Midstream: We revisit the role of midstream allocations as inflation expectations rise. Historically, rising inflation, even off a low base, has generated strong performance, with high correlations. Despite the pandemic, 10-year inflation expectations have risen rapidly, near the 80th percentile vs. history, while trailing midstream performance is bottom decile, implying a potentially attractive entry point. Investment allocations to our sectors appear near all-time lows and are so far unmoved by rising inflation. For reasons discussed in the resources write-up below, we believe policymakers could let commodity inflation run hot as energy's impact on CPI is likely to remain muted for some time.

Natural Resources: Policymakers have signaled that consumer price inflation (CPI) will be allowed to accelerate as the global economy emerges from COVID. Commodity prices comprise a smaller % of CPI than ever before, implying that impacts on CPI are likely to remain muted even with meaningful increases in commodity and basic materials prices. The outcomes of central banks' stated policies are likely to include significant commodity price inflation and are likely to benefit cash flow-generative natural resources and energy investments.

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.

January 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 January 2021, the Recurrent MLP & Infrastructure Strategy generated net returns of +4.66%, lagging the +5.84% return of the Alerian MLP Index (AMZ) by -1.18%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.35% (annualized, net of fees). Please see the performance section at bottom for more detail.

Midstream energy allocations in a time of rising inflation expectations – has weak trailing performance pushed investors into excessive underweighting?

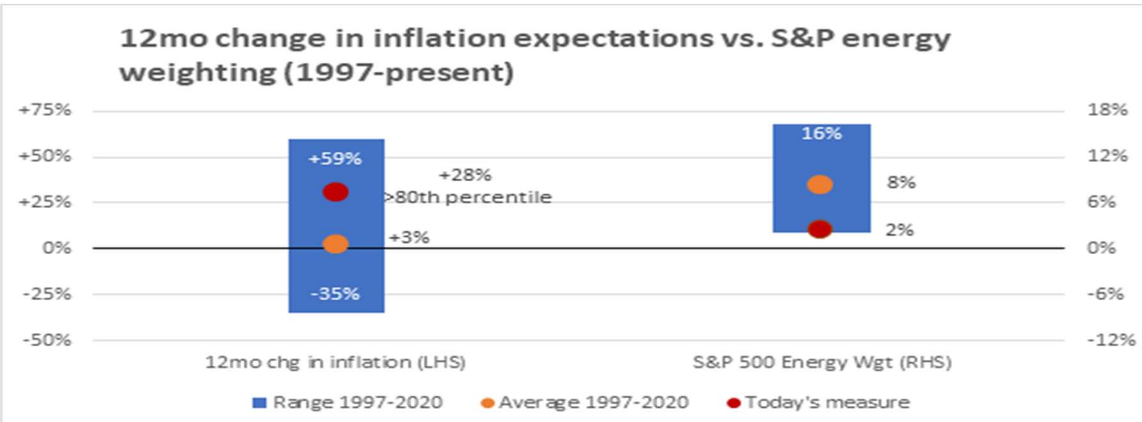
The broad midstream subsector (including Corps and MLPs in the US and Canada) has historically averaged 20% of the market cap of the S&P 500 Energy subsector, and so the S&P 500 Energy weighting of 2% (an all-time low) gives a useful, if imprecise, estimate of active allocations to the energy space today – with midstream representing only a fraction of that allocation.

On measuring inflation expectations: A widely-used measure of future inflation expectations – called an inflation "breakeven" – is derived by comparing yields on US Treasuries (UST) and Treasury Inflation

Protected Securities (TIPS). The difference, or "breakeven," between UST and TIPS yields gives us a market-based estimate of future inflation expectations, since TIPS principal amounts are adjusted to reflect cumulative changes in CPI inflation, while UST are paid in nominal dollars.

In the graph below, we see that despite an ongoing pandemic, 10-year inflation expectations have increased +28% over the last 12 months. Over a 23 year period, 12-month changes in inflation expectations have increased by as much as +59% and fallen by as much as -35%. Today's +28% measurement is approaching the 80th percentile of this range.

