Midstream: in our commentary 13 months ago, our analysis predicted that unprecedented buybacks in 2021 could offset potential outflows from midstream funds. How did our prediction hold up? Our expectation of record buybacks was met, but it was still trumped by fund outflows, although the balance improved dramatically vs. 2020. Going forward, there is good news: buybacks have only begun, with Q3 more than doubling Q2's pace. Several recent announcements all but guarantee another step-up in 2022. Encouragingly, there are early signs that growing buybacks are reducing the volatility seen in 2016-20.

Natural Resources: With inflation prominent in everyone's mind, we looked at the construction consistency of global CPI baskets. Unsurprisingly, since CPI baskets are designed to approximate regional spending habits, the composition of US and European CPI differs. However, by categorizing the underlying sub-categories consistently, notable differences emerge.

Check out Recurrent's video series, "Research in 99 Seconds," as well as our research white papers, here.

MLP & Infrastructure

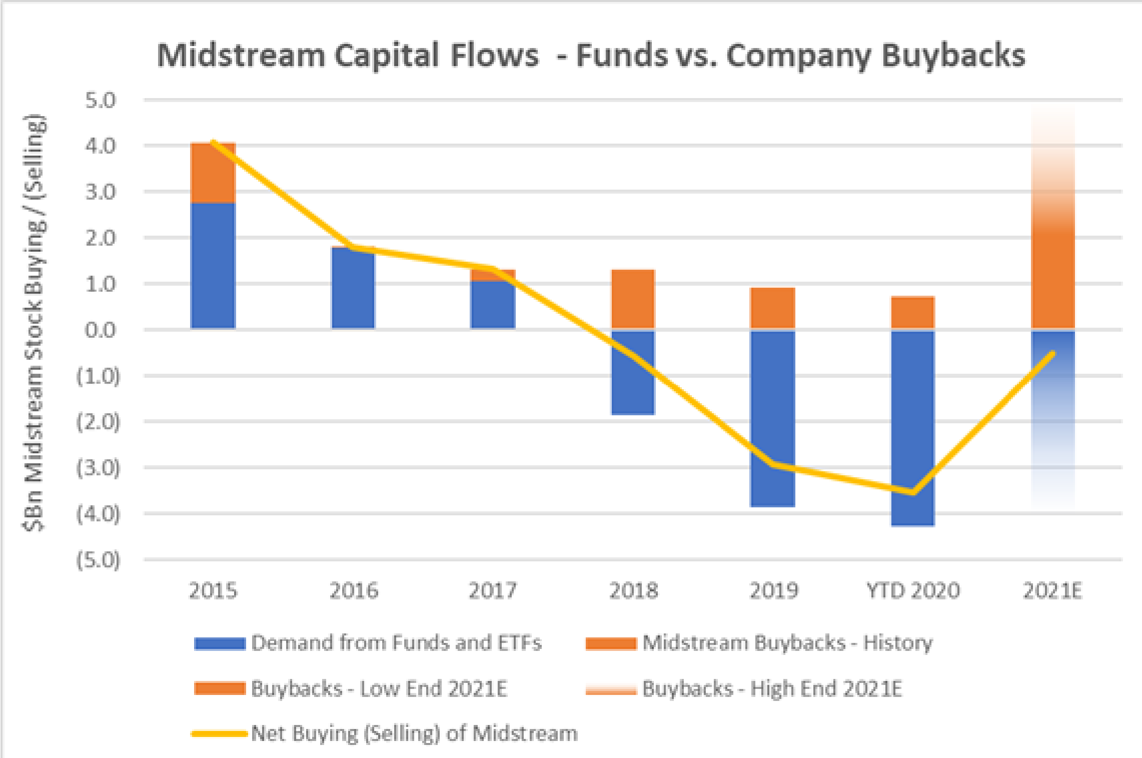
Performance review

During the month of November 2021, the Recurrent MLP & Infrastructure Strategy generated net returns of -6.99%, outperforming the -7.51% gross return of the Alerian MLP Index (AMZ) by +0.52%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.48% (annualized, net of fees). Please see the performance section at bottom for more detail.

