Midstream: It is "earnings" reporting season… but for midstream, "earnings" are just one part of the conversation. Midstream endured a multi-year collapse during 2015-2020 – while earnings never meaningfully fell! As we've written since 2018, debt caused the slide, and debt reduction is foundational to the recovery. In 2020, we said midstream needed to abandon externally-funded growth and focus on cash generation. As we compare these themes to actual performance, we are not surprised to find that efficient growth correlates to outperformance. We are surprised that 5+ years after our debt white paper, deleveraging remains an equally powerful driver of outperformance, even as midstream is now solidly investment grade. We pose a final provocative question: debt reduction works – why haven't high dividends/buybacks worked?

Natural Resources: Many investors associate an investment in gold with a hedge for inflationary periods. The reality is more complicated. While gold was a strong inflation hedge following the US's decision to leave the gold standard in the early 1970s, the last 40 years have seen no compelling evidence that gold hedges inflation. A stronger argument is that gold hedges the opportunity cost of money – so real yields should drive gold prices. Again, this relationship has been hard to discern since the 1970s, but has returned somewhat since 2020. But if real yields are a key driver for precious metals, how should precious metals investors feel about monetary policymakers coordinating to tighten real yields?

Click here for the latest white paper on the long-term relationship between inflation and capex

MLP & Infrastructure

Performance review

During the month of January 2023, the Recurrent MLP & Infrastructure Strategy generated net returns of +5.09%, lagging the Alerian MLP Index's (AMZ) +6.61% return by -1.52%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.18% (annualized, net of fees). Please see the performance section at bottom for more detail.

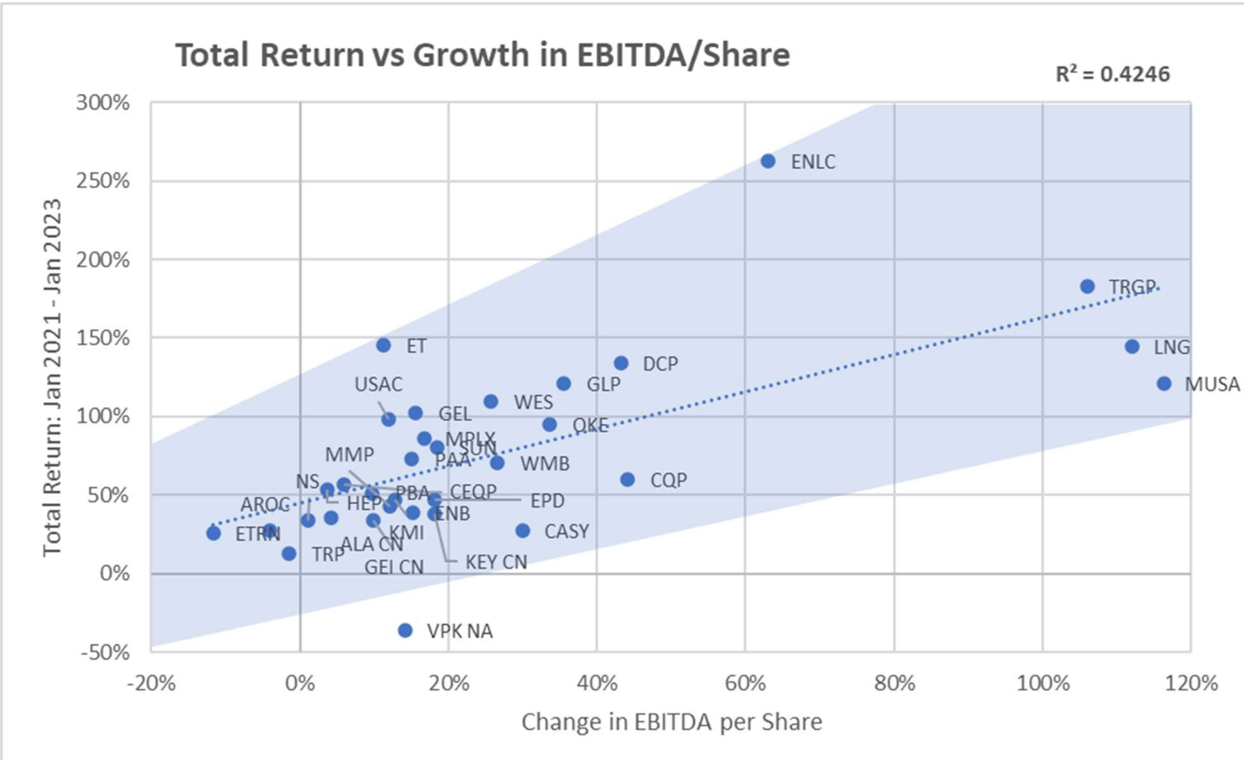
Midstream– a historically volatile sector with (relatively) low earnings volatility… so what *does* drive midstream performance?

For many investors, it is simply assumed that earnings drive stock performance. For midstream, it's more complicated – the sector saw robust EBITDA and earnings growth throughout the 2005-2015 period, but this strong cash flow growth culminated in a punishing multiyear downturn and a substantial reduction in valuation multiples.

As we discussed in the midstream white papers we released in 2018 through 2020, creeping debt loads and excessive dividend payout ratios led to a downturn where stock price volatility soared even as cash flows and earnings remained (relatively) stable. COVID was a catalyst for radically reduced dividend payouts, reductions in growth spending, and aggressive debt repayment. From a much stronger financial position, midstream companies are now increasing dividends and share buybacks.

Given the broad rally since 2020, many midstream observers have been content to say, "the medicine worked!" But as midstream companies continue to generate excess free cash flow, the question of optimal capital allocation only becomes more important. Which capital allocation decisions have been correlated to superior stock performance following the initial "sugar rush" of late 2020? We share our findings on the last 24 months of performance below.