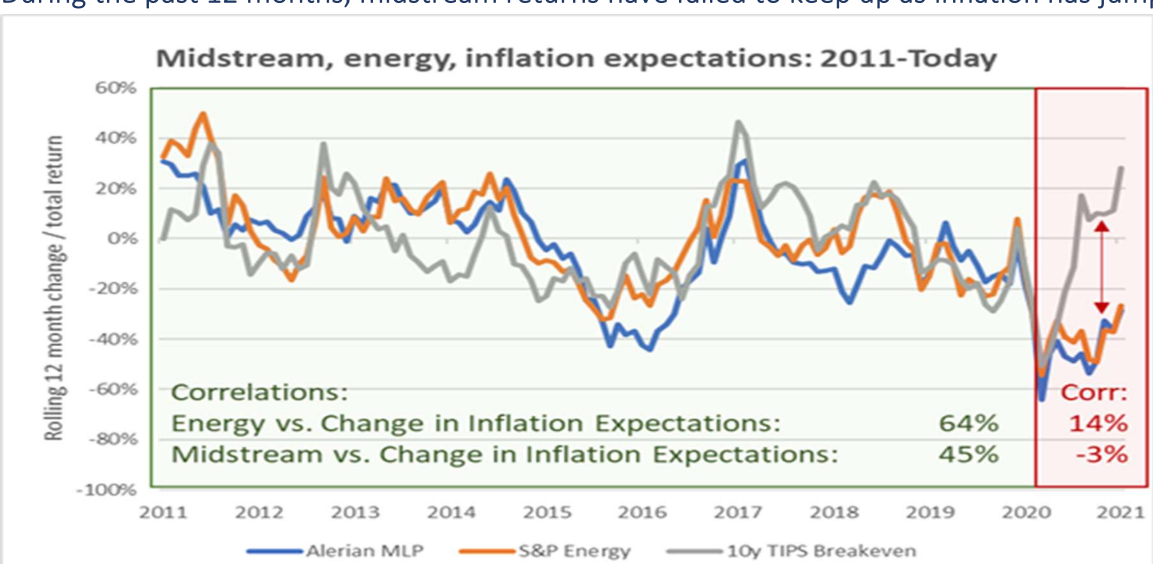
As inflation expectations are rapidly increasing (despite the last 12 months encompassing a pandemic), energy weightings sit at 2% of the S&P 500, an all-time low.



Data through January 31, 2021. Inflation expectations measured using 10-year US Treasury vs. 10-year TIPS. Source: Bloomberg data, Recurrent research.

Historically, energy and midstream sectors have tracked inflationary expectations with a high correlation – until today. As we see below, the dislocation between TIPS breakevens and midstream/energy performance is noteworthy, as shown in the trailing 10-year chart below.

