Energy Infrastructure: income investors find themselves paralyzed as the world waits on the Fed to cut rates. With much of the bond market priced for rate cuts, fixed income investors are forced to make an implicit bet on Fed policy, with asymmetric risk if the Fed doesn't cut. How can investors generate portfolio income without being hostage to the FOMC? Over the last 3 years, midstream has offered a rare combination: high income with minimal correlation to Fed policy. Our study below shows just how unique midstream has been, and how it can serve as a superior diversifier for rate-sensitive income portfolios.
Click here for our white paper exploring midstream's excess (and growing) yield vs. fixed income

Natural Resources: When discussing the short-term fluctuations in global oil prices, popular commentary regularly highlights geopolitical events. For example, recent news articles have focused on increasing, and then decreasing tensions in the Middle East as the cause for early summer rise, and late summer decline in oil prices. However, seasonal oil demand patterns have proven to play a much more consistent and identifiable role in oil price changes.
Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG

MLP & Infrastructure

Performance review

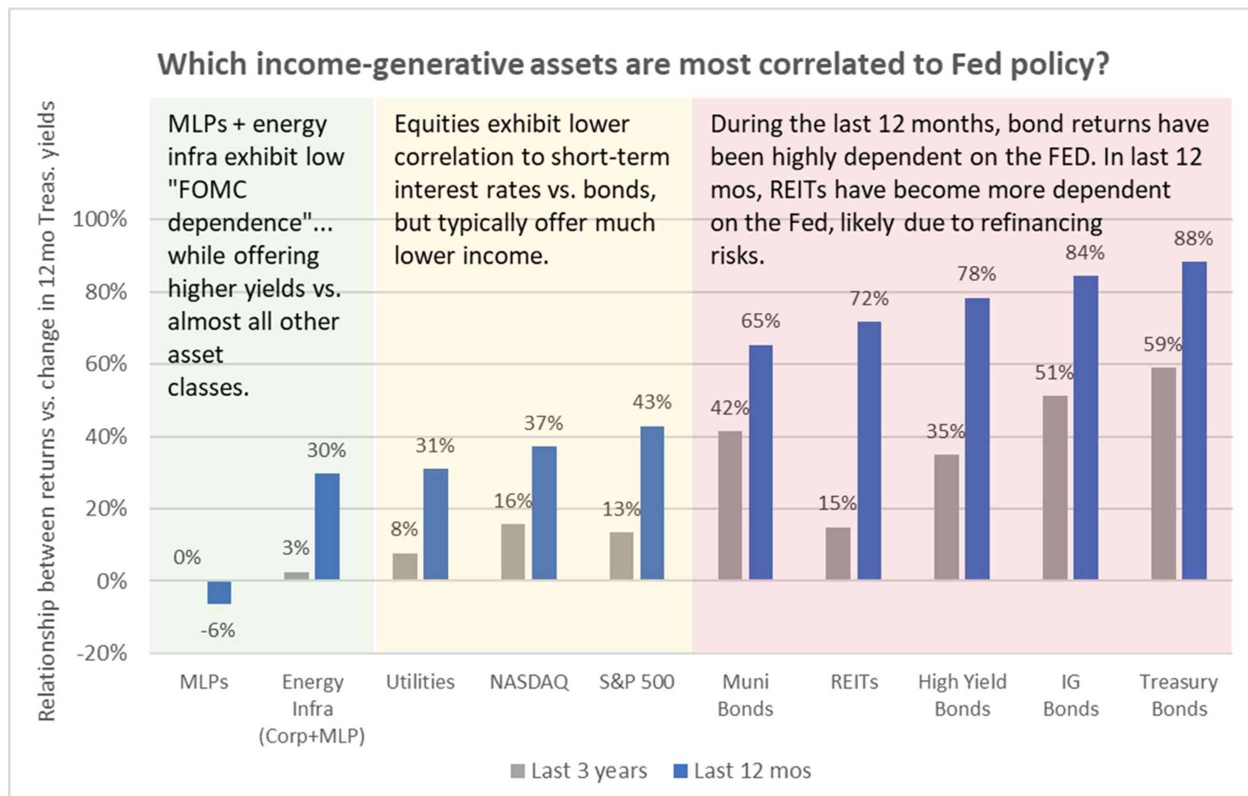
During the month of July 2024, the Recurrent MLP & Infrastructure Strategy generated net returns of +3.05%, outperforming the Alerian MLP Index's (AMZ) +0.62% return by +2.43%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +37.04% (+3.02% annualized), net of fees. On a gross basis, the Strategy has outperformed by +57.17% and +4.48% respectively. See performance section at bottom for more detail, plus performance detail on the Recurrent Energy Infrastructure Strategy, which seeks to track the MLP & Infrastructure Strategy while excluding MLPs.

