Midstream: After midstream veered into "euphoria" in May, mixed headlines, Covid spikes, and a heating up election campaign sharply reversed the rally in early June. Today, relative underperformance vs. the S&P 500 is again at late March's extremes. This strikes us as excessively negative, as we expect strong earnings reports in coming weeks. Recent news has ranged from "encouraging," as Warren Buffett made his first major investment in pipes since 2002, to "jarring" as an unprecedented court ruling ordered the shutdown of the Dakota Access Pipeline, finding a 4-year old environmental assessment "insufficient." This was specific to DAPL and broadly inapplicable, but it was a chilling reminder of the politicization of infrastructure. We expect DAPL and other disputes to find their way to the Supreme Court in coming months, where justices have generally lent pipelines a more sympathetic ear.

Natural Resources: Despite more recent concerns due to increased spread of COVID in many emerging markets and the Southern half of the United States, natural resources markets continued to recover in June, reflecting improving broader economic prospects. In global commodity markets, oil and copper global supply reductions have balanced markets, supporting commodity prices. Without ready supply additions on the horizon, further economic growth could increase prices closer to their long-term historical averages.

MLP & Infrastructure

Performance review

During the month of June 2020, the MLP & Infrastructure Strategy generated net returns of -2.95%, 4.92% better than the -7.87% return of the Alerian MLP Index (AMZ). Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.99% (annualized, net of fees). Please see the performance section below for more detail.

Portfolio discussion

Today's midstream market is notable, from our perspective, for its relatively strong operating results (as reflected in largely benign guidance revisions post-COVID), improving financial picture (reflected in lower debt loads), combined with frustrating sector performance and despondent investor sentiment, as the sharp underperformance of March 2020 has lingered, and outflows from midstream index products have continued. Despite poor investor sentiment and fatigue, fundamental headlines reflect the increasing value of pipeline assets and the attractiveness of low-growth, high cash flow assets as rates remain low and economic growth remains subdued.

Warren Buffett buys into pipelines, but perhaps more importantly, he bought pipelines that look like "tobacco"

On the evening of July 5, 2020, Warren Buffett made his first major foray into energy infrastructure since the early 2000s. By purchasing Dominion Energy's pipeline subsidiary and a stake in the Cove Point LNG export facility, Berkshire Hathaway effectively doubled the sizeable natural gas pipeline footprint that it acquired in 2002 in deals with Williams and Dynegy. *For more details on the deal, please reach out for our July 6 writeup.*

What, investors wondered, does Warren Buffett want with Dominion's low-growth natural gas pipeline system, which Dominion Energy sold after abandoning its ill-begotten midstream "growth" strategy?

How Dominion Midstream assets came to land in Warren Buffett's lap says a lot about the continuing evolution of the midstream sector. In the 2010s, midstream companies were growing rapidly, and trading at multiples significantly above historical ranges, as investors identified pipelines and MLPs as a "commodity agnostic" way to play the theme of growing shale production – the "American energy renaissance" theme. Perhaps bored by the "capped" growth rate in their regulated utility business, and enamored with the simplistic "yield + growth" midstream framework that Dominion executives heard from their investment bankers, Dominion launched an MLP and committed to a multi-billion dollar midstream growth program, capped by the $6bn Atlantic Coast Pipeline JV (ACP) with Duke Energy.

Several years later, the Dominion MLP was gone after a forgettable foray in the public markets, ACP was canceled, and Dominion was selling out of now highly-indebted pipeline assets to Warren Buffett, who saw a highly stable and cash flow-generative business underneath layers of financial neglect and high debt loads. In other words, Warren Buffett saw a low-growth business with limited capex and high free cash flow (FCF), as well as an excessive debt load that would rapidly be paid down by the assets' own cash flows, similar to the midstream business model we highlighted in **our white paper**. As we noted last month, it is this low-growth, high-FCF business model – which we likened to "tobacco" in the late 1990s – that makes midstream a compelling source of portfolio returns today.

As we noted in our recent white paper, we welcome the end of the midstream "shale growth era," because while catchphrases like "energy renaissance" and "energy independence" captured investors' imaginations and led to a short term expansion in midstream valuation multiples, the reality is that the shale-fueled growth plans meant that little cash flow was left for equity investors. These growth projects consumed cash, and left companies burdened with unprecedented debt loads and unable to support stable dividend policies (despite stable assets). The result has been a notably un-rewarding 5 years for midstream investors.

So while Dominion noted that its natural gas pipeline business had limited growth prospects beyond the now-canceled ACP, Warren Buffett saw assets that will generate nearly 10% free cash flow yields for decades to come in a world where interest rates are hovering just above (or below) zero, with minimal capital needs to support those cash flows.