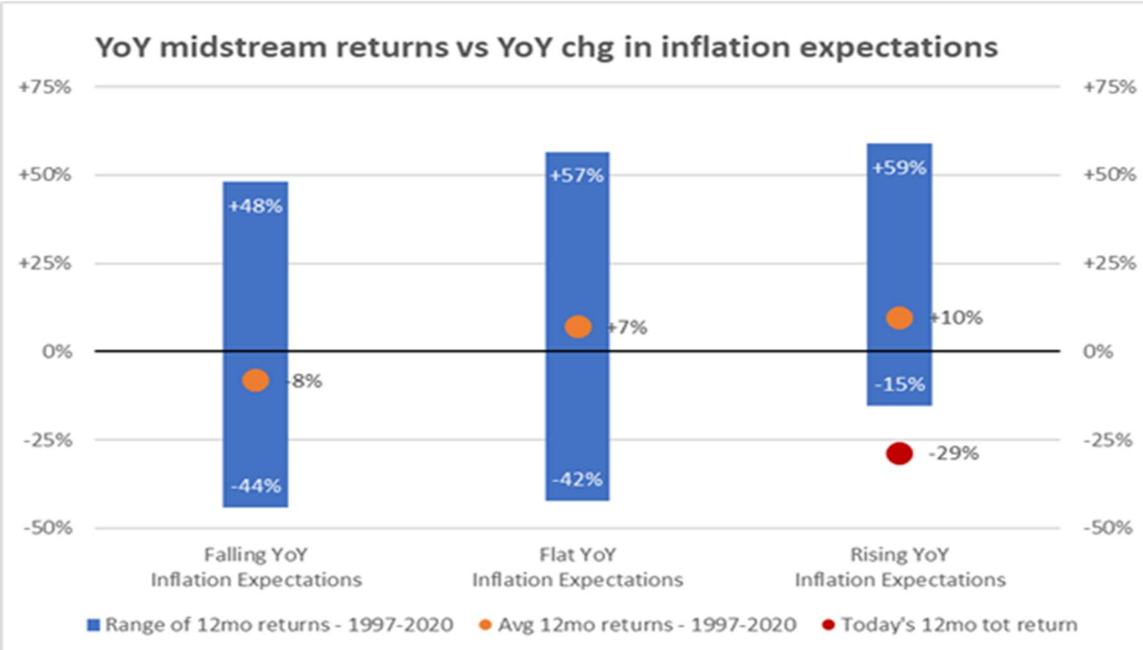
During the past 12 months, midstream returns have failed to keep up as inflation has jumped



Data through January 31, 2021. Source: Bloomberg data, Recurrent research.

If we include a longer time series, back to 1997, the dislocation remains striking. From 1997 to 2019, during periods of year-over-year (YoY) rising inflation expectations, the worst midstream 12-month total return was -15% - until now, where the -29% trailing 12-month return for the Alerian MLP Index (AMZ) is significantly worse than any historical period with a backdrop of rising inflation.

We see the current performance dislocation is noteworthy even if we include data back to 1997