Income investors are stuck between a rock (expensive bonds) and a hard place (hopes of aggressive Fed cuts)

With concerns of a global economic slowdown roiling the capital markets in early August, the bond markets appear to be pricing in at least two 50-basis-point rate cuts by the Federal Reserve in 2024. Income investors are now faced with buying bonds at lower yields, as fixed income investors wager that this previously hawkish FOMC (at least in public messaging) will pivot and cut rates aggressively to support slowing job and equity markets. For income investors skeptical of aggressive cuts, the risk-reward appears asymmetrically negative in bonds.

The graph below shows that bond buyers are correct in feeling trapped by the Fed. Bond performance has always depended on the path of interest rates, but correlations between bond returns and short-term Treasury rates (which closely track Fed policy) have spiked in

the last 12 months. Fed policy has always been important for fixed income investors, but it is the dominant variable today.



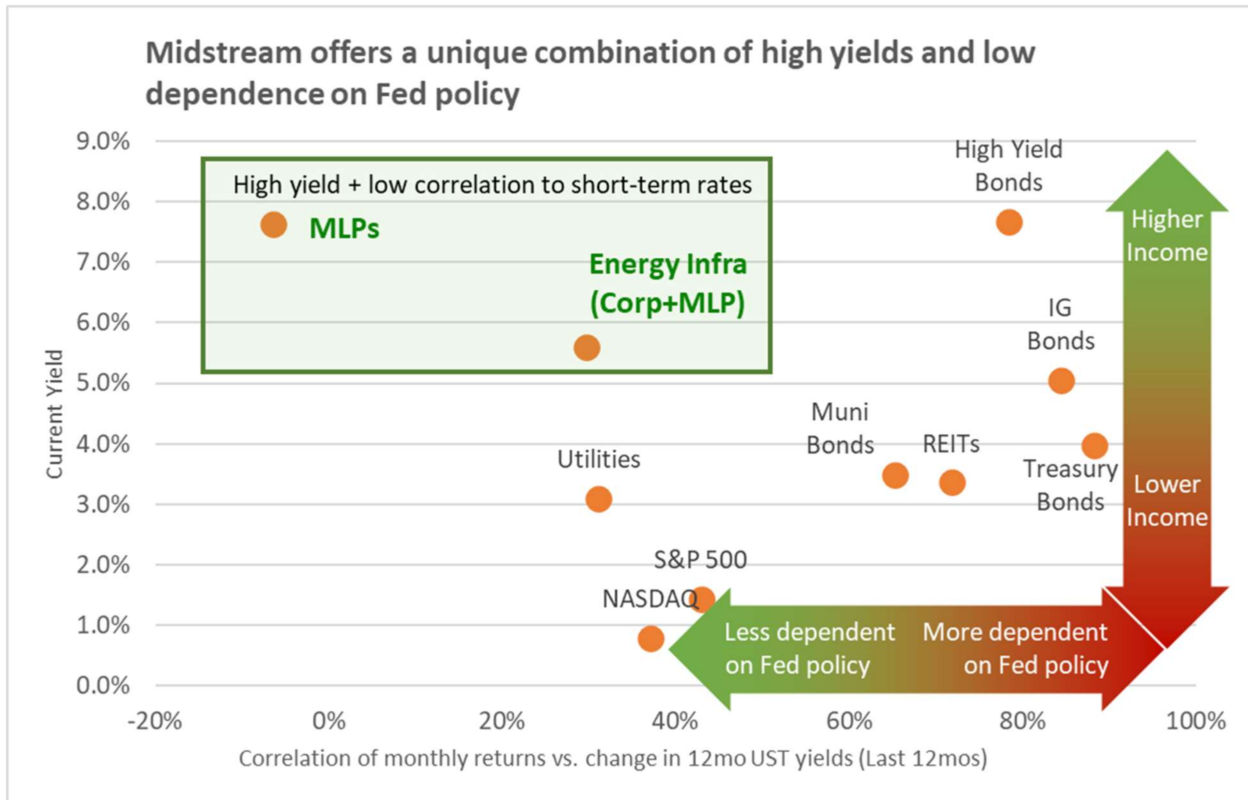
Notes: MLPs = Alerian MLP Index; Energy Infra = Alerian Midstream Energy Index; Utilities = S&P 500 Utilities; REITs = S&P 500 Real Estate; Muni Bonds, High Yield Bonds, IG Bonds, Treasury Bonds = LMBITR, LF98TRUU, LUACTRUU, LUATTRUU Bloomberg Indices.
Source: Recurrent research, Bloomberg.

