vs. 2019, encouraging US LNG exports. Top of the list of "surging commodities you haven't heard of" are Renewable Identification Numbers (RINs), issued to blenders of ethanol and biomass-based fuels into gasoline and diesel. With lower gasoline production during COVID, RINs have grown scarce, driving RIN prices nearly 20x higher than 2019 levels, increasing the value of midstream assets that can blend reliably and accurately.



Data as of 5/10/21. Source: Bloomberg data, Recurrent research.

As rates rise, a reduction of capital employed could provide further tailwinds

Fundamentally, the outlook is improving for midstream, as shown in the graph above. But from a macro perspective, the pressure of rising rates will be felt by other capital-intensive sectors, such as global infrastructure and utilities. As Secretary Yellen indicated last week, higher rates are a high-likelihood outcome of the current proposal for surging government borrowings in coming years. The result for most capital-intensive businesses will be higher costs of capital and less returns left over for equityholders. Midstream, in this regard, is unique – capital intensity has been reduced dramatically by a multi-year downturn, meaning that midstream will experience significant increases in free cash flow (FCF), reducing capital employed, while many other "growth-oriented" businesses like utilities and cleantech will be forced to finance growth plans as the cost of capital is rising.



Note: CF and Capex estimates reflect Wall Street consensus for North American midstream companies as of 5/10/21.

Natural Resources

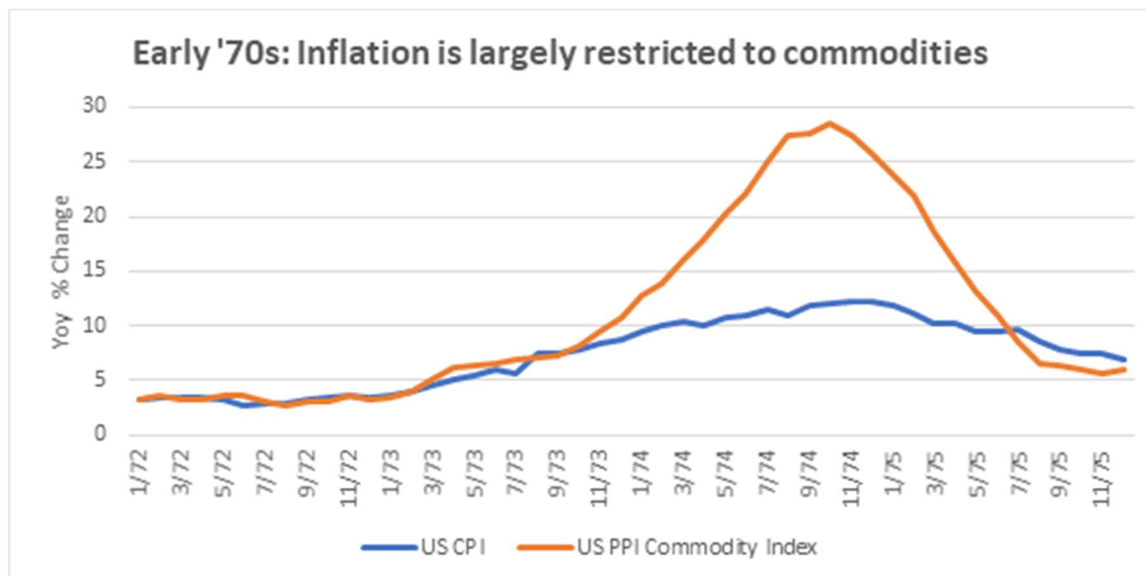
Performance Review

During the month of April, the Recurrent North American Natural Resources Strategy returned 4.25% net of fees, outpacing the S&P North American Natural Resources' 3.50% return. During the month, portfolio's holdings in the copper and aluminum sectors both added significant value, most notably Freeport McMoRan and Alcoa. Plug Power, a portfolio holding in the Electrical Components sector, mildly detracted from performance during the month.