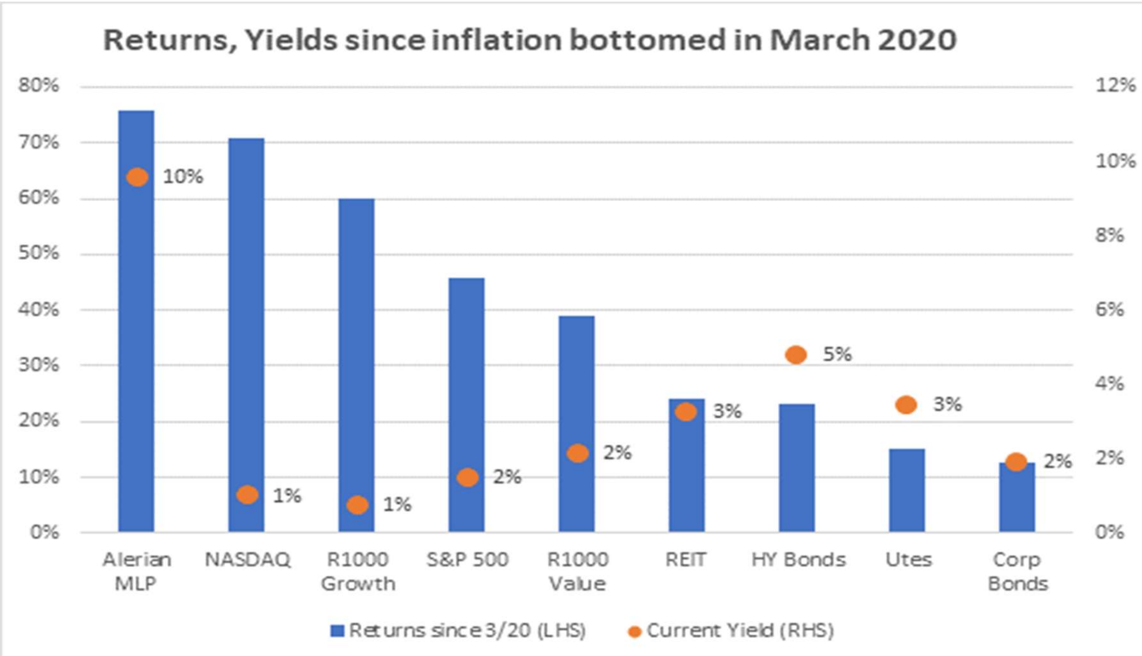


Data through January 31, 2021. Source: Bloomberg data, Recurrent research.

As we discuss in further detail in our resources writeup below, today's investment community is understandably weary of guarding against the threat of rising inflation – especially consumer inflation – when CPI has failed to meaningfully break above 5% since the 1970s. But ironically, it is the fact that CPI readings have been so muted – since commodity inputs comprise a smaller share of CPI than ever before – that policymakers are more likely to allow persistent commodity inflation as the global economy emerges from COVID.

This in turn could end up having a disproportionately positive impact on midstream sector revenues in the years to come, especially as other yield-oriented sectors struggle with the headwind of rising rates. It's come at the high price of trailing underperformance, but we see below that today, midstream appears positioned to generate meaningful yield and protect against rising inflation – attributes that have already been in evidence since inflation breakevens bottomed during March 2020.

Midstream may play an increasingly sought-after role in investor portfolios: inflation-resistant yield



Data through January 31, 2021. Source: Bloomberg data, Recurrent research.

Natural Resources

Performance Review

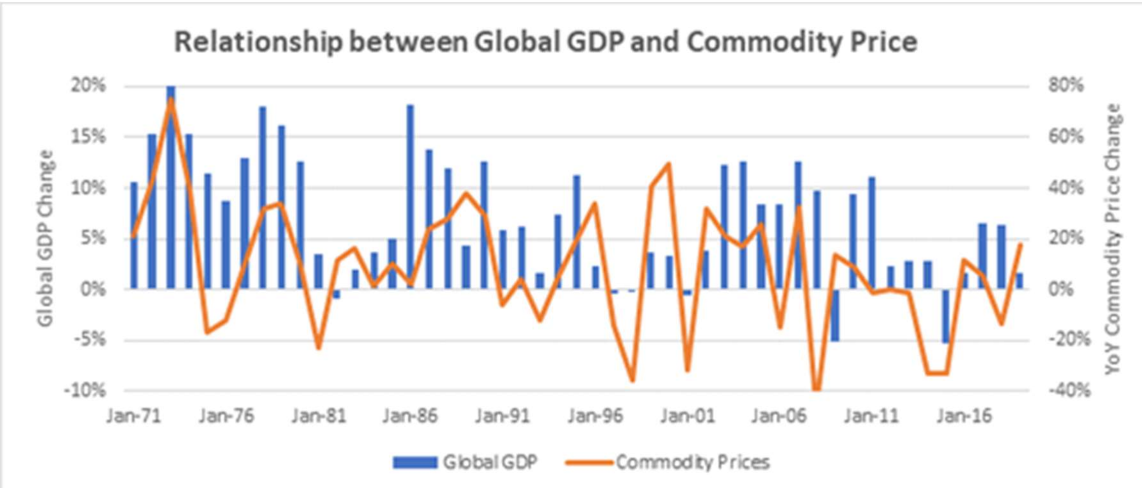
Natural resources markets outpaced broader markets as improving economic prospects and increased inflation expectations supported the sector. The Recurrent North American Natural Resources Strategy rose 1.97% net of fees, outperforming the S&P North American Natural Resources Index's 1.27% return. During the month, portfolio holdings Viper Energy, Renewable Energy Group and Plug Power rose by 18.24%, 26.52%, and 86.29% respectively. Aluminum and steel holdings fell, pausing after an extended period of outperformance.