13 months ago, we predicted that sizeable midstream fund outflows could be offset by buybacks

Back in our November 2020 investor letter, we wrote that potential 2021E buybacks could "mitigate even the record midstream capital outflows in 2020 YTD," which reached $5bn. Thankfully, investor redemptions and outflows from midstream funds and ETFs have not reached the brutal levels of 2020, but at just over $3bn, remained significant in 2021. Similarly, while the pace of midstream buybacks through Q3 2021 has exceeded anything seen in the past decade, buybacks have only utilized a third of the "roughly $5bn of free cash flow" we forecasted 13 months ago.

Exhibit 1: our November 2020 forecast saw $2bn to $5bn of buybacks to offset outflows



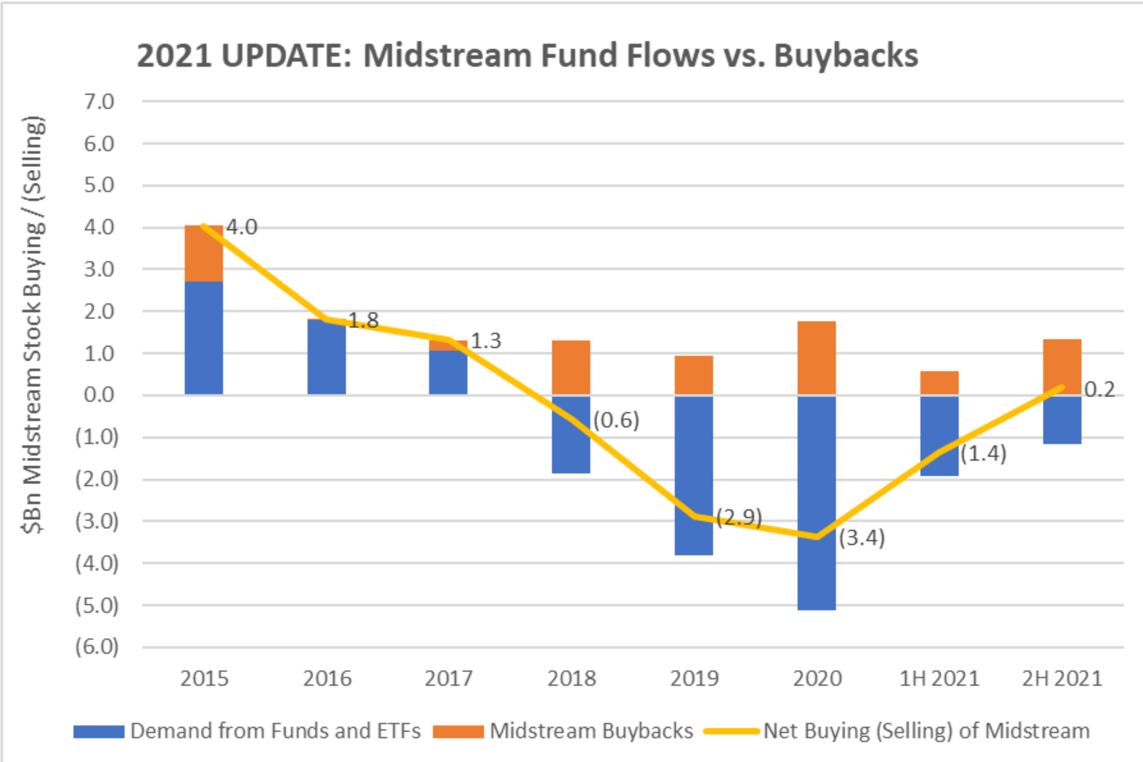
Source: Recurrent research, Bloomberg data

In 2021, buybacks took longer to materialize than we expected, although progress has accelerated into 2022

In reality, the $1.9bn annual buyback pace seen YTD in 2021 was the strongest buyback pace seen in the history of the midstream sector, but it represented roughly a 35% payout ratio vs. the available FCF we forecast back in Nov 2020. What happened? Well, of course, the stop-start nature of the fight against COVID – with 2 variants slowing the pace of recovery during 2021 – caused management teams to take a more cautious approach, holding more cash in reserve with a slower pace of buybacks than we expected.