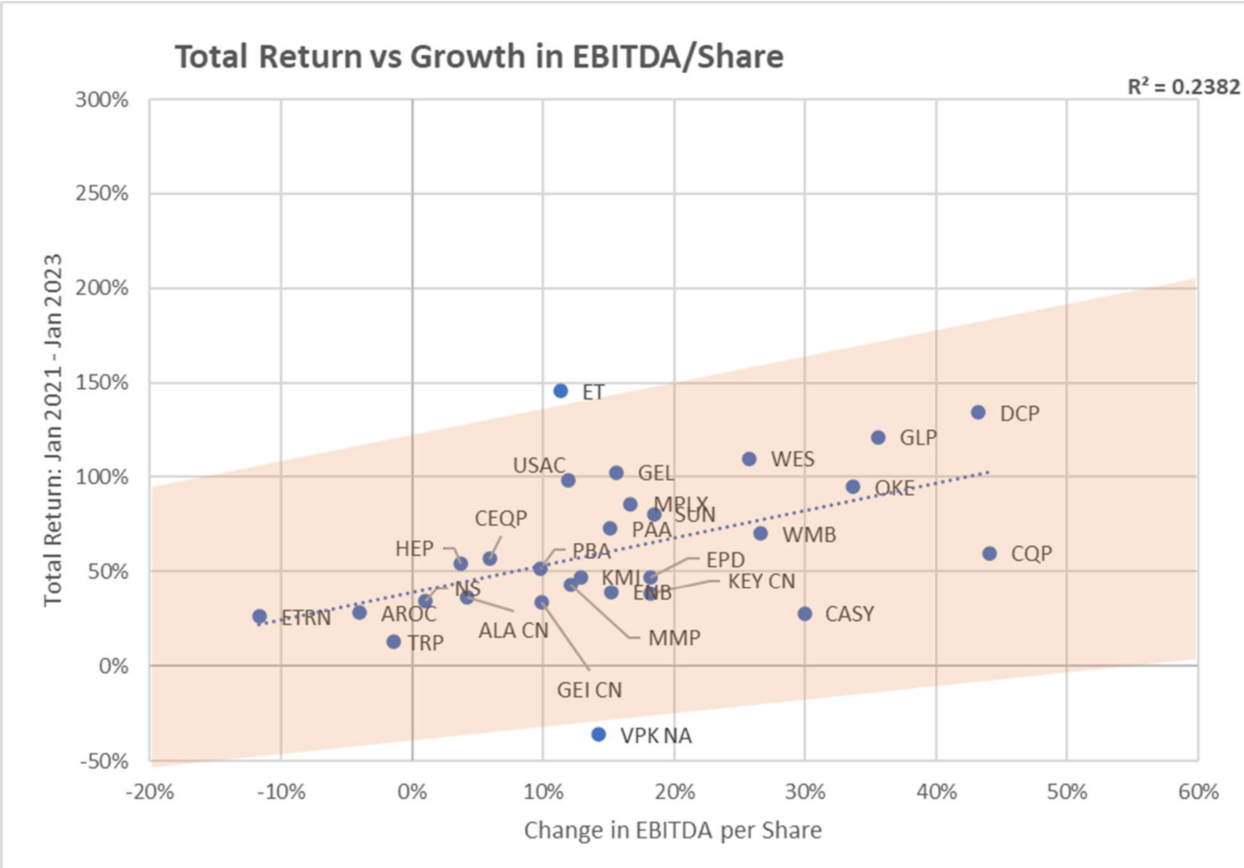
Strongest Performance Correlate: Growth in EBITDA per Share (R^2 = 0.42)



Midstream Universe includes KMI, TRP, ENB, WMB, PBA, EPD, LNG, CQP, TRGP, OKE, PAA, ENLC, KEY CN, WES, CEQP, DCP, GEL, ETRN, MMP, NS, ET, MPLX, GLP, HEP, USAC, SUN, VPK NA, GEI CN, CASY, MUSA, ALA CN, AROC.
Sources: Recurrent research, public filings, Bloomberg estimates.

Unsurprisingly, higher EBITDA per share has been correlated with higher total returns over the past 24 months. This is reflective of leverage to the (rising) commodity environment, but also reflective of capital efficiency – after all, the 2005-2015 period saw dramatic EBITDA growth, but EBITDA growth was diluted by massive growth in share count. Companies that reduced share count have only added to the rate of improvement since 2020.

But wait… when we exclude high-growth outliers, EBITDA/share is a much weaker performance correlate



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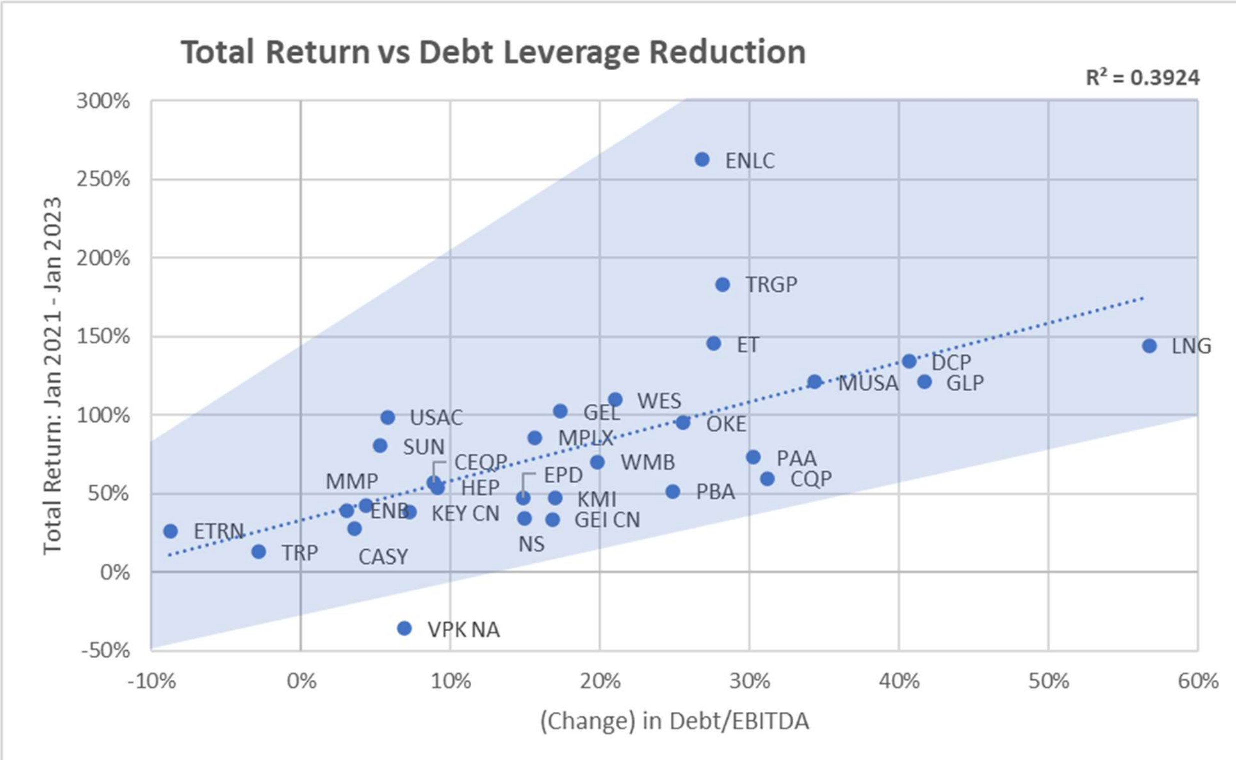
Sources: Recurrent research, public filings, Bloomberg estimates.

