Midstream: Elevated unemployment and rising commodity prices almost never occur together – with exceptions in the 1970s, when the US abandoned the gold standard, and half a century later, in 1H 2021. Despite clear inflationary trends, many investors remain underweight energy. Many have opted for REITs, TIPS, gold, and even utes. Below, we show these assets have been inconsistent (at best) at hedging inflation, while midstream and energy have been more reliable hedges, with higher betas to changes in economic conditions, meaning even small allocations can provide powerful protection.

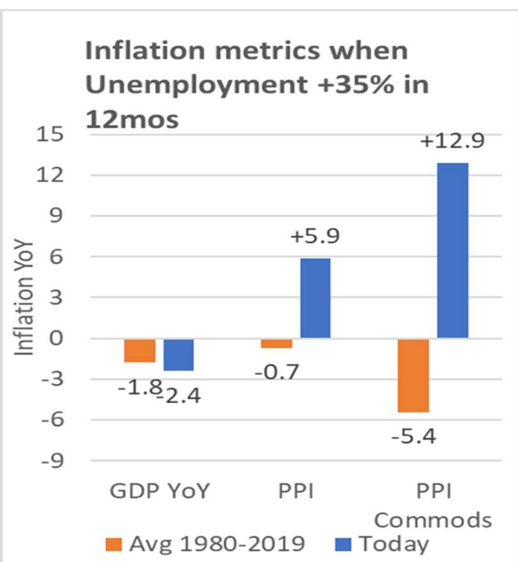
Natural Resources: While many investors note the economic similarities between 1H 2021 and the 1970s, the stock data necessary to analyze market behaviors is more difficult to find. Commonly used financial data services such as Bloomberg do not maintain historical data encompassing companies' full publicly traded history. As such, the inconsistency of data makes historical relationships to the 1970s more difficult to assess, leaving many investors without a complete understanding of how the inflation of the 1970s upended stock market dynamics.

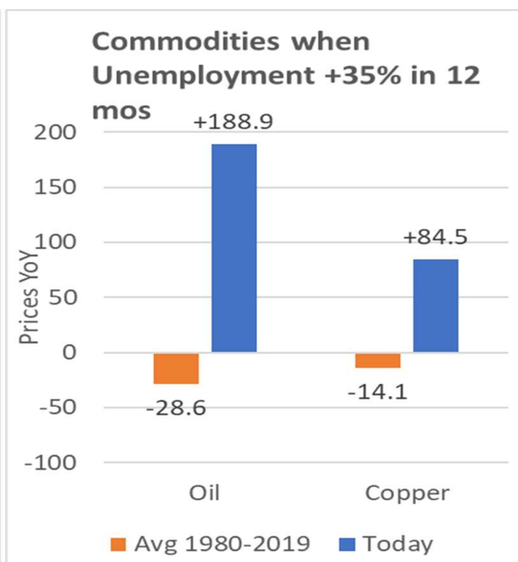
Check out Recurrent's new video series, "Research in 99 Seconds" here.

MLP & Infrastructure

High unemployment hasn't stopped surging commodity inflation – even before the stimulus appears in the data

As discussed last month, signs of inflation are emerging at an unexpected time – the physical economy is depressed by lingering impacts of the pandemic, and joblessness remains elevated. We update last month's charts below, where the signals have only become more emphatic since last month.





Data through March 31, 2021. Source: Bloomberg data, Bureau of Labor Statistics, Recurrent research.

