Russia's invasion: last month, we released a white paper about how the "Energy Transition" has increased the cost of capital for new oil projects, and will effectively cut off funding for low-cost, 30-year international megaprojects. Russia's invasion further increases the international "risk premium" and poses the question if a 30-year foreign oil asset will ever be viewed as low-risk again. One necessary outcome of this convergence of financial and geopolitical risks is the increased development of higher-cost US Shale.

Midstream: US Shale will need to backfill the loss of reliable Russian exports, which even if physically restored in time, will never again be viewed as "reliable," at least in the West. While we expect to see a strong bid for assets with high commodity price leverage, pervasive oilfield *cost* inflation means that some energy assets with high required maintenance capex will be fighting inflationary headwinds for years. On the contrary, thanks to the "pipeline overbuild" of 2015-2020 and the earnings power covered previously, midstream is well-positioned for cash flow growth with minimal capex increases.

Natural Resources: As we have outlined several times in the last 12 months, the current market environment – from increased money supply, the composition of inflation, and equity market concentration and valuation – have reminded us of the early 1970s. The one feature of the early 1970s not been present until now was geopolitical conflict, which disrupted global supply chains and sustained inflation. Last month, the Russian invasion of Ukraine provided further indications that the early 1970s would offer a valuable analog to the current market environment.

Gerald Ford's "Whip Inflation Now" Pin from the mid-1970s

Source: Wikipedia

Recurrent's new White Paper on the rising "risk premium" in the oil market
Recurrent's latest video on the impact of Russia's invasion

MLP & Infrastructure

Performance review

During the month of February 2022, the Recurrent MLP & Infrastructure Strategy generated net returns of +5.12%, outpacing the +4.82% gross return of the Alerian MLP Index (AMZ). Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.50% (annualized, net of fees). Please see the performance section at bottom for more detail.

Russian invasion makes domestic energy production strategic (again) – investment must increase – but it will take time

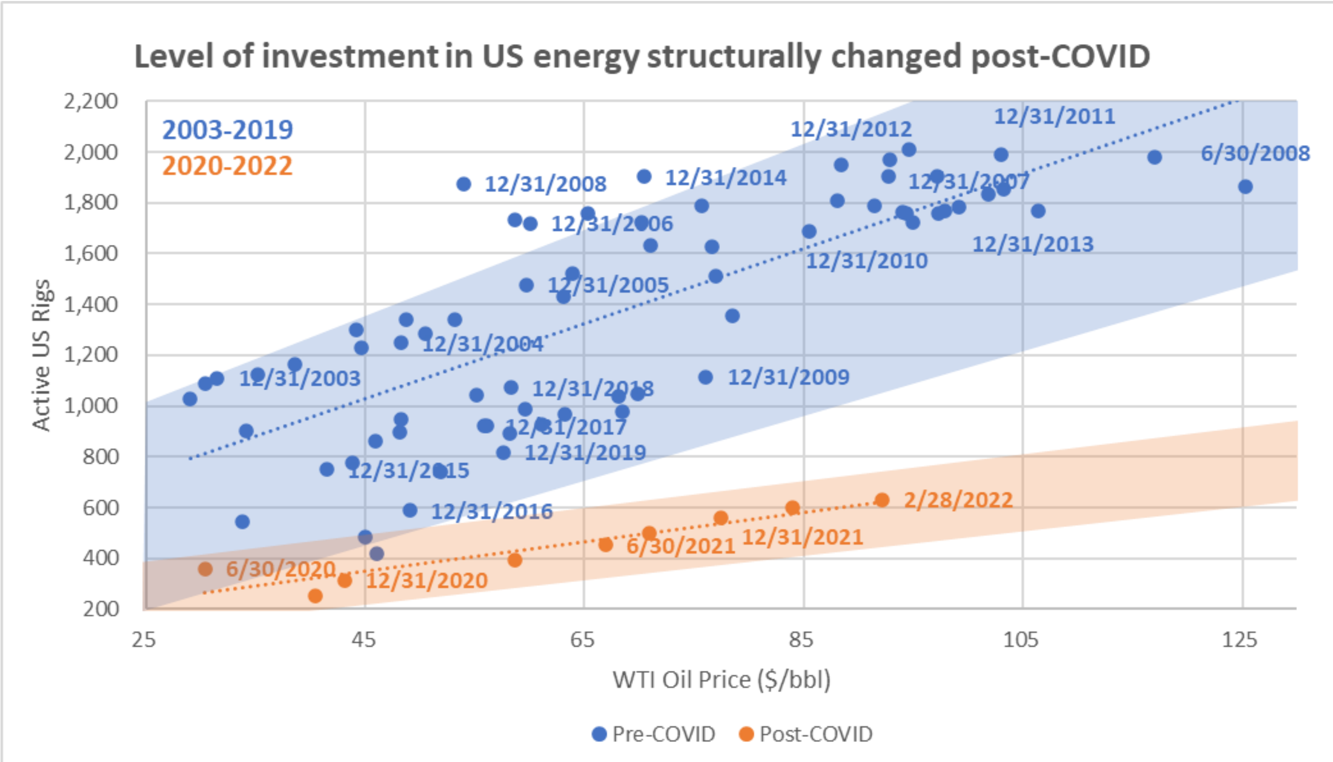
As discussed in our recent video and in further detail in our Natural Resources discussion below, Russia's invasion has provided a supply shock that is of comparable magnitude to the 1973 Arab Oil Embargo. This all but assures an extended period of high commodity prices and higher inflation for several years. In contrast to 1973, Russia produces a much broader array of commodities than just oil and gas – but the market has focused first and foremost on energy security, as this is where the West is perhaps most acutely and clearly exposed at the moment.