Interestingly, we would note that the removal of outliers like ENLC, TRGP and LNG causes the R-squared for EBITDA/share to decline from 0.42 to 0.24. Sure, companies with high operating leverage (>30% EBITDA/share growth) such as DCP and OKE were strong performers; but ET, WES, GEL, SUN, MPLX – these companies all experienced lower rates of EBITDA/share growth and performed comparably. A decision to own MMP instead of ET cost 100% over 2 years, despite comparable EBITDA per share growth between the two!

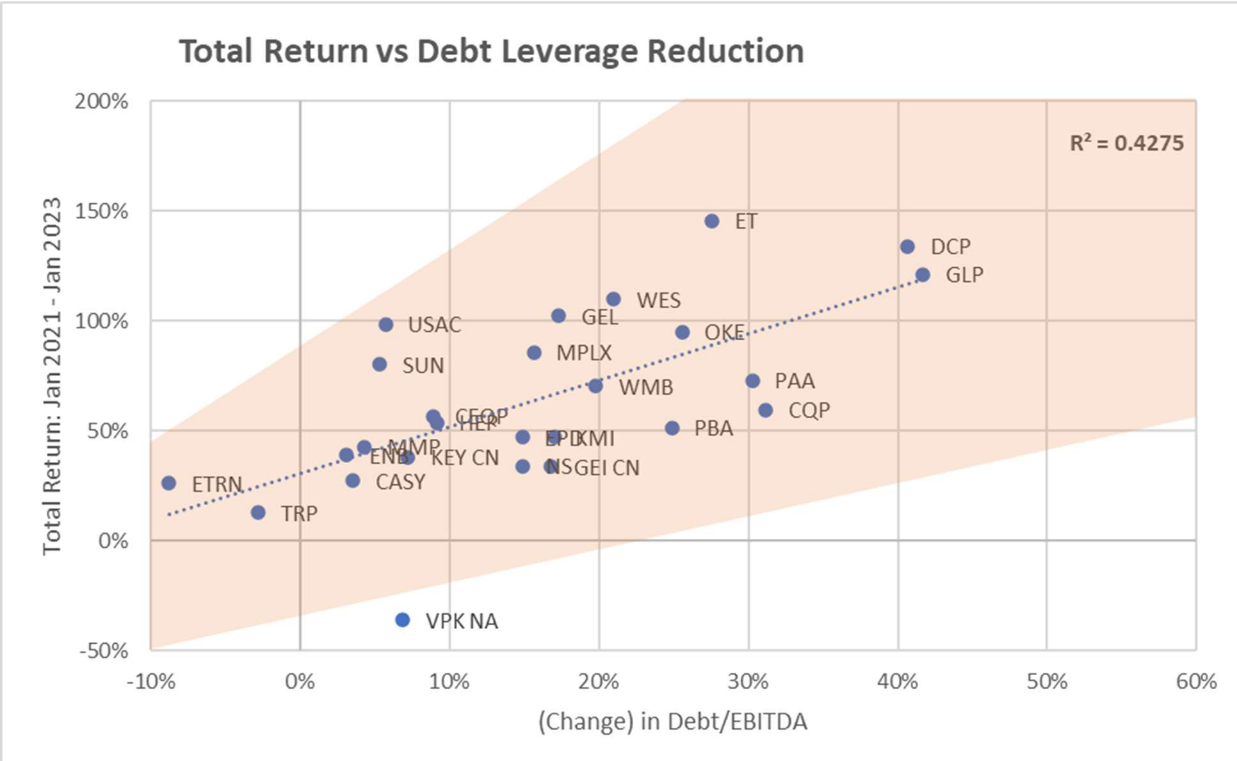
Second-Strongest Performance Correlate: Debt Leverage Reduction (R^2 = 0.39)



Midstream Universe includes KMI, TRP, ENB, WMB, PBA, EPD, LNG, CQP, TRGP, OKE, PAA, ENLC, KEY CN, WES, CEQP, DCP, GEL, ETRN, MMP, NS, ET, MPLX, GLP, HEP, USAC, SUN, VPK NA, GEI CN, CASY, MUSA, ALA CN, AROC.