Notably, despite the (likely overstated) shock of Omicron in late November, the pace of buybacks has accelerated across the midstream sector in 2H 2021, with buybacks accelerating and outflows decelerating as we move towards 2021. As shown below, 2H 2021 saw net buying for the first time since 2017.

Exhibit 2: buybacks started slow but accelerated into 2H 2021, driving the first net buying since 2017

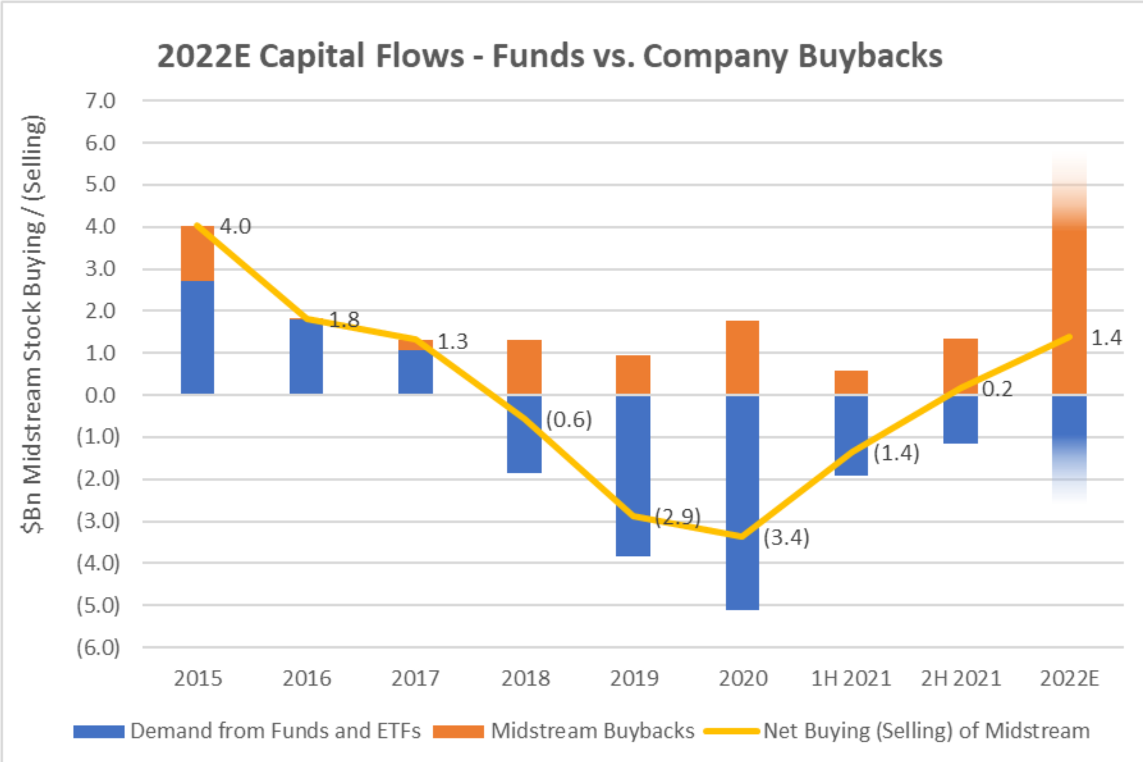


Source: Recurrent research, Bloomberg data

With several large-cap buyback programs announced in recent months, another sizeable step-up in buybacks is likely in 2022

We acknowledge that the slow ramp up of buyback activity caused our buyback forecast to come up short in terms of absolute dollars. Notably, ET and KMI experienced windfall profits in Q1 2021, but opted to retain cash and eschew buybacks altogether in 2021. That said, the same trend of growing FCF and restrained dividend payouts that drove record buybacks in 2021 will continue and gain momentum into 2022, with several major buyback plans announced in 2H 2021 (including large-cap names like LNG, WMB, TRP, ENB, KMI, PBA and MMP). Accordingly, below we share our forecast of midstream buybacks for 2022E, which promises to be the best year of net buying since at least 2017. Of course, as fund managers ourselves, we are eager to see the trend of sector outflows come to an end, but even if it doesn't, 2022E buybacks will be enough to offset all but 2020's COVID-driven $5bn outflow tidal wave.

