Midstream: March 2020's midstream despair, which seemed overdone even as it occurred, tilted towards euphoria in May, with MLPs up over 60% since March 31st. With the closed-end fund dislocation largely corrected, we again pivot to the longer-term outlook for midstream stocks with our latest white paper (link below). We examine one of the "truths" that many midstream investors subscribe to: "growth is good." Unfortunately, this "truth" has not proven to be true – the era of shale-driven growth has hurt shareholders and left a legacy of high debt and weak returns on capital. Covid is accelerating the already-underway shift to a less capital-intensive midstream model with higher returns on capital. History shows that midstream investors have actually done best when midstream companies are less growth-oriented. The transition from "heavy spend, low cash flow" to "low spend, high cash flow" has historically driven strong relative and absolute stock returns for midstream. Investors in a variety other sectors, from tobacco to tech, have seen a similar pattern – we offer more detail around this trend in our white paper.

Natural Resources: Natural resources markets continued to recover from March 2020 lows, as signs of global economic recovery combined with low valuations to attract investor capital. As China, the US and Western Europe emerged from COVID restrictions, several commodities prices such as copper, iron ore and aluminum continued to strengthen. Notably, crude oil, which fell to a low of $-37/barrel in March, ended May higher than $35/barrel. Conversely, natural gas, which benefited from the prospect of reduced US oil shale drilling as oil prices fell, reversed gains as increased May oil prices portended increased oil shale drilling activity.

MLP & Infrastructure

Performance review

During the month of May 2020, the MLP & Infrastructure Strategy generated net returns of 6.79%, -2.16% behind the 8.95% return of the Alerian MLP Index (AMZ). Since the strategy's July 2017 inception, it has outperformed the AMZ by +3.65% (annualized, net of fees). Please see the performance section below for more detail.

Portfolio discussion

After performing relatively defensively vs. the Alerian MLP Index in Q1, the Recurrent MLP & Infrastructure portfolio has lagged the index in April and May. We seek to deliver long-term outperformance vs. the AMZ, and remain confident in our process and comfortable with our relative positioning. In April, we saw a violent rally among the midstream names with the most volume and commodity price exposures, as we would expect given the steep selloff in March. In May and early June, we've seen more speculative midstream companies continue to perform strongly on a relative basis, with the most notable outperformance coming from midstream operators whose assets are currently experiencing record low drilling activity, or in some cases, no drilling activity at all.

Driven by our focus on acquiring companies with a low ratio of EV/IC – that is, enterprise value (EV) to book value of invested capital (IC) and a track record of delivering high returns on invested capital (ROIC), we see a variety of opportunities in companies with strong historical and projected ROICs, trading at or below the historical cost of building the business. With this focus on historical (and prospective) returns on capital, our portfolio remains exposed to the subsectors of the energy economy where we believe we have the greatest line-of-sight to a post-Covid recovery: motor fuel demand (which must precede any broader commodity recovery), storage and long-haul transportation services (essential even with lower drilling activity), with a lesser focus on an absolute commodity recovery and relatively little exposure to a North American drilling recovery, especially in producing basins where we see drilling economics as challenged with oil prices below $55/bbl.

Natural Resources

Performance Review

During the month of May 2020, the Recurrent Natural Resources Strategy increased by 3.54%, outpacing the S&P North American Natural Resources' 2.55% return. During the month, stock selection in integrated oil and gas added value relative to the index, while Archrock Inc (AROC), an oil services company, rose 36% in the month. Overweights in economically sensitive sectors such as aluminum, chemical, and oil and gas refining added significant value in May, as several major global economies loosened shelter-in-place mandates.