While Europe has been a structural importer of energy for much of the 20th century, the US's post-2001 fixation on becoming "energy independent" culminated in the US moving from a net import position of 12 million barrels per day in 2006 to a slight exporter of oil and petroleum by 2020, with natural gas falling from imports of 2 million barrels equivalent to slight net exports over the same timeframe. As energy prices declined in response, policymakers from Washington to Europe were content to allow the oil market to operate as a largely deregulated market, de-emphasizing the strategic nature of energy production.

US Shale will eventually meaningfully increase investment, but the Russian supply shock arrives at an ill-prepared moment

With domestic energy security largely secured over the past decade (and energy companies declining into irrelevance in most stock benchmarks), politicians, investors, and society at large focused elsewhere, or demanded that US energy companies minimize reinvestment. The result has been a massive reduction in new drilling and an exodus of labor from the oilfield, as shown below.

The US is ill-equipped at the moment to rapidly ramp up to the drilling levels observed during previous periods of $100/bbl WTI prices. Today, 600 rigs are running, far below the 1,800-2,000 historical average seen during periods of high prices. Already, US CEOs are warning that the lack of labor, steel, and equipment will cause significant inflation in the oilfield and delay the return of millions of barrels per day of domestic production.



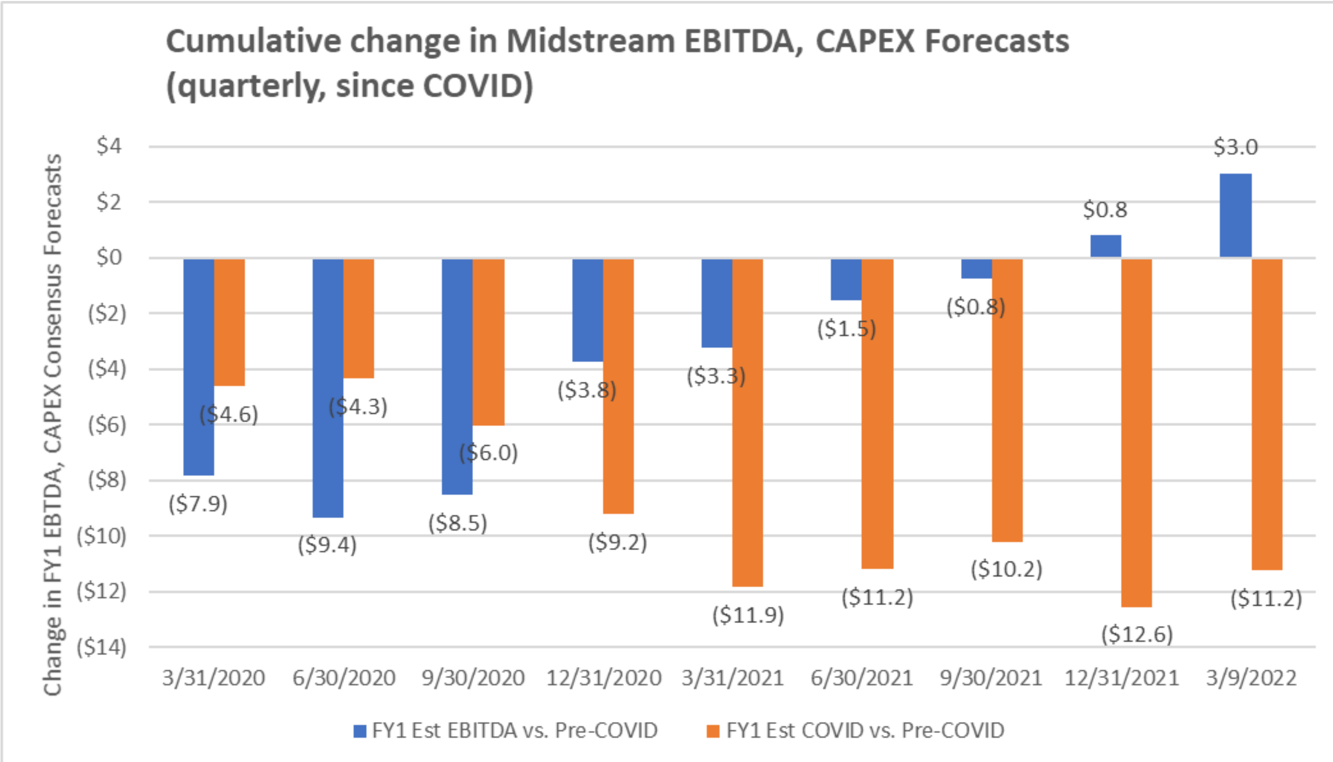
Source: Baker Hughes rig count, Bloomberg, Recurrent research.

New investment will aggravate oilfield inflation which is already running 3-5x CPI; midstream offers an oasis from inflation risks