Midstream correlations to the interest rate environment are consistently low, while offering outsized income

Above, we can see that **Treasuries** are most dependent on the Fed (88% correlation to changes in 12mo yields), while **investment grade bonds** are similarly Fed-dependent (84% correlation). **High yield bonds**, historically exhibiting lower duration risk and lower correlation to Fed policy, have also seen increasing correlations to the Fed. Interestingly, **REITs** have also seen a sharp increase in correlation to Fed policy, perhaps as refinancing risks have increased.

On the other end of the spectrum, we can see that returns for **MLPs** and **Energy Infrastructure** (MLPs + Corps) have exhibited very low correlations to short-term rates over the last 1- and 3-year periods, much lower than even broad equity indices. While **Utilities** have also exhibited low correlations to short-term rates, we have written elsewhere about our concerns regarding Utilities' financial health.

Perhaps most intriguingly, midstream offers a truly diversifying total return stream (given the low correlation to interest rates above), but also offers an income stream that looks much more like a high yield bond vs. a traditional equity. This is despite debt leverage, returns on capital, and payout ratios all at the best they have been in at least 20 years.



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Source: Recurrent research, Bloomberg.

For all the income investors glued to their screens, turning up the volume whenever a Fed governor speaks on the timing and magnitude of interest rate cuts, there may be an alternative: using **energy infrastructure** to generate income whose total return proposition is much more than a simple bet on the direction of Fed policy, and getting to enjoy some peace and quiet in the office.

Natural Resources

Performance Review

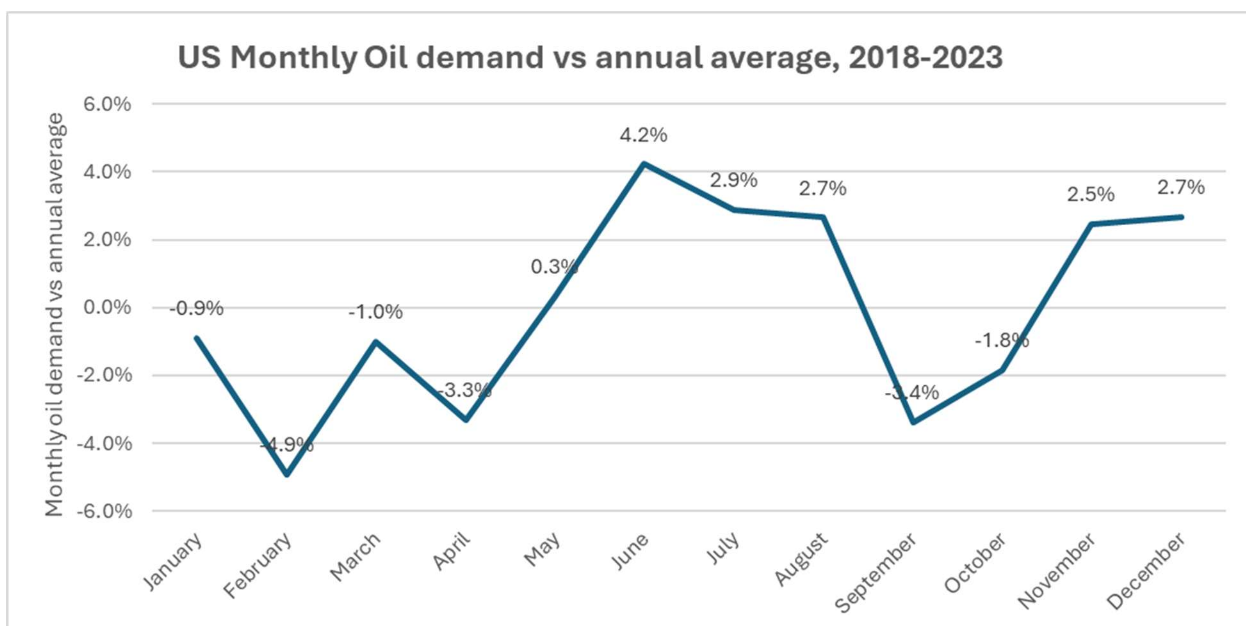
In the month of July, the Global Natural Resources strategy rose by 0.27% net of fees, underperforming the S&P Global Natural Resources Index's 1.37%. The portfolio's underweight in gold stocks negatively impacted performance, as the sector rose nearly 14% in the month. Additionally, the portfolio's overweight in aluminum equities weakened performance, as the sector fell more than 11% in the month.