Exhibit 3: even 30% utilization of 2021 buyback announcements would offset $3-4bn of sector outflows



Source: Recurrent research, Bloomberg data

A final question: do buybacks even help the midstream sector?

The increase in buyback activity has triggered a key debate: for a sector like midstream, with a long history of rewarding investors with dividends, do buybacks actually help improve trading dynamics?

While a definitive "yes" or "no" answer is impossible, it is undoubtedly true that buybacks are a natural way to address potential oversupply of midstream equities available for sale each day in the stock market. And while unscientific, the last 13 months have suggested that midstream upside/downside capture vs. the S&P 500 has improved after years of a clear negative skew vs. the broad market.

We would suggest that there is no "wrong" answer as midstream management teams fight their way out of a period of negative investor sentiment and dedicated fund outflows. Buybacks are certainly a good first step to address oversupply of stock in the market, but for a low-growth, high-FCF sector like midstream, regular and special dividends also provide a powerful proof point that the years of low cash generation and debt reduction are definitively behind us.

Natural Resources

Performance Review

In the month of November 2021, the Recurrent Global Natural Resources Strategy fell by -5.56% net of fees, underperforming the S&P Global Natural Resources Index's -4.54% return by -1.02%.

The Recurrent North American Natural Resources strategy fell by -4.90%, underperforming the S&P North American Index's -4.49% fall. During the month, Alcoa, a top 10 holding, rose 1.26% and significantly outperformed the global aluminum sector's -11.63% return. Steel holding ArcelorMittal fell by -20.59%, detracting from portfolio performance.

Investment discussion – breaking down differences between US and EU CPI measures

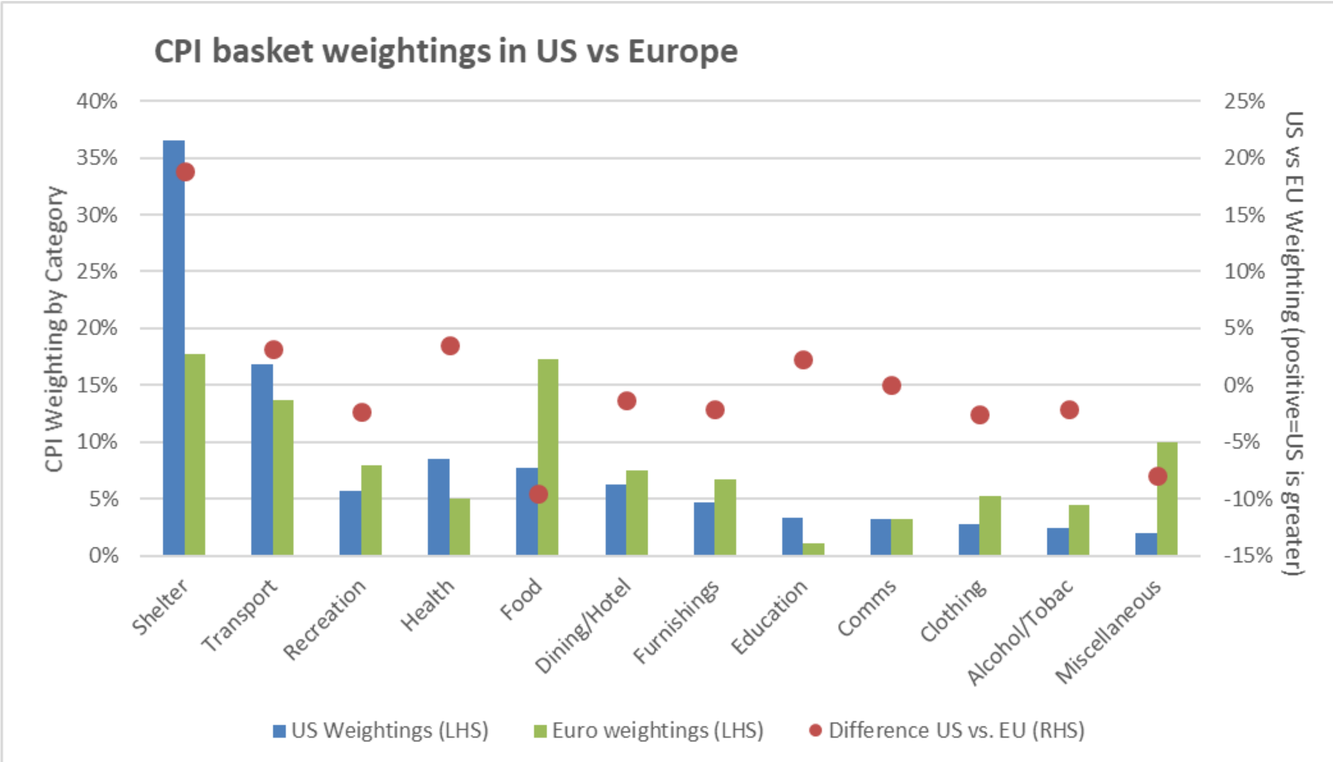
In the last few months, more and more investors we speak with are interested in the topic of inflation. Price indices, whether measuring consumer or producer prices, are closely watched to determine the pace of price growth and the economic impact.