Perhaps our most powerful finding is that debt deleveraging – as defined by the change in debt/EBITDA ratio - is almost equally correlated with total return performance over the past 2 years as is EBITDA/share growth. However, this conclusion gets more intriguing as we remove outliers – the explanatory power actually *increases*. In other words, a few superstars heavily influence the EBITDA/share study – but deleveraging leaders overwhelmingly outperformed companies who did not reduce debt leverage. ET again is an interesting case study – a fairly pedestrian growth in EBITDA/share (due to expansion of share count associated with the ENBL acquisition) still saw massive outperformance, and debt reduction is the one metric where ET stands out.

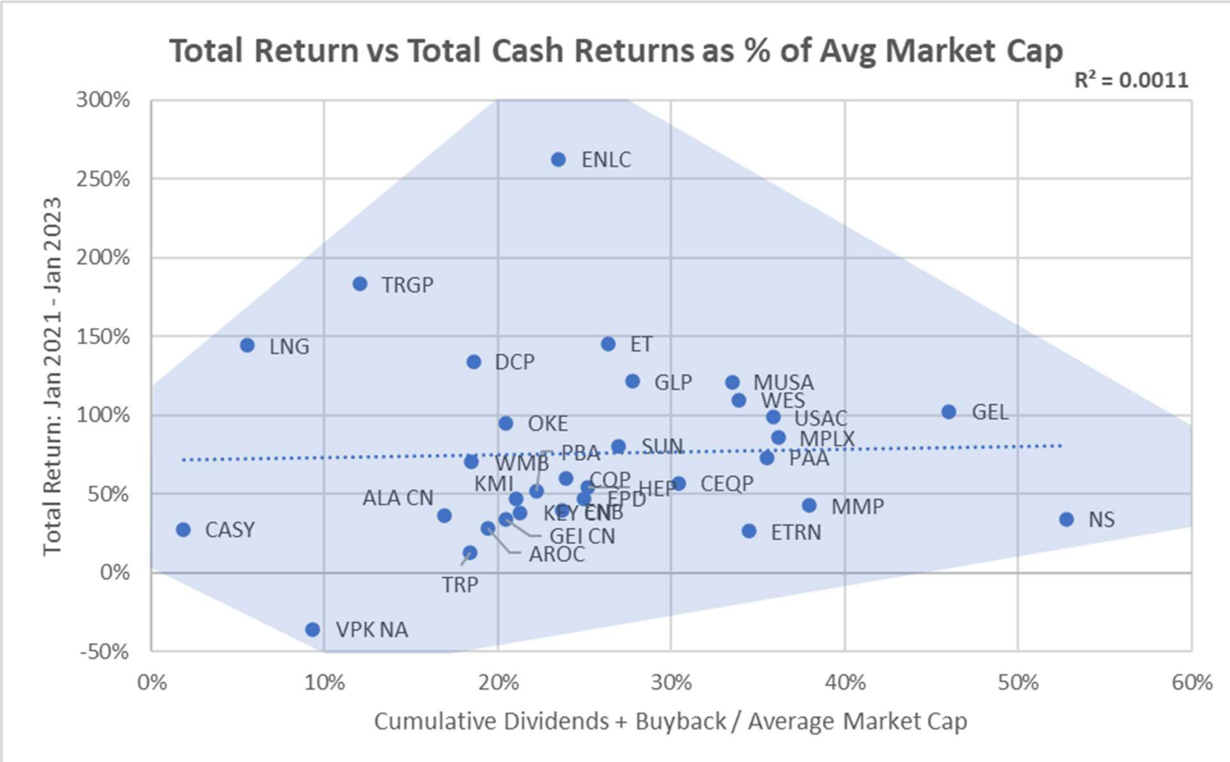
But wait again… when we exclude outliers, the explanatory power of debt leverage reduction gets stronger



Midstream Universe includes KMI, TRP, ENB, WMB, PBA, EPD, CQP, TRGP, OKE, PAA, KEY CN, WES, CEQP, DCP, GEL, ETRN, MMP, NS, ET, MPLX, GLP, HEP, USAC, SUN, VPK NA, GEI CN, CASY, ALA CN, AROC.
Sources: Recurrent research, public filings, Bloomberg estimates.

While the first 2 conclusions around debt and EBITDA/share are fairly straightforward, the next finding leaves us questioning some of our preconceived notions about the (potential) return of higher payout ratios. With dividend payouts back at 20-year lows (~40% payouts today, down from a high of nearly 90% in 2016), there is understandably pressure for higher dividends and potential as a special div or a stock buyback. But the graph below gives us some pause. LNG and TRGP have seen massive outperformance – yes, they have seen significant EBITDA expansion, but they are also leverage reduction leaders. They have been (relatively) stingy on payout, only returning 5% to 15% of average market cap over the last 2 years, but it hasn't interfered with performance. NS, MMP, PAA, CEQP and ETRN are among the companies who have maintained or expanded payouts even when operating performance has stagnated, and performance has been mixed. Perhaps unsurprisingly, situations where payouts have seemingly gone unrewarded, have been laggards on deleveraging.