Investment Discussion – 1970s inflation began with highly-focused commodity inflation, before becoming broad-based

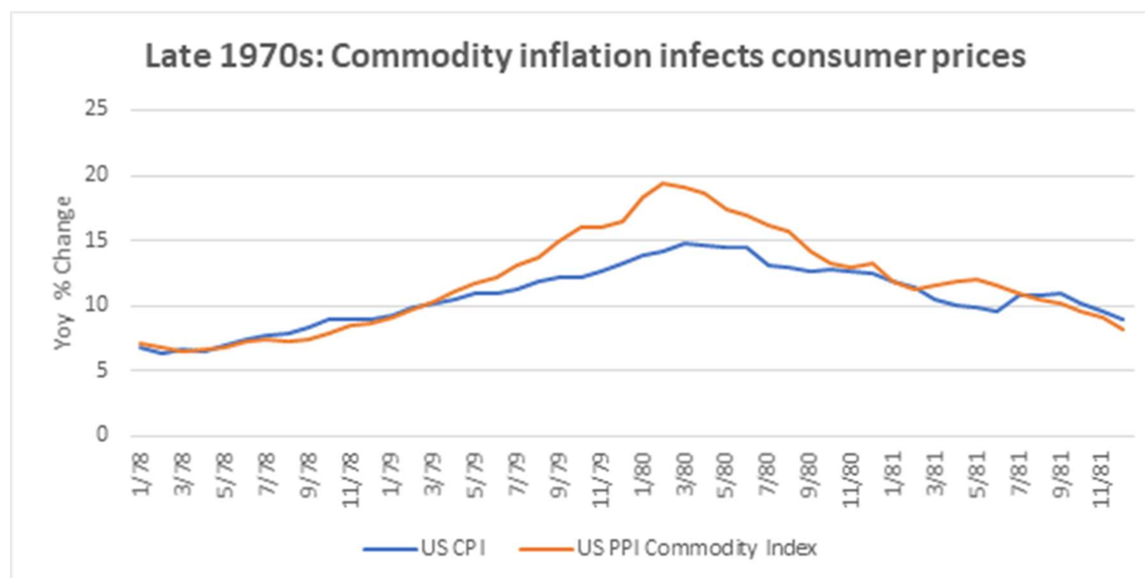
With inflation playing a prominent role in investor discussions, investors are increasingly looking to the 1970s to gain insights into potential prospective market behavior. While the late 1970s/early 1980s is the period attracting most investors' attention, we think the early 1970s is a more appropriate analog. From both a fiscal and monetary perspective, the early 1970s exhibited early signs of commodity inflation which set the foundation for the late 1970s inflationary period many current investors recall today.

The early 1970s saw inflationary factors accelerate. As the Vietnam War intensified, government deficit spending increased. Under President Nixon, in 1972 the US abandoned the gold standard, allowing the US to borrow backed only by the full faith of the government. And with geopolitical conflict rising in the Middle East, oil prices rose as OPEC was formed and declared an oil embargo against the West. Commodity inflation, as measured by the PPI Commodity Index, exceeded 10% year-over-year growth by the end of 1973 and peaked above 28% YoY growth in October 1974. However, the broader CPI Index exhibited less price acceleration, reaching 12% YoY growth during the same period. It is important to note that in the early 1970s, while commodities rallied strongly, the implied inflation rate of the non-commodity portion of CPI was minimal – strikingly similar to today's environment.



Source: Bloomberg, Recurrent Research

In the latter portion of the 1970s, inflation re-accelerated. Despite reduced involvement in Vietnam, US Government deficit spending continued. Commodity inflation re-emerged, as Middle Eastern geopolitical tensions highlighted the scarcity value of oil. Interestingly, the PPI Commodity Index saw a lower peak YoY growth rate, at 19.4%, while the CPI Index peaked at 14.8% YoY growth, higher than the 1974 peak.



Source: Bloomberg, Recurrent Research

When we think about the state of the economy today, many elements of the early 1970s bear noting. First and foremost, the first wave of inflation in the early 1970s was driven primarily by commodity inflation, as shown by the wide difference between commodity (PPI Commodity) and broad based (CPI) inflation measures. As inflation pressures persisted, the second inflationary wave in the late 1970s/early 1980s had a broader basis, highlighted by the broad economic indicators like CPI peaking alongside commodity-only indicators.

As the global economy recovers from the COVID induced slowdown, inflationary pressures are building, primarily due to commodity inflation. In previous monthly commentaries, we noted substantial price increases in lumber, copper, and steel, while oil prices have risen above $65/barrel, after falling to negative prices just over 13 months ago. While inflation in the short term seems to be aligned with consensus thinking, the long-term sustainability of inflationary pressures remains a hotly debated topic. When analyzing the early 1970s, the profound impact of commodity inflation on the broader economy is clear, which ultimately set the stage for the broad-based inflation more investors are familiar with from the late 1970s/early 1980s.

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