While revenues are clearly moving higher across the entire energy sector, the impact of inflation on cost line items remains harder to forecast. Furthermore, oilfield cost inflation has historically had a more insidious and persistent negative impact on energy companies' full-cycle returns on capital. As fears of inflation restrain growth ambitions and impact decision-making in the oilfield, it's natural to ask which subsectors are best positioned to combat inevitable cost inflation.

One obvious answer is **Midstream**. The concerns that kept investors away from midstream for years – "overcapitalized sector with overbuilt pipeline capacity, with more commodity price exposure than many realize" – is now a bull case, as overbuilt pipeline systems provide significant growth upside without significant new investment requirements. Similarly, while oil producers and OFS companies must continue to drill new wells to maintain commodity leverage, many midstream companies have an evergreen claim on a share of their customers' commodity production, with much lower capital intensity.

The argument laid out above is reflected in the data below, where we track the changes in forward EBITDA and Capex estimates for the Midstream sector as a whole. Midstream cash flow forecasts now exceed pre-COVID cash flow estimates, while capex forecasts have been drastically reduced, and even with forward guidance issued in January-February, capex remains forecasted at close to the lowest level since COVID began, $11bn (or one-third) lower than the late 2019 forecast of $34bn.



Source: Bloomberg, Wall Street consensus estimates, Recurrent research.

While commodity prices will stabilize at some higher “new normal” as the world frantically reduces dependence on Russian markets, American energy investment will increase. But the impact of inflation will be a headwind for subsectors of the energy industry as well. We see significant value in areas of the market that can will benefit from higher revenues while continuing to minimize costly reinvestment at a time when raw material prices are surging – Midstream is one such sector.