Shockingly, high payouts (dividends+buybacks) have not translated to performance



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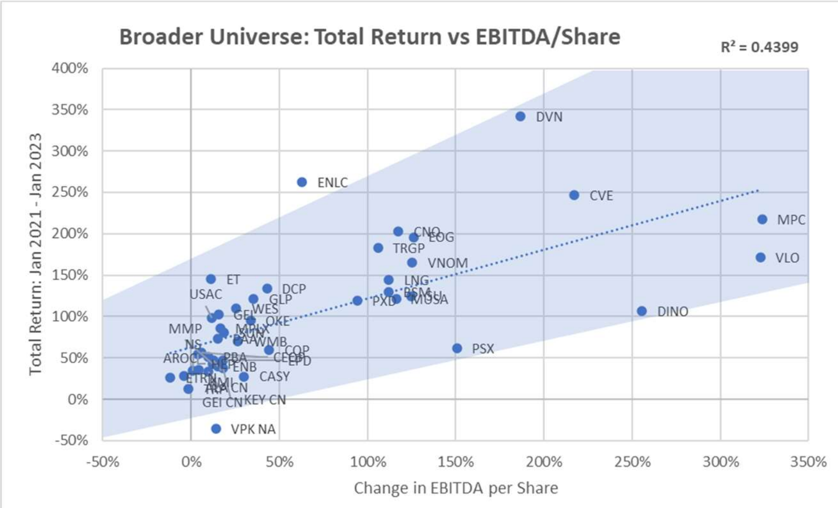
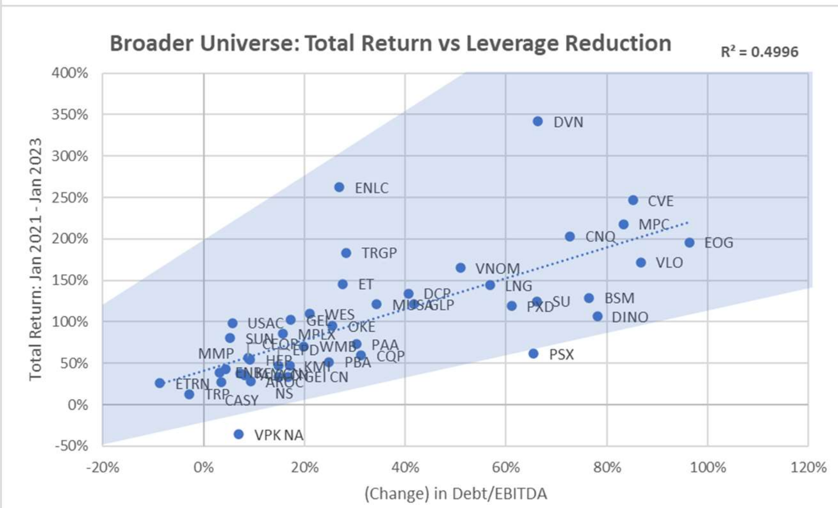
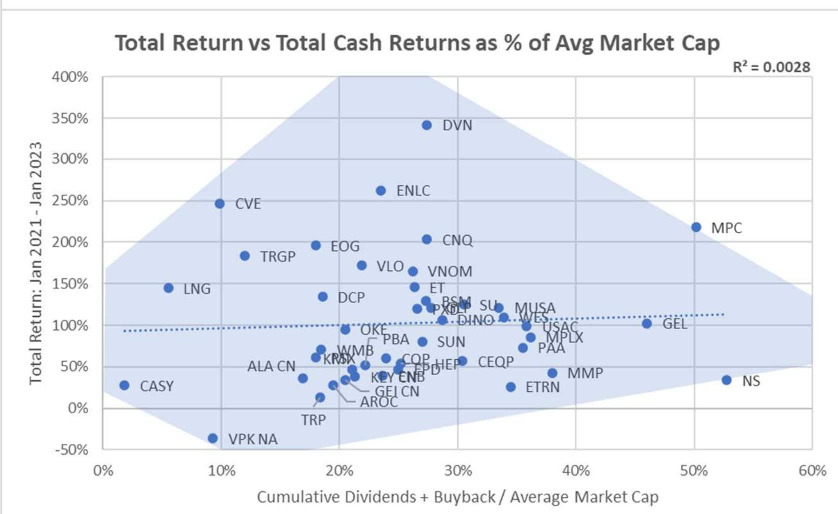
So how much of this market preference for better balance sheets is a midstream phenomenon?

When we add several “adjacencies” that have similar earnings profiles and capital intensity as midstream energy assets – downstream refining, Canadian oilsands, royalties, convenience stores – we actually find the same conclusions – albeit even stronger. Again, in this slightly broader universe, debt reduction has been a powerful driver of performance. EBITDA/share growth is also a powerful variable, albeit less so. Once again, cash returns to shareholders are disappointingly weak. We share this broader universe study below.







Broader universe includes: KMI, TRP, ENB, WMB, PBA, EPD, LNG, CQP, TRGP, OKE, PAA, ENLC, KEY CN, WES, CEQP, DCP, GEL, ETRN, MMP, NS, ET, MPLX, GLP, HEP, USAC, SUN, VPK NA, GEI CN, ALA CN, AROC, MPC, VLO, PSX, DINO, CASY, MUSA, VNOM, BSM, PXD, EOG, DVN, CVE, SU, CNQ.
Sources: Recurrent research, public filings, Bloomberg estimates.

In conclusion: maybe continued deleveraging is the only "free lunch" for CEOs deploying excess cash?

It is intuitively appealing for finance types (like us) to think that paying down debt, beyond what is absolutely required by the credit markets or ratings agencies, is financially "inefficient". After all, if the market provides leverage that enables "freeing up" of precious equity capital, then CEOs and CFOs are expected to utilize it.

But the study above suggests that more powerful behavioral elements are at work in how the market values capital allocation. **In other words - it appears that debt reduction still works.** Many companies have already seen credit ratings upgrades to investment grade, and yet the most dramatic outperformance for many companies has coincided with aggressive debt reduction.

Perhaps, after the traumatic experience of COVID, investors are still averse to any balance sheet risk? Perhaps, the "invisible hand" is skeptical of the value added by cyclical buybacks? And philosophically, perhaps holding "inefficient" cash on hand or unutilized debt capacity – effectively a "rainy day" fund – appeals more to cyclical investors, who have experienced the dramatic ebbs and flows of this sector in the past decade.

Natural Resources

Performance Review

In the month of January 2023, the Recurrent Global Natural Resources Fund increased +9.04% net of fees, outpacing the S&P Global Natural Resources Index's +7.52% return. During the month, the prospect of China reopening supported metals/mining shares, with several portfolio holdings rising >10% in the month. Energy holdings increased less than the benchmark, as oil/natural gas commodity prices fell by 2%/23% during January.