Recent judicial rulings highlight the end of the "growth era," increase the value of existing pipelines

One day after the announcement of the Buffett-Dominion deal, the DC District Court shocked the market by ordering a shutdown of the DAPL Pipeline JV. *For more details on the rulings, please reach out for our July 6 writeup.*

In effect, the DC District Court held that DAPL's 4-year old environmental assessment, the quality of which had been hotly debated in the waning days of the Obama Administration, was "insufficient" for evaluating the environmental risks of the DAPL pipeline. ET's immediate response was to seek an appeal and then a stay with the DC District Court, both of which were summarily denied. It is now possible, if not likely, that ET is headed to a Circuit Court and ultimately to the Supreme Court. The Supreme Court has been hearing increasing numbers of pipeline disputes recently, a recent ruling regarding pipeline water crossings for assets under construction. The Supreme Court ruled favorably for pipeline companies, by issuing a stay, ruling that the Montana District Court's decision to vacate a streamlined water permit for all pipelines in the US was too broad given the concerns of the Montana Court, which were specific to Keystone XL.

While the outcome of DAPL is difficult to call, one thing is certain: the few major pipeline projects still under development or under construction in the US are going to find the environmental review and permitting process more and more challenging. While frustrating for the remaining pipelines still in legal limbo (primarily DAPL and Keystone XL, now that ACP is canceled and ETRN's Mountain Valley has been favorably impacted by the Supreme Court's ruling mentioned above), it is a reminder that long-haul pipeline assets are becoming more valuable, as new pipeline construction has been made prohibitively difficult and expensive by a patchwork of rulings that effectively make for a costly, multi-year pipeline planning and approval process for any long-haul pipeline.

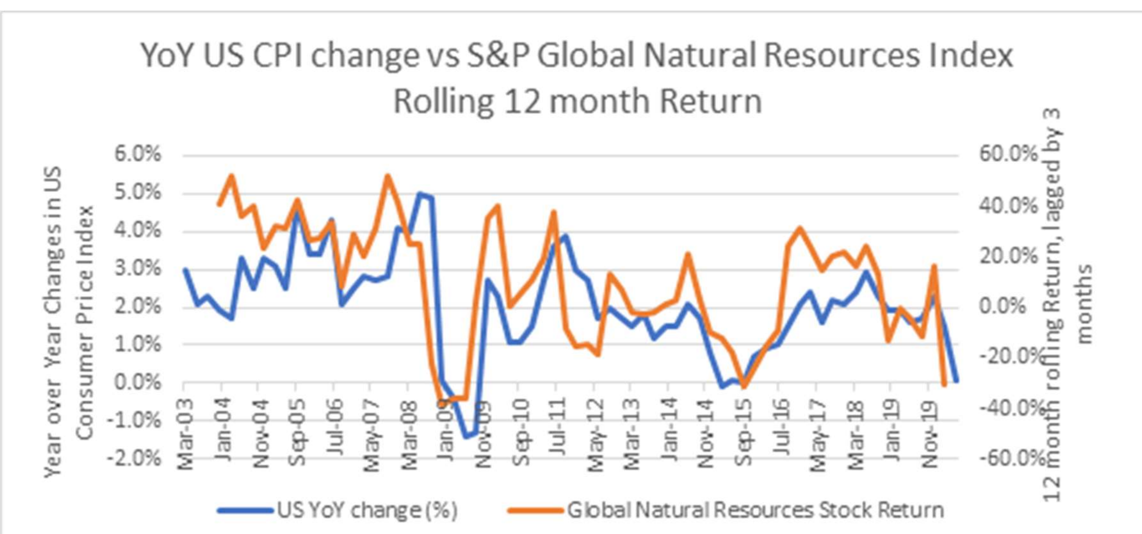
Natural Resources

Performance Review

During the month of June 2020, the Recurrent Natural Resources Strategy rose by 2.93%, outpacing the S&P North American Natural Resources' 0.88% return by 2.05%. Early cycle resources holdings, such as Freeport McMoran and Alcoa, performed strongly, rising 27.6% and 22.0% respectively, as improved global demand and supply discipline made markets much healthier. Energy companies underperformed, particularly in the US, as the re-acceleration of COVID cases muted demand prospects in highly populated Southern states.