Natural Resources

Performance Review

During the month of February 2022, the Global Natural Resources Strategy rose 9.21% net of fees, outpacing the S&P Global Natural Resources Index's 4.59% return. As a result of the Russia/Ukraine conflict, industrial commodities performed strongly, with portfolio holdings Alcoa (AA), Nucor (NUE) and Freeport McMoran (FCX) rising 32.9%, 29.8%, and 26.1% respectively. The portfolio's underweight position in the Fertilizer & Agricultural Chemicals sector mildly detracted from performance.

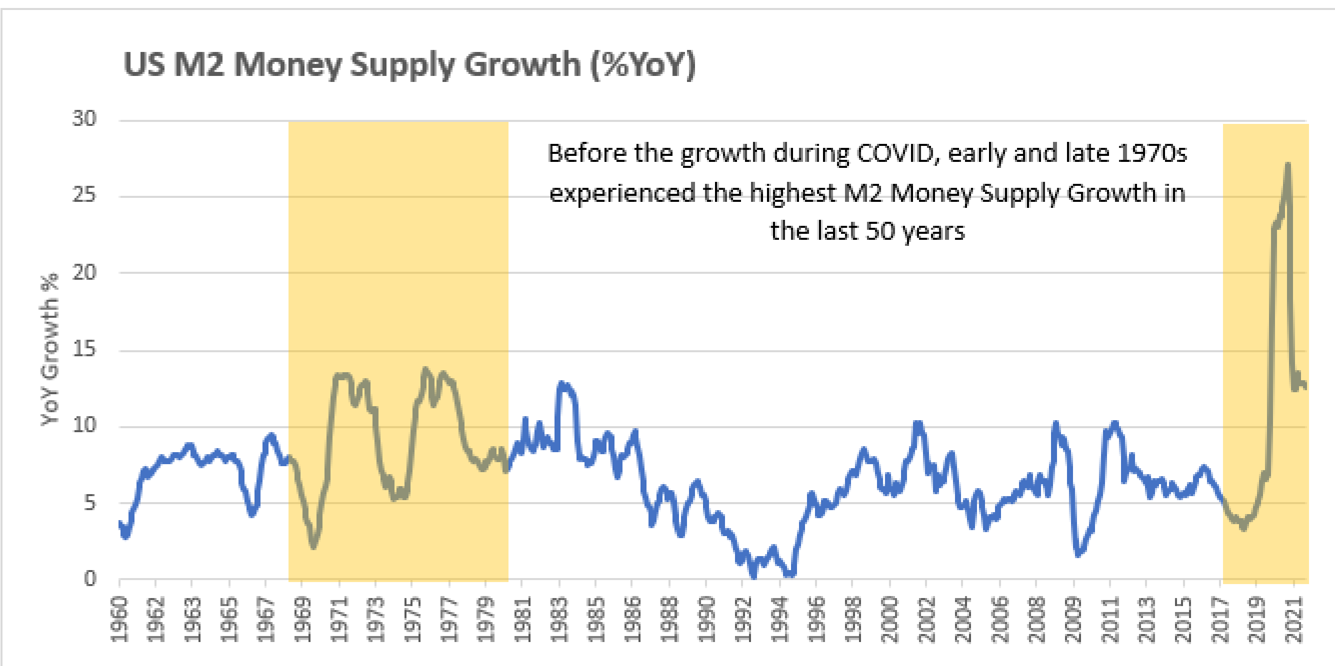
Investment Discussion

In April 2021, our monthly commentary highlighted the increasing similarities between the early 1970s and the current market environment. Given the evolution of the last 12 months, we wanted to update the comparison, which has only been furthered in the last 2 weeks as Russia invaded Ukraine.

A year ago, we looked at some of the key economic and market components of the early 1970s which fostered an extended inflationary environment. A few of the of the key similarities to today included:

Increased global money supply

In August 1971, President Nixon moved the US off of the gold standard. In doing so, the US no longer funded the government based on gold reserves; instead, the government was able to borrow backed by the "full faith of the US Government". Along with other leading global economies, government borrowing grew, and M2 money supply expanded rapidly, more than doubling over the subsequent decade.