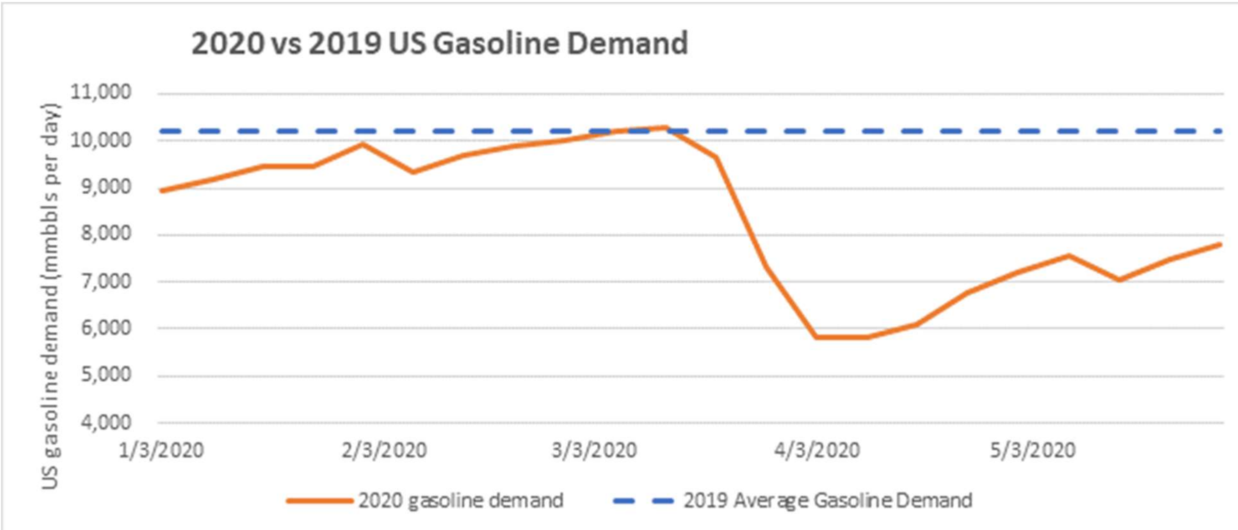
Portfolio Discussion - Early and clear signs that low oil prices will cause US oil production to fall, and more quickly than most realize…

As major global economies reduce quarantine mandates, early signs of economic recovery are present. China, the first major economy to loosen restrictions, is seeing the strongest signs of economic growth, with PMIs > 50 and demand growth in essential industrial materials like steel, copper and aluminum. While US and Western Europe PMIs remain <50, are rapidly improving, providing optimism for global demand growth. China, the US and Western Europe represent approximately 60% of global GDP and are critical to economic recovery. It is important to note that other regions such as Southern Asia, Latin America, the Middle East and Africa remain several weeks behind as COVID economic impacts remain on the upswing. Countries still facing negative economic impacts remain approximately 20% of global GDP, restraining the full global recovery, but the signals are clear – the recovery is broadly underway. Below are sample headlines that we saw during the month, that exemplify the building global economic recovery :

China steel mills run-rate marginally higher w/w

Global commercial aircraft utilization has recovered from 39% to 46% last week

Energy trends are similarly constructive, as mobility data, miles driven and urban congestion show persistent improvement, and early signs of increased airline traffic bode well for continued energy demand growth, necessary for a return to pre-COVID levels. The chart below shows the evolution of US gasoline demand in 2020 vs 2019. Early June data shows demand to be roughly 2 million barrels/day below average 2019 levels, with weekly growth approximating 500,000 barrels/day since early April troughs.



Source: Bloomberg, Recurrent Research

Similar to US commodity trends, European and Chinese gasoline demand trends trended favorably in May, as miles traveled increased, and as seen in the headline below, urban congestion increased as well:

France, UK and Greece seen notable increases in congestion

From an investment perspective, the key question is what the market is implying and whether or not those expectations are appropriate. In contrast to many market segments, many natural resources sectors remain at below average valuations, on many different metrics. While strong in absolute terms, May performance slightly underperformed the broader markets, and relative valuations grew even more inexpensive. As we highlighted in last month's commentary, many natural resources sectors remain well below multi-year valuation ranges, with aluminum, steel and energy exhibiting particular value despite strong performance since March 2020. Given the continued global economic recovery from COVID, we expect valuations in those sectors to improve, returning closer to long term averages as economic conditions normalize.