Are GDP and inflation data effective indicators of inflationary cycles as in previous cycles?

Since the announcement of successful vaccine trials in November, global economic prospects have improved. In short order, the combination of strengthening economies and significant fiscal stimulus have increased inflation expectations, which many investors associate with physical assets like natural resources.

In this discussion we look at the evolution of Gross Domestic Product (GDP) and Consumer Price Index (CPI) and consider whether we can expect these widely tracked indices to appropriately identify inflationary economic trends, particularly regarding hard assets like natural resources.

As we outlined in last month's (December 2020) commentary, there is a strong historical relationship between commodity prices and GDP, as seen in the chart below. This relationship causes many investors to closely watch GDP and CPI for signs of inflation, influencing countless "physical asset" investment decisions.



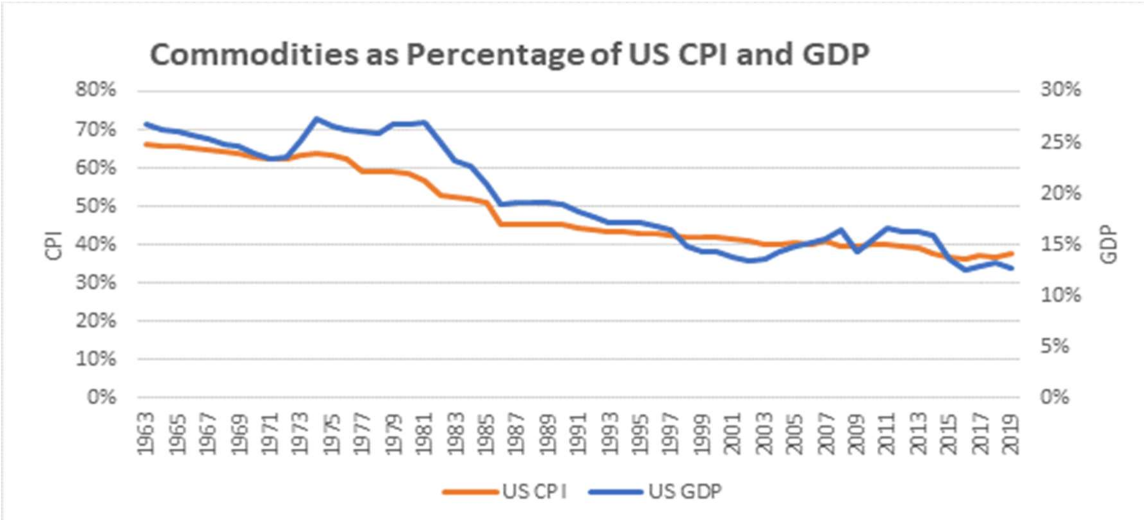
Source: Bloomberg, Recurrent research

With significant global fiscal stimulus and the prospect of global economic improvement as COVID impacts lessen, many investors look to historical periods as a guide. It has been many years since meaningful inflation in developed markets, with US CPI increases briefly exceeding 3% most recently in 2008, when YoY CPI growth reached a peak of 5% for a short period of time. More notably, in the 1970s CPI exceeded 10% YoY growth in 2 periods: from 1974-1975, and for a longer and even more intense period from 1979-1981.

The question many investors ask: Can 1970s-style inflation happen again?