While the figures are widely referenced, how the indices are created – what is in the CPI basket – is less understood. Since the baskets are designed to represent consumption patterns, localized differences are to be expected. However, broadly speaking, it seems easy to assume the that baskets are relatively similar in their constitution, making for straightforward comparability.

In that vein, our commentary this month may serve to be somewhat surprising. When comparing CPI baskets in the US and the Eurozone, compositional differences proved to be quite large. In each Index, broader categories, such as "food", have sub-categories such as "fruits" and "non-alcoholic beverages". In that regard, the indices are structured similarly.

In other areas, differences grow larger. For example, in the US version of CPI, sub-categories titled "electricity" and "natural gas" costs are categorized as "energy", whereas in Europe those sub-categories are defined as "shelter". While seemingly small individual differences, when aggregated the basket shows meaningful changes. To better understand the differences between the baskets, we used the European CPI basket categorization methodology to reconstruct the US CPI basket.

As seen in the chart below, when the industries are adjusted to be compared on a like-for-like basis, there are large differences between several sectors of the US and European CPI baskets. Most notably, In the US, housing comprises more than 36%, more than double the European weighting. European food and beverages (both alcoholic and non-alcoholic) comprise double the weighing of the US basket.

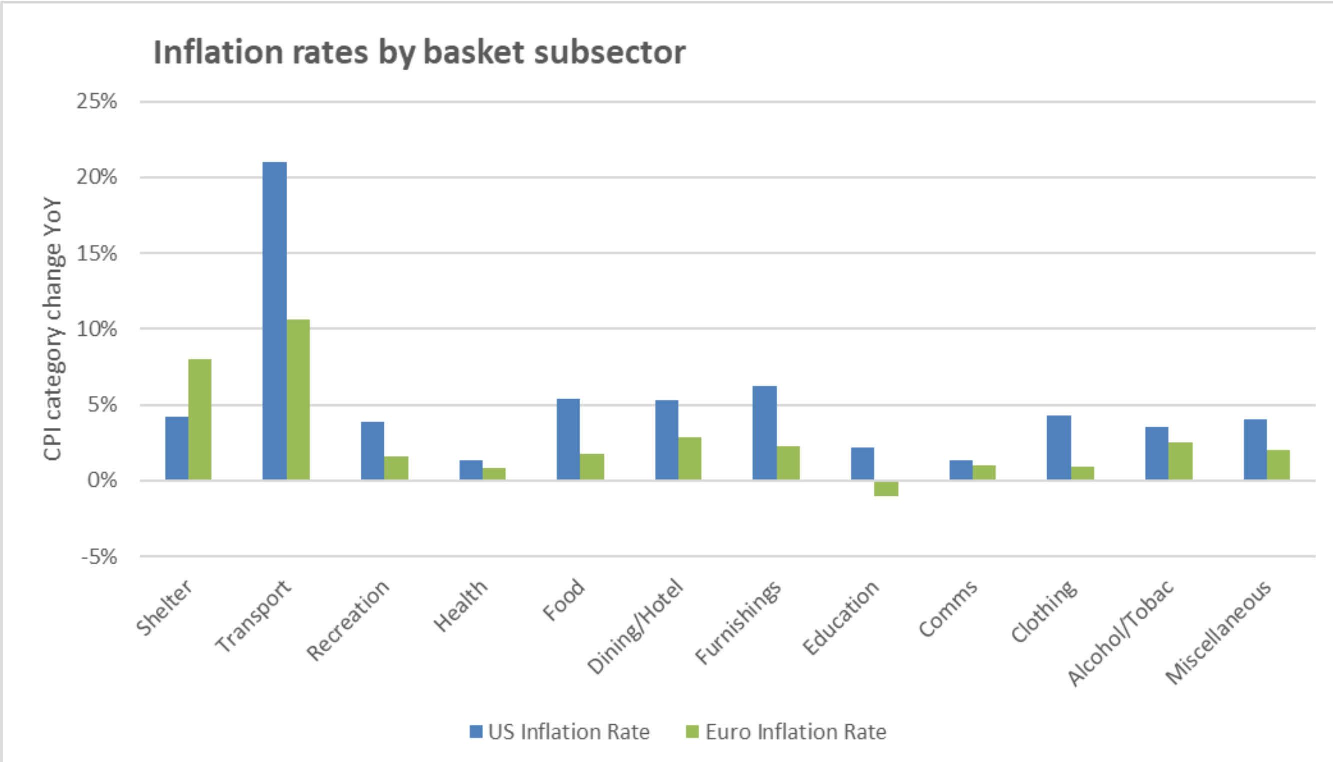


Source: Recurrent research, Bloomberg data, US Bureau of Labor Statistics, European Central Bank

While there are many side comments about European vs American spending habits which may be worthy of inclusion, the broader issue is the general comparability of the two widely used indices. The most recent measure of US inflation as measured by CPI exceeds 6%, while in Europe, the CPI remains higher than normal, but below 5%.