Investors are starting to pay attention, but many common inflation hedges are ineffective

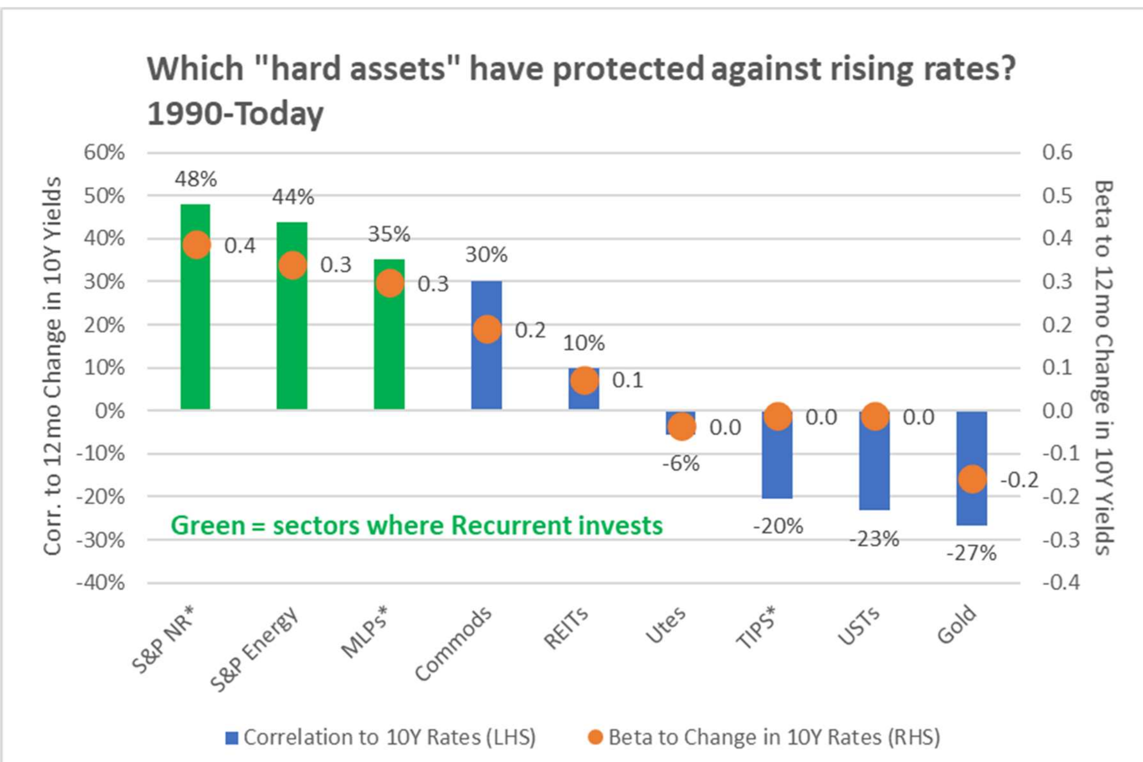
Inflation expectations (as measured by Treasury/TIPS breakevens) are now at their highest point since before the 2008 Great Financial Crisis. With "real rates" (interest rates less inflation expectations) currently negative, interest rates and inflation expectations are both marching higher.

How are investors hedging against the risk of rising rates and rising inflation? Many investors remain underweight energy (vs. a historically low 2.8% S&P 500 weighting as of 3/31), opting for a "diversified basket" of TIPS, gold, REITs, and even utilities. This quirky set of "real assets" seems to illustrate how many allocators do not have an effective "playbook" for inflation, given a ~40-year cycle of falling rates and falling inflation since the early 1980s – more on that blindspot in our natural resources writeup.

Many portfolios – including "real asset" allocations – are vulnerable to higher rates

As we show here, over the past 30 years, natural resources, energy, and midstream have offered some of the highest correlations to changes in interest rates (measured by 10-year Treasuries), as well as the highest beta to the underlying change in rates.

Some consensus hedges, like REITs, utilities, gold and TIPS, have offered <u>negative</u> exposure to rising rates, with REIT and utility businesses typically highly vulnerable to rising costs of financing. Meanwhile, embedded CPI hedges in TIPS have historically offered little protection in the event of higher interest rates.