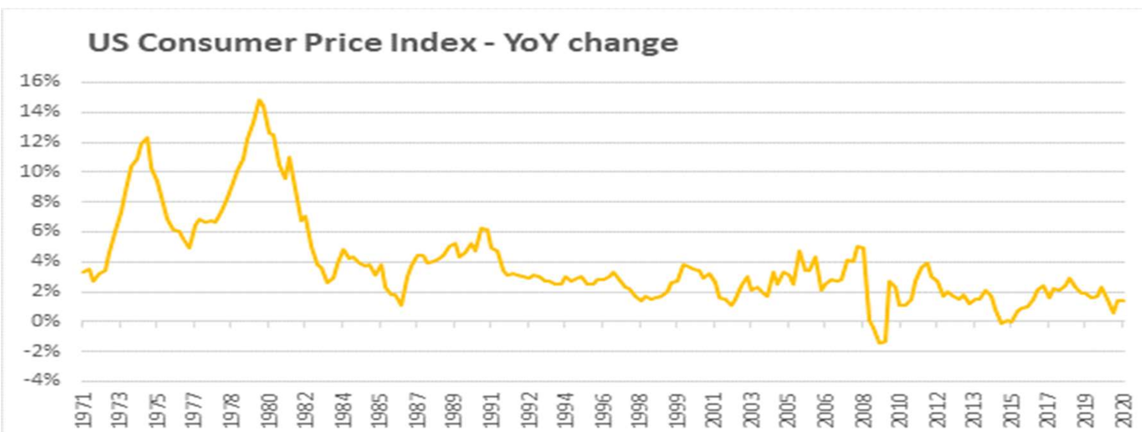
The short answer, as we discuss below, is no. But this is, counterintuitively, positive for hard assets and commodities, not negative. Services are a much larger part of today's economy than in the 1970s. In the 1970s, "hard assets", in the form of commodities and industrial goods, comprised approximately ***60%*** of the CPI and ***25%*** of US GDP. As services became a larger part of the US economy, those percentages have fallen to 38% and 13% respectively, as seen in the chart below.

Today, commodity-sensitive hard assets are a much smaller part of GDP, and accordingly, a smaller weighting in the "baskets" that central banks use when calculating inflation. With commodities and industrial goods as a much smaller portion of GDP and CPI than in the 1970s, price increases in commodities and hard assets are likely to be tolerated by monetary policy makers for much longer than in the 1970s, when the impact of rising commodity prices triggered meaningful increases in inflation that were felt by consumers almost immediately.



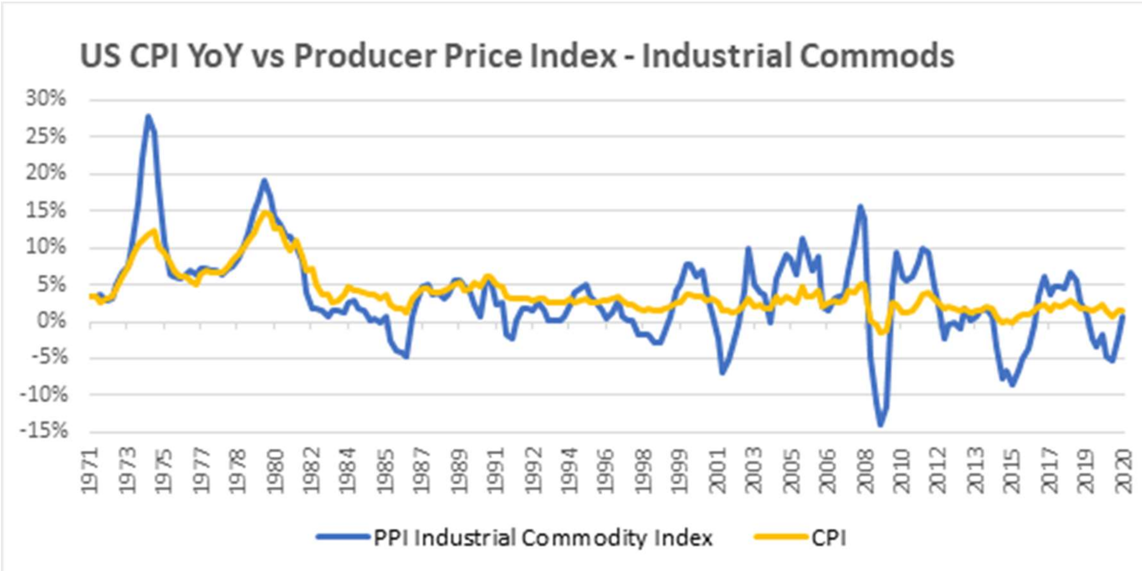
Source: Bloomberg and Recurrent research

The ability of "hard asset" prices to cause inflationary pressures is muted, particularly in broad based economic data such as CPI, which as of 2019 is 62.5% determined by services industries. In the first chart, we noted that YoY changes in commodity prices have ranged from -40%-+40% since the late 1970s. However, changes in the constitution of the CPI have muted the volatility, as seen below.