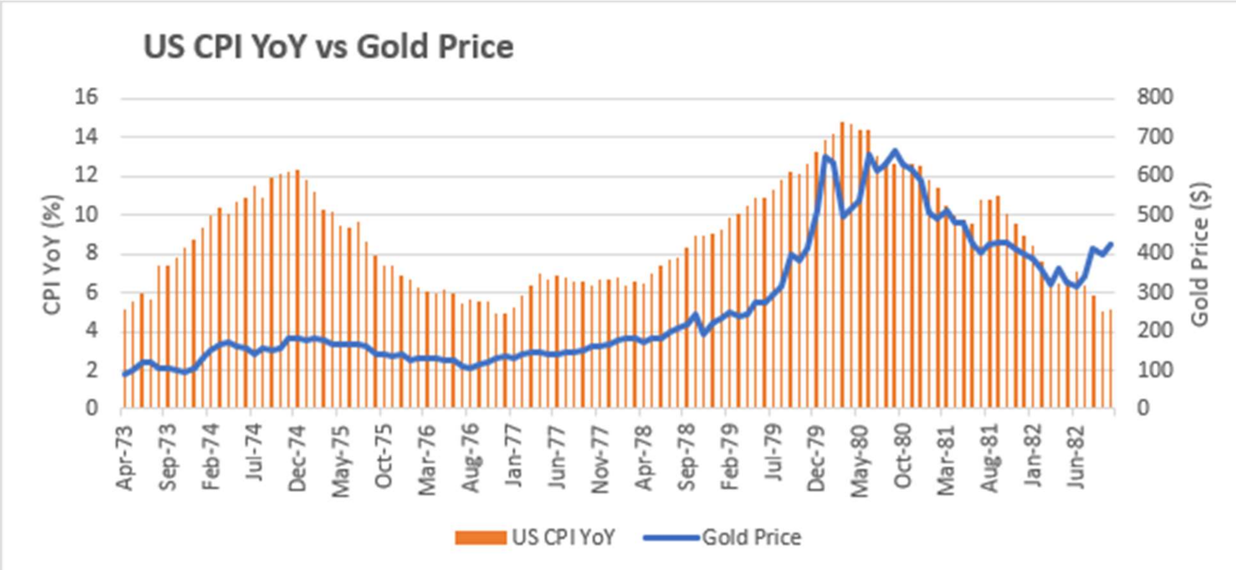
Investment Discussion

In recent investor meetings, one of the most commonly asked questions regards the significant relative underperformance of gold mining companies compared to the broader global natural resources index. Over time, a common refrain of "if inflation, then buy gold" has proliferated among many investors, but over the last 2 years, as CPI has accelerated to 40-year highs, the global natural resources index has risen +20.80% while the MSCI ACWI Select Gold Miners Total Return Index has fallen -9.56% per year on an annualized basis, underperforming by a cumulative -55.63%!

Source: Bloomberg, Recurrent Research

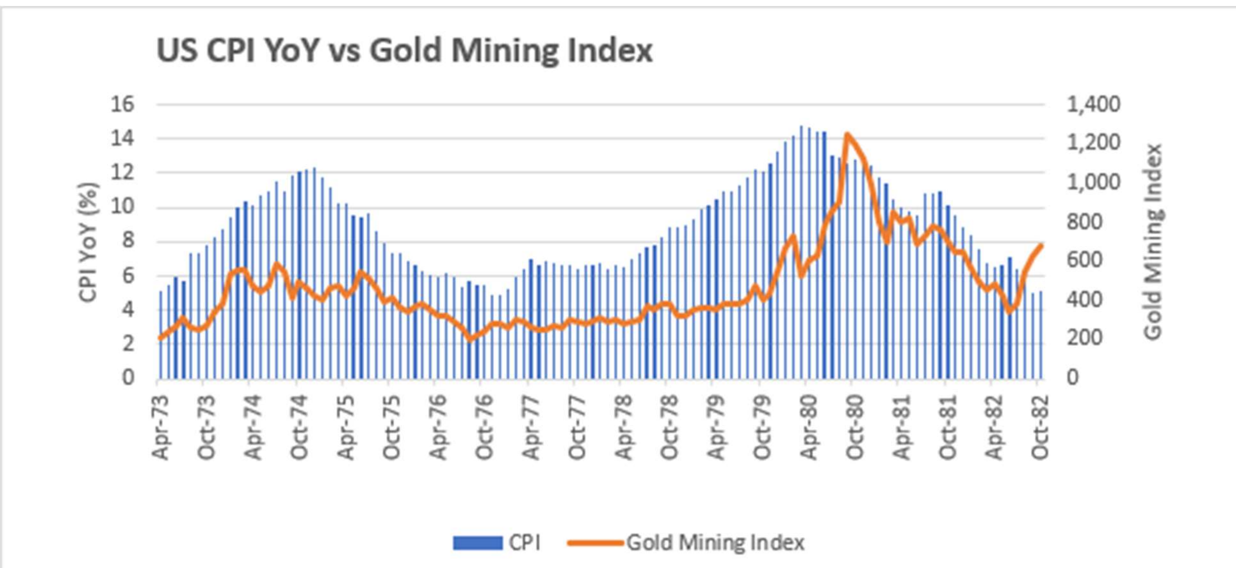
How did historical experience influence investor perception?

The perspective that inflation and gold equities are strongly correlated is rooted in the inflationary period of the 1970s and early 1980s. During the period from 1970 to 1982, the relationship between CPI and Gold prices was strong, as seen below.