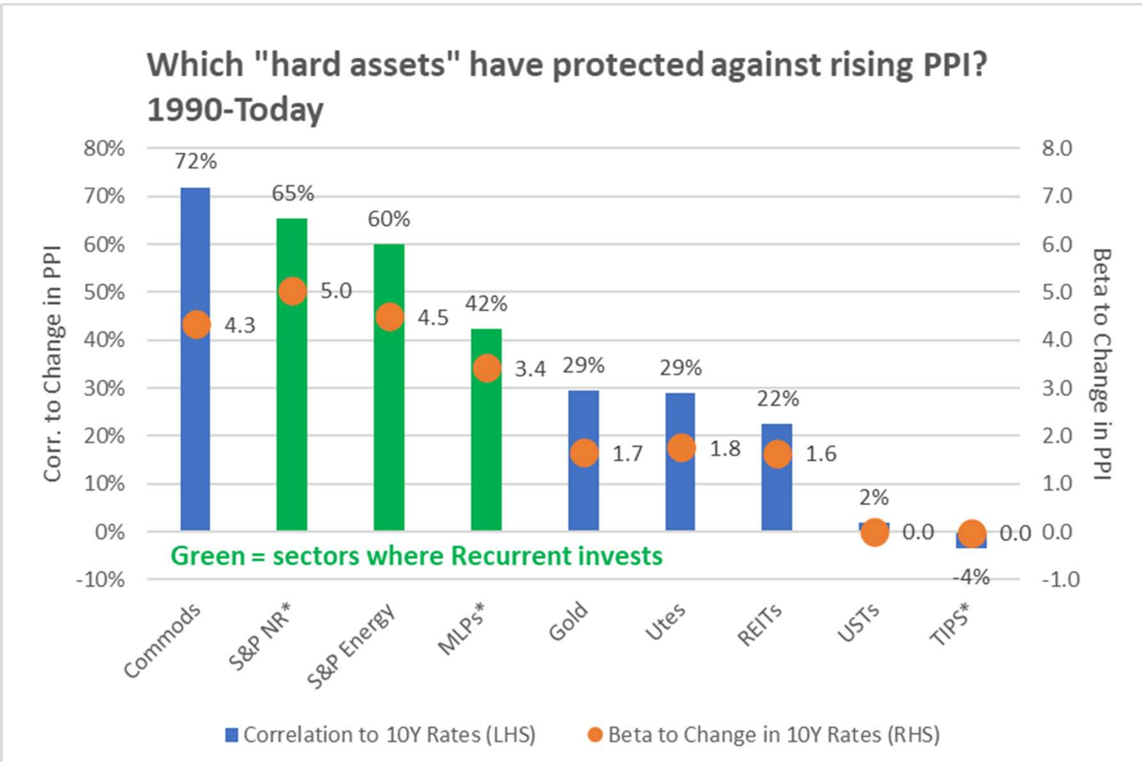


Data through March 31, 2021. Source: Bloomberg data, Bureau of Labor Statistics, Recurrent research.
Notes: Commods = Bloomberg Commodity Index; REITs = Dow Jones REIT Index; Utilities = S&P Utilities; MLPs = Alerian MLP Index; TIPS/Treasuries = Bloomberg Barclays Indices. Asterisk indicates data series beginning in 1997 (24 years instead of 31).

Many portfolios' "real assets" have historically offered weak hedges vs. PPI inflation

So many "hard assets" are in fact highly vulnerable to higher rates, but even against changes in PPI inflation, these "hard assets" offer lower correlations and a lower beta to changes in the underlying inflation rate than energy, midstream, and natural resources.

TIPS once again offer weak correlation vs. PPI and low beta, as TIPS remain vulnerable to higher rates. Gold and utilities have offered some protection, but with such low beta that a larger allocation is required to achieve the same effect as a smaller energy allocation.



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Ultimately, we believe that underweight energy investors will increasingly be forced to consider an allocation as inflationary pressures continue to grow throughout 2021 – it is a topic we expect to continue to follow in detail as the impacts of fiscal stimulus and widespread vaccinations are better understood.