Investment Discussion: seasonality can offer a more compelling – and less alarming – explanation for oil price volatility than media narratives

On a daily basis, oil market followers receive "news" articles, highlighting why oil prices rose/fell that day. The explanations frequently cite market sentiment regarding geo-political risks, primarily in the Middle East. A recent article on Morningstar noted "Crude is benefiting from a greater risk premium after tensions in the Middle East sharply escalated…". This, just a week after oil prices fell due to "increased concern" over economic risks…..and the news cycle "explaining" oil price movements spins on and on.

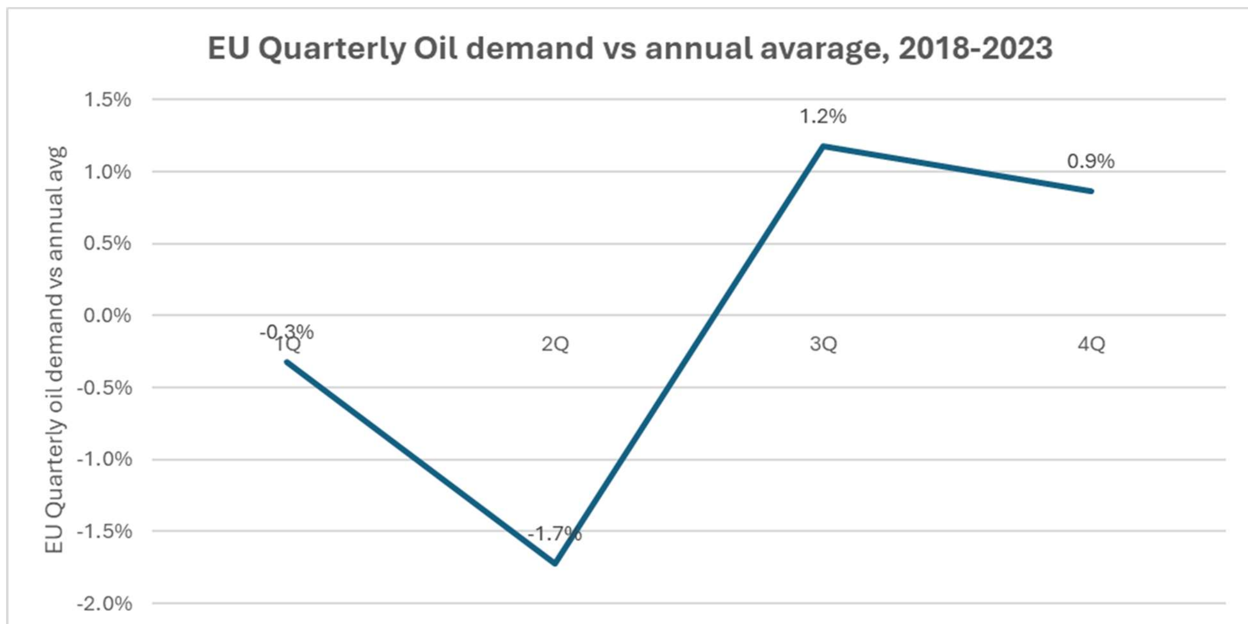
The volatility of oil prices has long been a challenge for a wide range of investors, from equities and bonds to commodities. Most of the financial commentary doesn't provide any repeatable process to predict oil prices, it merely identifies hypothetical rationales for daily price movements which in many cases are difficult to "prove".