A few points of interest regarding the respective CPI compositions:

- Within both the US and Europe, by far the largest contributors to recent inflation, given their relative size and rate of inflation, are the transport and shelter sectors. While the rate of inflation is not particularly high for the housing components of shelter, since electricity and natural gas are included, the broader sector's inflation rate is much higher.
- In both the US and European CPI calculations, the largest contributor to inflation is the transport sector. In the European method of calculating the CPI basket, this sector includes energy; with the recent increase in oil and gasoline prices, the rate of inflation in many sub-sectors exceeds ***50***% year over year. Interestingly, despite headlines outlining the increase in European natural gas prices, the smaller weighting in the European basket dilutes the impact to the overall inflation rate. In the US, energy inflation and its higher weighting accounted for more than 50% of all US inflation, when calculated using the European CPI classifications.
- Interestingly, European inflation is relatively muted outside of the energy and transport sectors. Major components of the CPI basket like food and clothing remain at inflation rates <3%, with negative inflation rates for education! In contrast, the US basket shows elevated inflation across more economic sectors.



Source: Recurrent research, Bloomberg data, US Bureau of Labor Statistics, European Central Bank

In the last 12 months, inflation has moved to regularly top the general news cycle. While the headline figures show elevated inflation, within certain sub-categories, regional differences exhibit further inflationary stresses, particularly relating to energy (hitting the EU "Shelter" category especially hard) and transportation (which has driven up prices at the pump in the US).

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