Portfolio Discussion

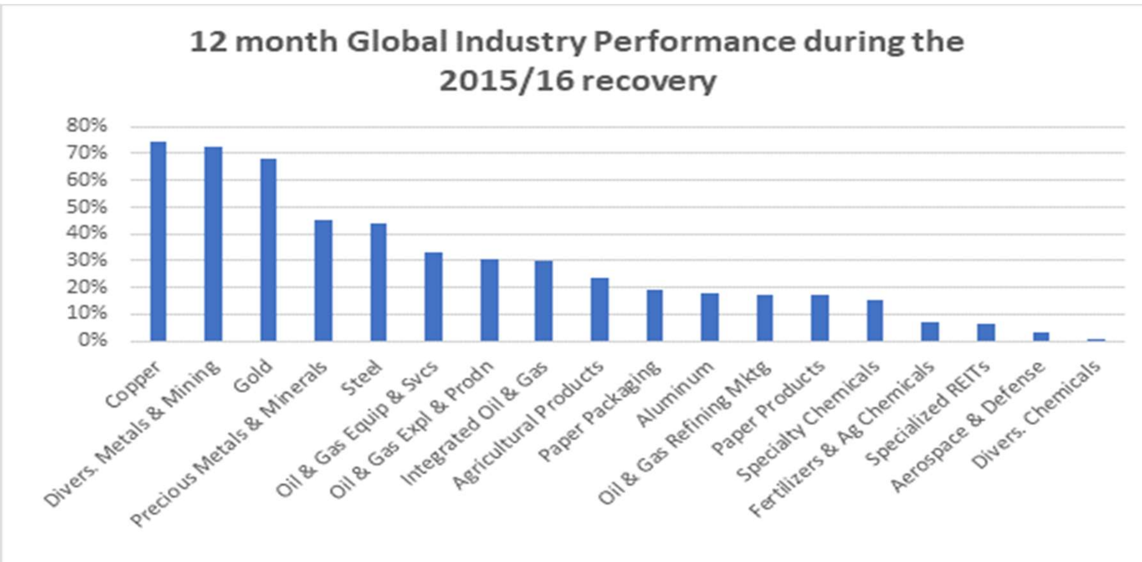
Since the beginning of COVID in 1Q, global economic growth has fallen into negative territory. Excess capacity in many industries has weakened pricing power, and global inflation has turned negative. As a beneficiary of inflation, the natural resources sectors have been among the market's worst performers. Many people are aware of the strong relationship between CPI and natural resources, as seen in the chart below.



Source: Bloomberg, Recurrent research

While many are appropriately focused on continued weak demand as a result of COVID, one other interesting conclusion stands out from the data since 2003. The CPI has only been this low 3 times since 2003, and in the other two cases, within a 15 month period (the chart shows rolling 12 month returns, on a 3 month lag), stock performance increased by 30% or more. Given reduced prices causing reduced supply in many resources industries, small increases in demand are likely to have an outsized impact on profitability, which is generally reflected in stock performance.

With that in mind, we looked at the 2015/2016 experience as an example to identify potential industries which would outperform in an economic recovery…

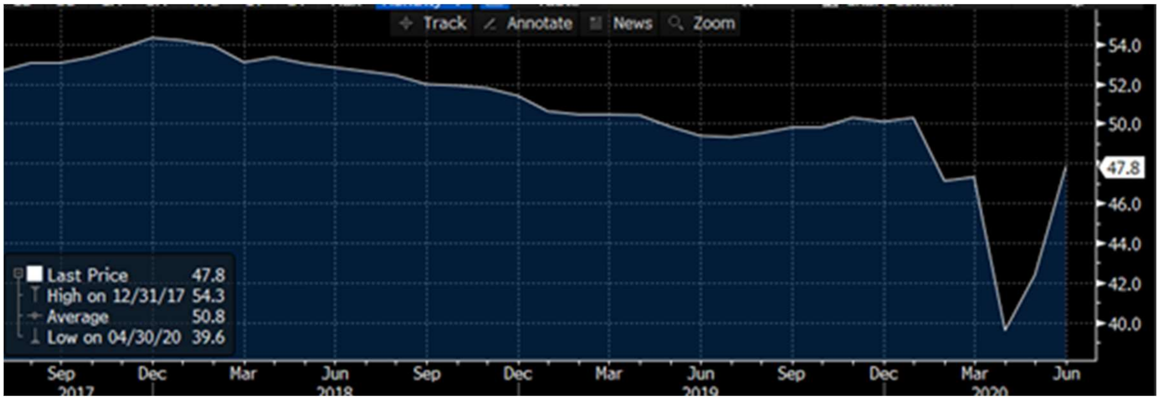


Source: Bloomberg, Recurrent research

While to many, the industries that lead the sector in a recovery probably are not all that surprising, the strength of the recovery may be of higher interest. Economically sensitive industries such as metals, steel, copper, and energy are most likely to benefit from a slack economy tightening, since increased volume is associated with pricing improvement, greatly improving profitability. More so, during times of economic weakness, it is natural to forecast continued weakness, or at best a muted recovery. Instead, this analysis shows that the recovery may in fact be more immediate and impactful than most realize.

Since the April trough, global manufacturing has since recovered to close to 2019 levels, as seen in the chart below. However, as we highlighted in our April monthly, many early beneficiaries of economic improvement – most notably aluminum and steel – still reflect bottom quartile valuations relative to historical levels. As such, the negative expectations embedded in current valuations is too pessimistic, and the portfolio is overweight these sectors in expectation of economic recovery.

JPM Global Manufacturing PMI, Seasonally Adjusted (3 year trailing)



Source: Bloomberg, Recurrent research