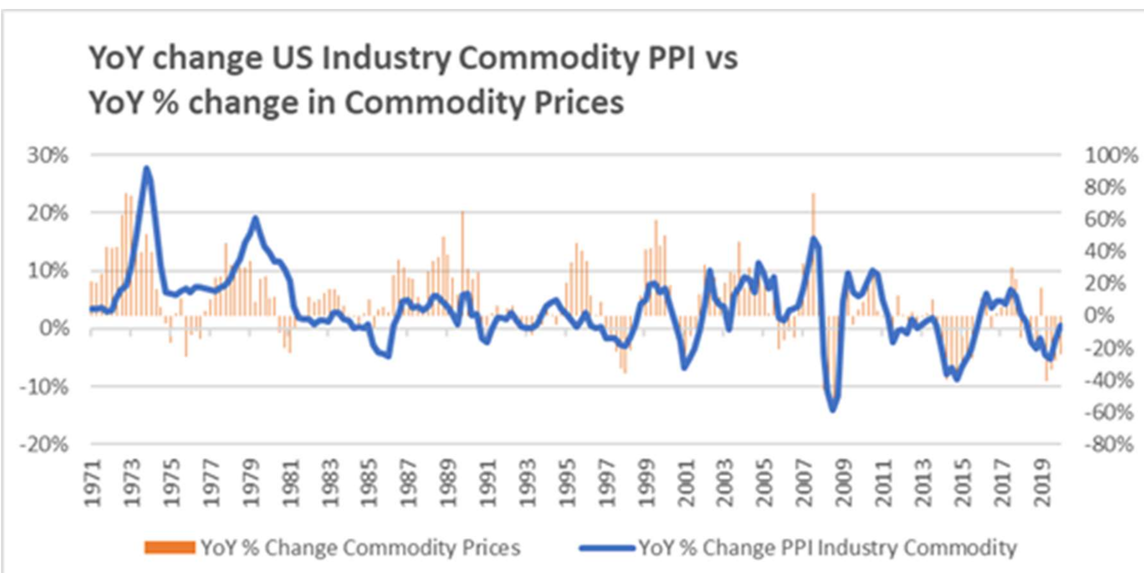
Source: Bloomberg and Recurrent research

To further highlight the reduced influence of hard assets in CPI, we can look to another economic data set – the Industrial Commodities portion of the Producer Price Index (PPI). As a closer approximation of the impact of hard assets on producers' input costs, we can see that that index's volatility remains, while CPI volatility has been reduced in comparison.



Source: Bloomberg and Recurrent research

As we monitor real-time economic indicators which identify asset inflation critical for natural resources investments, changes in commodity prices show a much stronger relationship to the Industrial Commodities PPI Index rather than the CPI, as shown below.



Source: Bloomberg and Recurrent research

As the US economy has evolved to a nearly 2/3 services focus, the CPI grown to be less valuable as an indicator of asset inflation. While many investors continue to look to CPI for signs of economic inflation, our analysis shows that compared to the past, higher levels of asset inflation would be required to have a meaningful impact on CPI. In an attempt to analyze monthly asset inflation data critical for natural resources investing, our focus has migrated from CPI data to secondary indicators like the PPI Industrial Commodities Index, which recent data shows to have already returned to 2019 levels.

The foregoing is for research purposes only. Does not constitute a recommendation or offer to buy any securities. This communication is intended for qualified investors and financial professionals only. If you have received this email in error, please contact us to be removed from our mailing list.