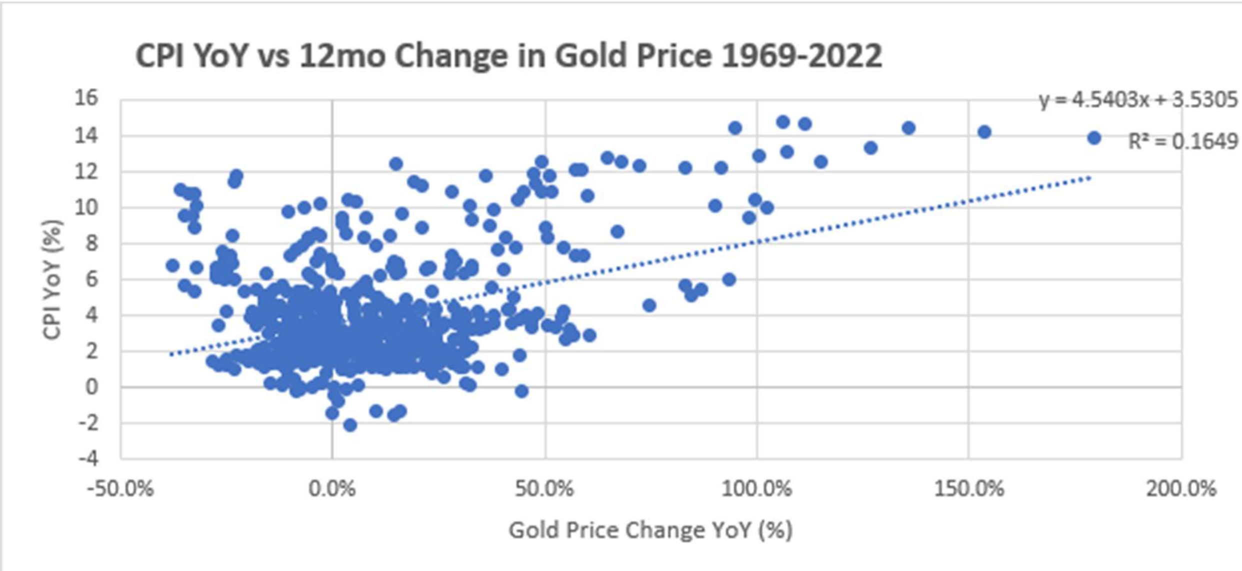
Source: Bloomberg, Recurrent Research

Unsurprisingly, the strong relationship between inflation and gold extended to gold mining companies. As seen below, the relationship was strong enough to remain in investors' memories for decades!



Source: Bloomberg, BGMI, Recurrent Research

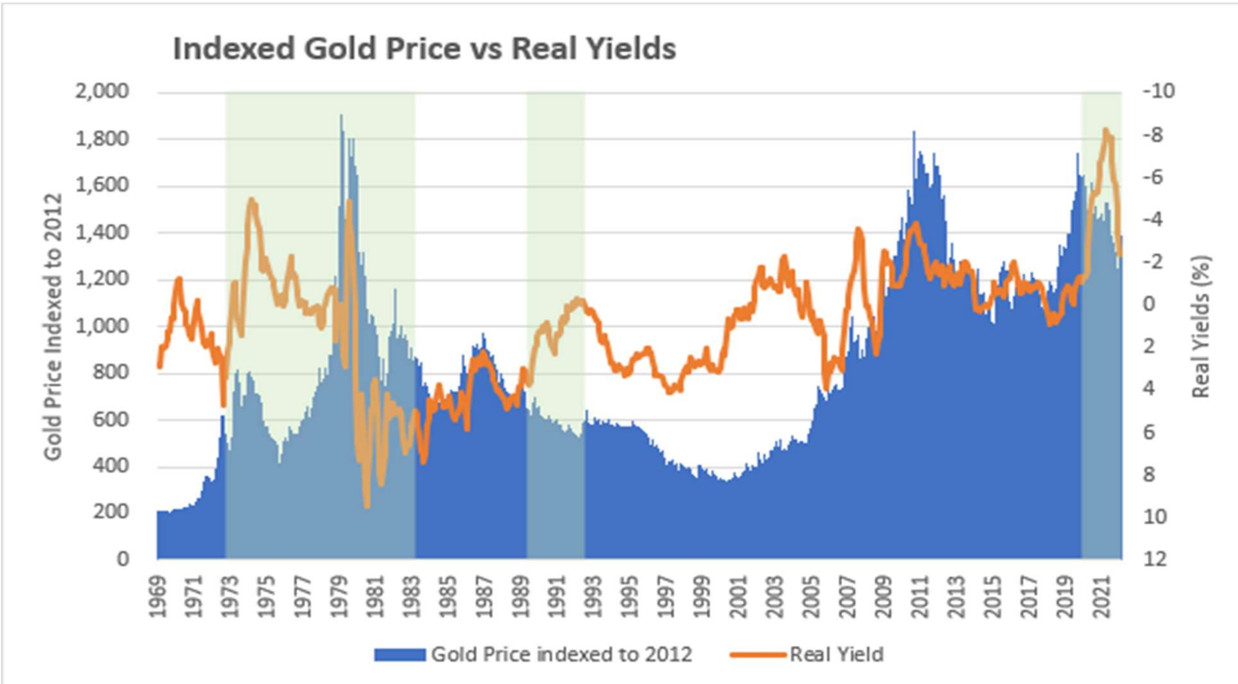
In the inflationary period of the 1970s and 1980s, gold prices and gold miner stocks showed a strong correlation with inflation, but subsequent periods have seen a much weaker relationship. In fact, the relationship between CPI and the gold price has offered little explanatory value in the period from 1969-2022, as seen by the R-squared value of merely 0.1649 to almost zero.



Source: Bloomberg, Recurrent Research

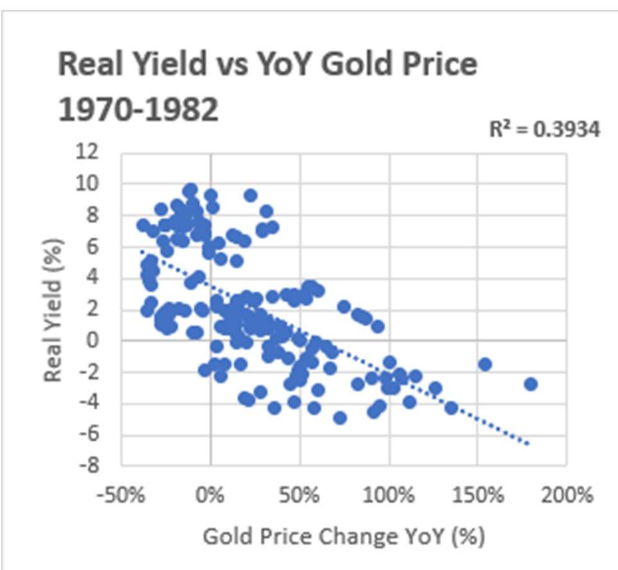
The diverging correlations between CPI and gold during the inflationary period of the 1970s/1980s compared to the weakness across the entirety of the period raises the question of whether the relationship was primarily formed during a particular period which may be unlikely to occur in the future. Furthermore, if CPI was not an appropriate indicator, the search for a more highly correlated indicator would provide additional value.