Natural Resources

Investment Discussion – difficulties in analyzing the impact of inflation on the stock market of the 1970s

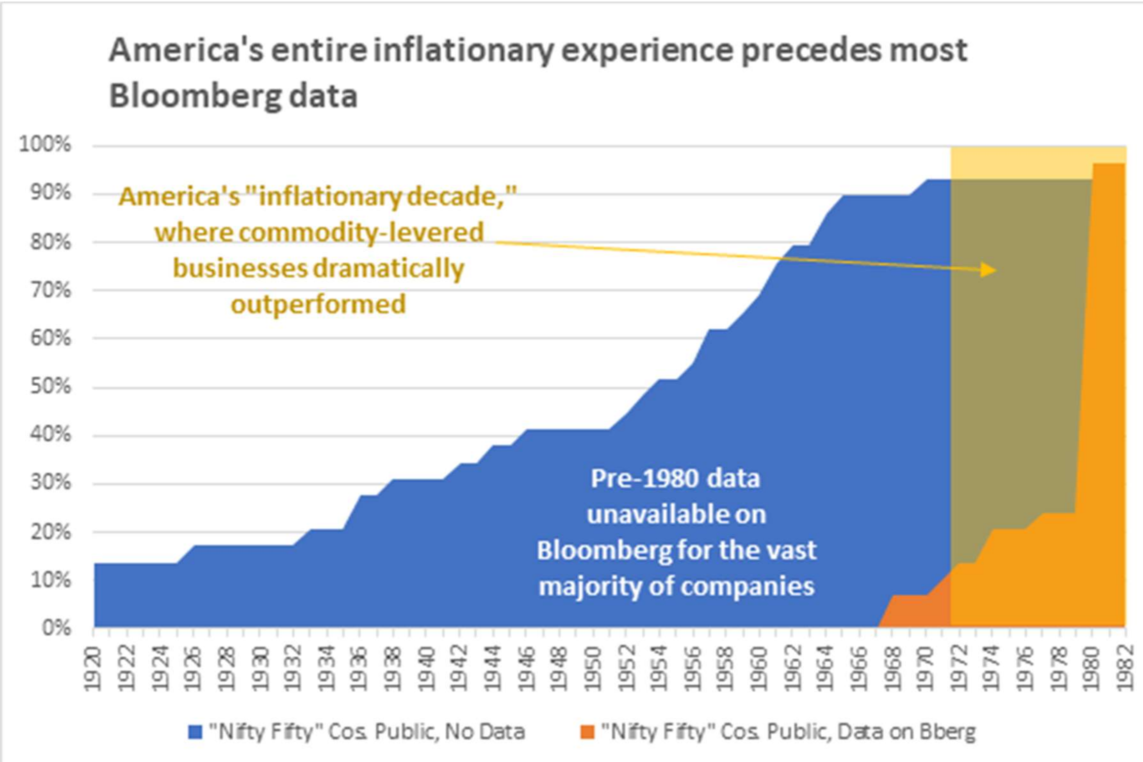
As we have highlighted in recent monthly commentaries, as global economies emerge from COVID, emerging inflationary pressures have driven many investors to look to historical periods to analyze market behaviors. From many of our recent client conversations, the 1970s have attracted the most attention.

Historical market data is ubiquitous, right? Well… not exactly

While 1970s economic data is generally available, interestingly, stock data is harder to come by. In fact, many frequently utilized data services like Bloomberg do not have even stock prices preceding 1980. For example, below is the stock chart for ExxonMobil (XOM). While Standard Oil, the predecessor company has been publicly traded since the early 20th century, in Bloomberg the first trading day recorded was in July 1980.