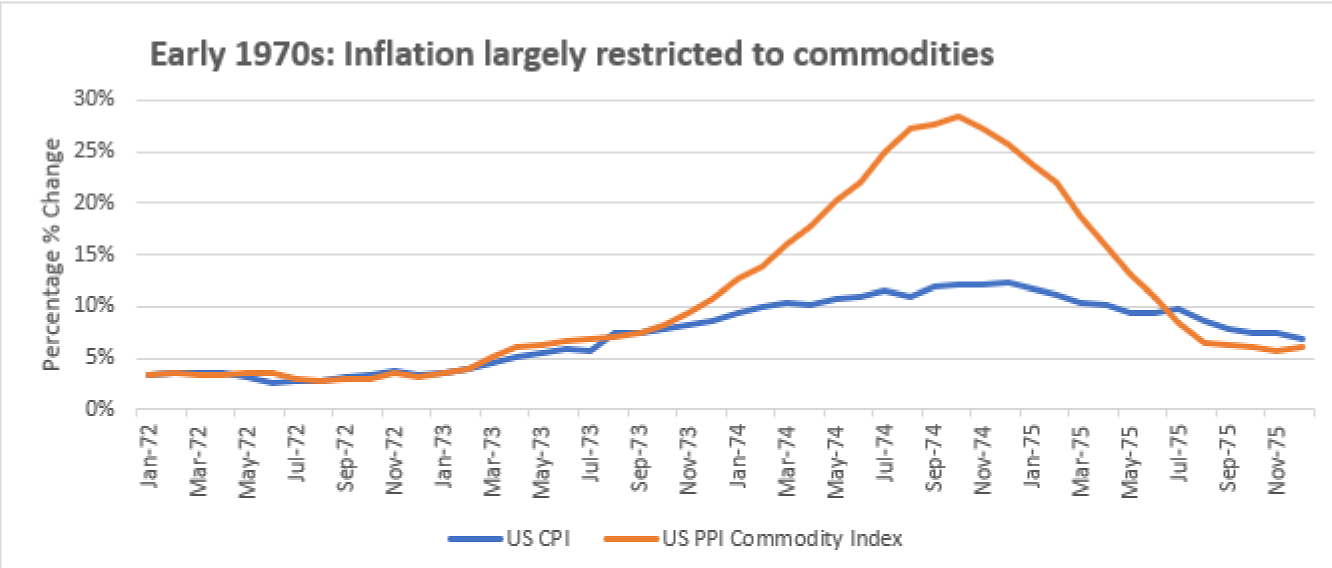


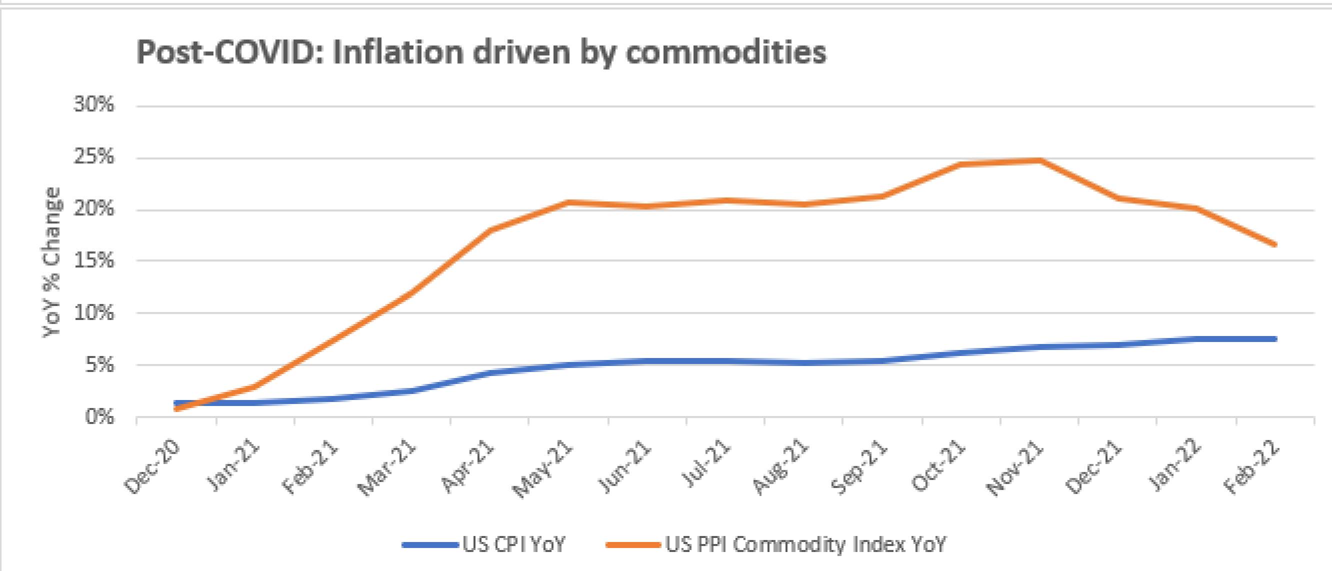
Source: Bloomberg, Recurrent Research

Since COVID, global money supply as measured by M2 has similarly expanded, growing by more than 20% in order to support global economies. While global economies have largely recovered to pre-COVID levels, the M2 money supply remains elevated, supporting inflationary pressures similar to those in the early 1970s when the US moved off of the gold standard.

Inflation

In our April 2021 monthly commentary, we noted that many market watchers have likened the current inflationary environment to the late 1970s/early 1980s. In fact, during the 1970s there were actually two distinct inflationary periods where CPI rose above 10% YoY growth. The first period, in 1974/1975, was driven primarily by goods. Today's inflation is similarly driven by goods/commodities as opposed to services; as a result, we view the current inflationary period to more closely resemble the early 1970s.





Source: Bloomberg, Recurrent Research

In contrast to inflation in the early 1970s, the second period of 1970s inflation from 1979-1981 saw both goods and services inflation, with CPI peaking above 14% in 1980. In our view, the second inflationary period was an extension of the early 1970s, where goods inflation continued, furthered by wage/services.