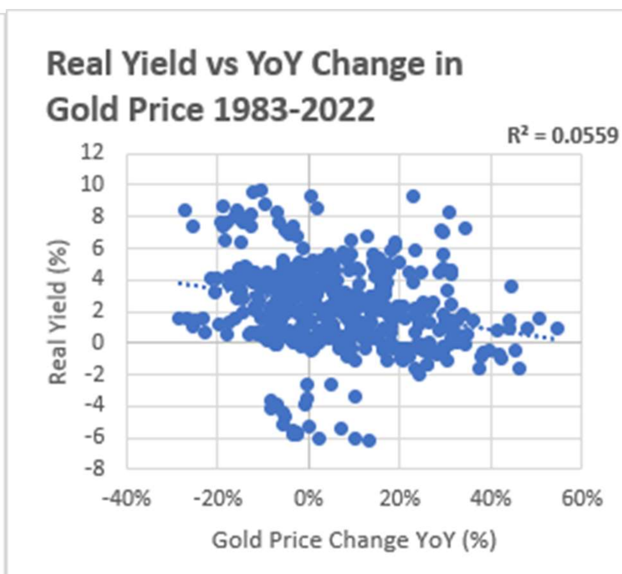
From a correlation perspective, the recent increase in interest rates has turned the focus from absolute inflation to real rates. As a storer of value without generating income, gold and gold equities would increase in value as real rates fall, an in particular when real rates turned negative.



Source: Bloomberg, Recurrent Research

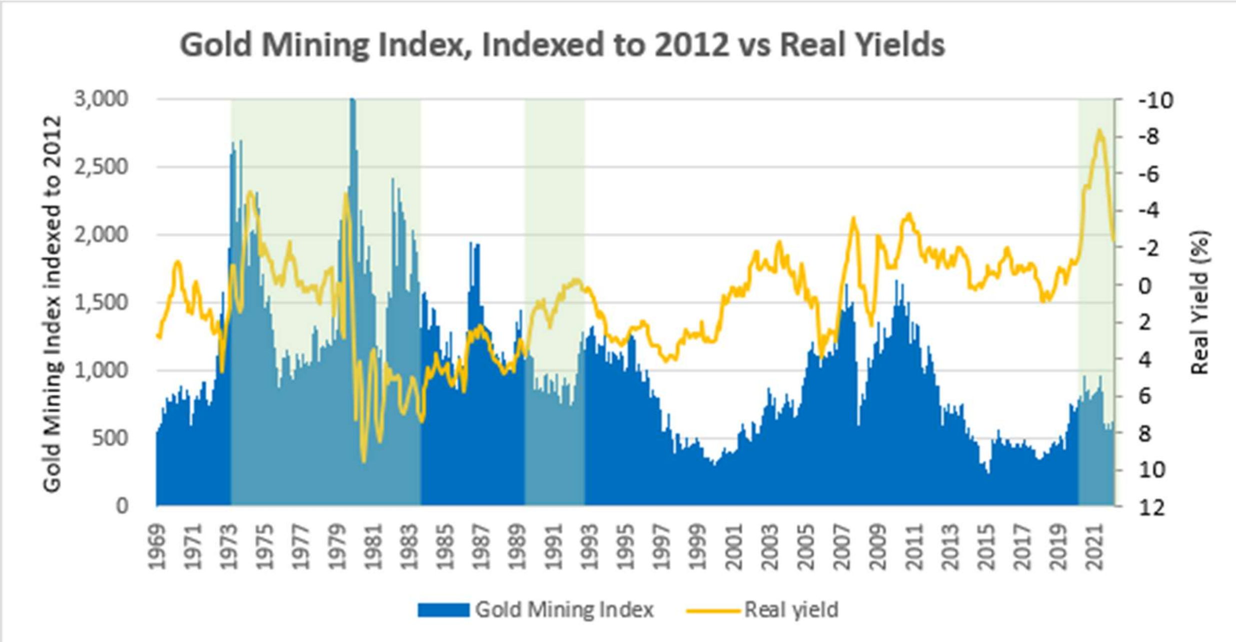
Interestingly, this view of the relationship between real yields and gold, with inflationary periods highlighted in green, again shows dramatically different correlations in different historical eras.





Source: Bloomberg, Recurrent Research

As we look forward, the predictive relationship between gold mining equities and real yields appears to be much stronger. Throughout the period since 1969, directional changes in real yields, both positive and negative, have a higher correlation to gold mining stocks. Particularly in inflationary periods, falling real yields directionally correlated to increased gold mining equity performance, while rising real yields correlated to falling gold mining equity valuations.



Source: Bloomberg, BGMI, Recurrent Research

In sum, the relationship between real rates and gold mining equities was strongest during the inflationary periods of the 1970s/1980s, and has remained active in investors' consciousness decades later. Since the 1980s however, the relationship weakened. In the last 24 months, the relationship seems to have strengthened, although the gold mining sector underperformed the broader global natural resources index by more than 50%. To the degree that the relationship between real yields and gold mining equities do have predictive power, global central banks' indications to increase real yields closer to parity would imply that the gold miners' performance may be further challenged. At a minimum, the relationship has been far from consistent, and the future durability of the relationship remains an open question which we will continue to analyze closely.

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