Source: Bloomberg

To further consider the potential to use historical stock data to analyze stock behavior in the 1970s, we looked at the Nifty Fifty stocks, prominent in the early 1970s. As that era's most widely-followed and well-known companies, many investors would rightfully assume that stock data would be readily available to analyze. In the chart below, we show the relationship between the year of IPO and the initial stock data available on Bloomberg.



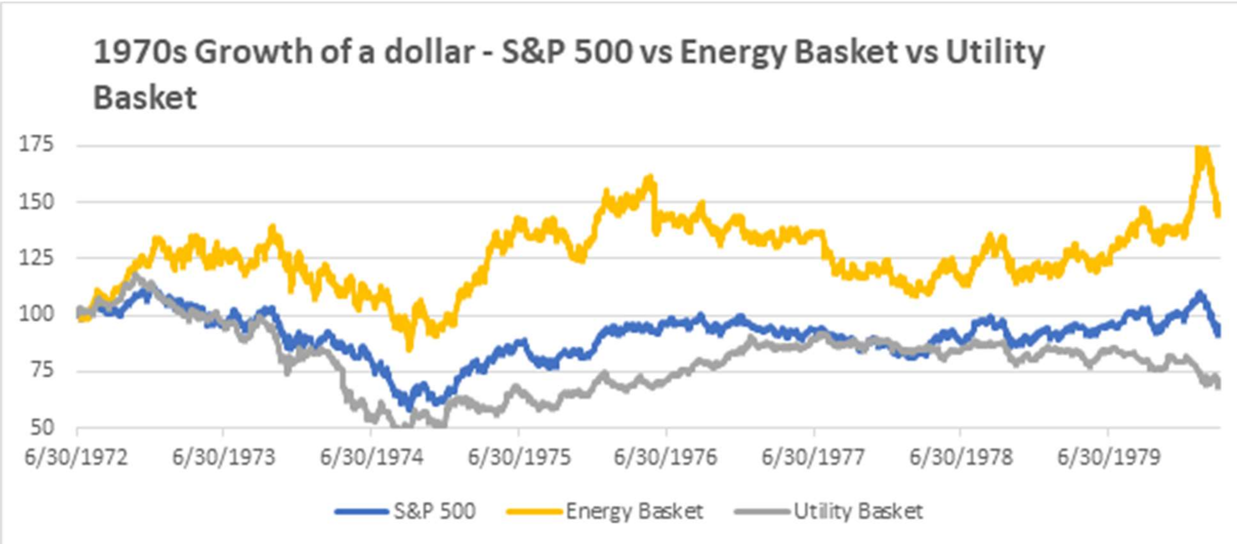
Sources: Bloomberg, Wikipedia, Recurrent Research

Of the Nifty Fifty stocks with continuous data available on Bloomberg, the vast majority have market data available only after July 1980 – by which time America's inflationary decade was in its final innings.

So what did happen when CPI rose in the 1970s?

While 1970s stock data may be more difficult to find, it does exist. The number of stocks with that length of history is limited, but can be used as a proxy for the period when CPI troughed in June 1972, until peaking in March 1980.

As inflation as measured by CPI peaked above 12% in 1974, and then again above 14% in March 1980, energy outperformed the S&P 500, while utilities underperformed. As seen in the chart, from the CPI trough in June 1972 to the second peak in March 1980, the stock prices of a basket of large cap energy stocks outperformed the S&P 500 by more than 50% over the period. During the same period, stock prices of a basket of large cap utilities underperformed the S&P 500 by more than 20%.



Energy Basket is an equal weighting of XOM, HAL, CVX, MRO; Utility basket is an equal weighting of AEP, ED, and CNP

Note: Changes in stock prices only

Source: www.macrotrends.net

With the investment community increasingly focused on inflationary periods like the 1970s, basic information like stock data is essential to analyzing and understanding historical relationships which may re-emerge today. Surprisingly, despite many companies having been publicly traded for many decades, the historical data is not readily available on commonly used financial data subscriptions, making analysis and conclusions more challenging to complete.