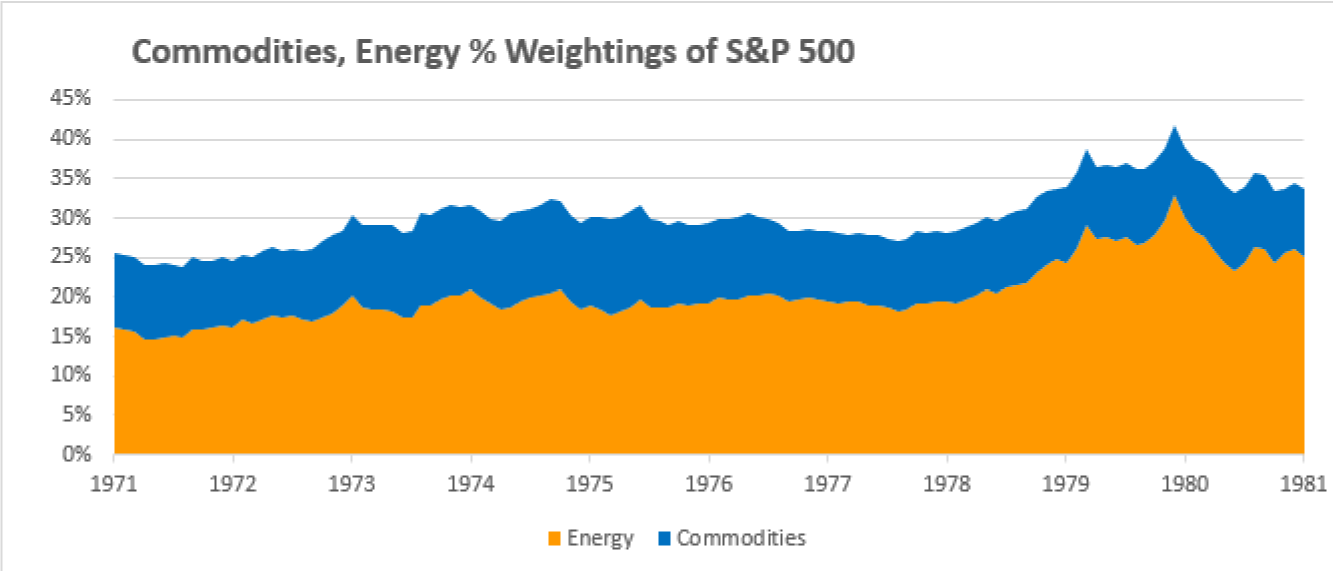
Source: Bloomberg, Recurrent Research

Geopolitical environment

While geopolitics are a fact of life, the recent events in Russia/Ukraine have noteworthy impact on global commodity markets. Using the oil market as a proxy, as a result of sanctions in response to Russian aggression in Ukraine, 3 million barrels of oil/day and 1 million barrels of oil/day will no longer be exported to Europe and the US, respectively. In today's roughly 100 million barrels/day global market, this accounts to approximately 4% of global oil supply being disrupted. The reduced supply and disrupted supply chain have a similar impact to the Arab Oil embargo of November 1974, when in response to countries' supporting Israel in the Yom Kippur War, OPEC reduced production by 25%. According to the BP Statistical Review, in 1975 Middle Eastern oil production fell by > 2MM barrels/day, in the context of a 55 million barrel/day global oil market (3.6%). Unsurprisingly, immediately after the Oil Embargo, the oil price rose doubled, and continued to rise through the remainder of the decade.

Market Reaction

As might be expected, in the inflationary environment with rising oil prices, energy was one of the strongest performers in the S&P 500. From the early 1970s to the early 1980s, energy grew by nearly 15% within the S&P 500. The chart below shows that energy/commodity sectors comprised 28% of the S&P 500 Index at the end of 1971, and peaked above **40%** a decade later, in October 1980! While we do not expect energy/commodities to grow to similar levels in the next few years, the current 6% weighting certainly has potential to significantly grow in and inflationary environment.



Source: Sanford Bernstein and Recurrent Research

Importantly, the beginning of the decade was marked by the prominence of the "Nifty Fifty" – a basket of operationally sound companies which maintained expensive valuations. In Jeff Fesenmaier and Gary Smith's 2002 paper "the Nifty-Fifty Re-Revisited", it was noted that 14 of the stocks had P/E ratios above ***50x*** earnings. While not exact, the valuation and concentration of equity markets certainly rhyme more today than in any time in memory. Note the reduced weighting of consumer staples (many of the Nifty Fifty companies were consumer staples) in the table below, in contrast to energy. =

S&P Sector	12/31/1971	12/31/1981	Change
ENERGY	16.2%	25.0%	+8.8%
FINANCIALS	1.0%	6.7%	+5.7%
HEALTHCARE PRODUCTS	5.3%	6.9%	+1.6%
TRANSPORTS	1.7%	2.2%	+0.5%
DEFENSE	1.2%	1.6%	+0.4%
UTILITIES	11.0%	11.1%	+0.1%
COMMODITIES	9.3%	8.7%	-0.6%
CAPITAL EQUIPMENT	9.8%	8.3%	-1.5%
CONSUMER DISCRETIONARY	10.7%	8.4%	-2.3%
TECHNOLOGY	12.1%	9.1%	-3.0%
AUTOS/HOUSING	8.6%	4.0%	-4.6%
CONSUMER STAPLES	13.2%	8.1%	-5.1%

Source: Sanford Bernstein and Recurrent Research

Summary

In short, as we look at the current market environment, we believe the growth in money supply, inflation and broader equity market environment, the most appropriate market comparison is the early 1970s, which saw significant outperformance for energy and commodity sectors of equity markets, lasting over a decade.

Monthly Investment Commentary
February 2022

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