A more reliable dynamic of the global oil industry is the seasonal change in demand. Summer is generally a time of higher demand, as vacations increase oil demand. As an example, when comparing US monthly oil demand to average annual demand, June/July/August demand from 2018-2023 is higher than the annual average by 4.23%/2.89%/2.65%, while the "shoulder months" of March/April and September/October are considerably lower than the annual average.



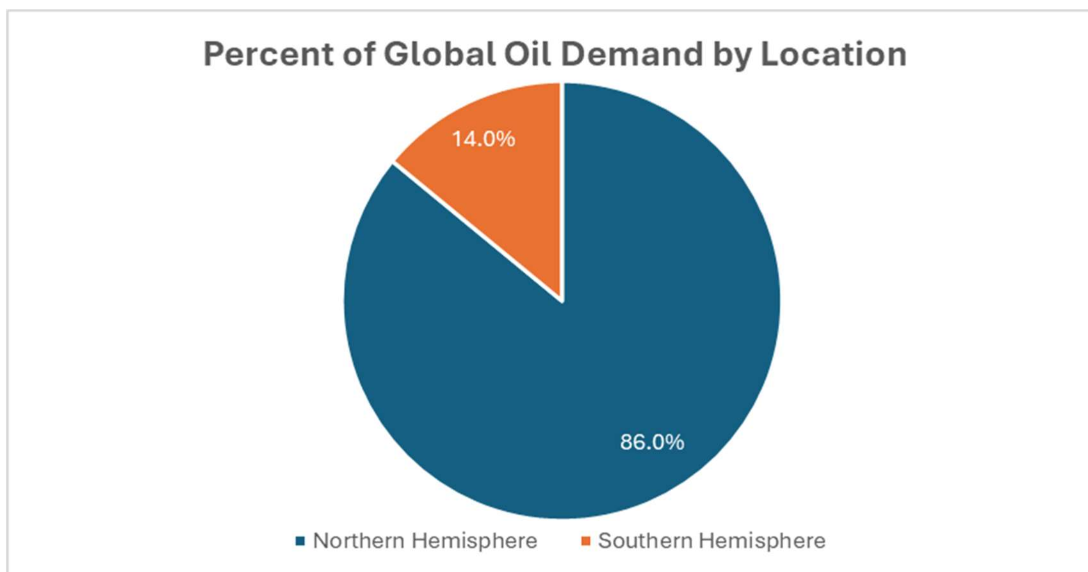
Source: Bloomberg, Recurrent Research

A similar pattern is identifiable in Europe, where 3Q demand is 1.18% higher than annual average demand over the same 2018-2023 period.



Source: Bloomberg, Recurrent Research

When considering the "summer" impact on global oil demand, it is important to note that nearly 86% of global oil demand resides in the Northern Hemisphere, with more than 60% in North America, Europe, Japan, South Korea and China. If summer is truly a higher demand period than winter, and 86% of global demand experiences summer at the same time, then seasonal impacts on global demand should have an identifiable impact which can generally be reflected in prices.



Source: 2022 BP Statistical Review, Recurrent Research

In the absence of other external factors, the seasonal demand factors would imply that global oil demand, and therefore price, should be highest in the summer. More specifically, the elevated demand

begins in late spring/early summer when refineries purchase oil to begin the refining process, and ending sometime between during the month of August as purchases slow in preparation for demand to slow at the end of summer.

The post-COVID experience of the oil market exhibits this relationship. In the 3-year average prices of oil measured on a month-over-month basis, oil prices rise leading into and during summer months, as shown by the increases in April-June. In August, as the summer is preparing to end, demand for oil to supply refineries slows. On average, oil prices fell by -4.78% as compared to July.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
3 Year Avg	+6.78	+8.03	-0.28	+4.45	+0.84	+2.25	+3.23	-4.78	+2.29	+3.16	-11.32	+3.43
		Refineries Ramp up for Summer						Refineries Ramp down for Winter				

Source: Bloomberg, Recurrent Research

So while every day we see news articles professing to identify the causes for oil price increases and decreases, we keep our eye on the calendar, reminding ourselves of the importance of seasonal impacts on demand and prices.

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