Midstream: The harsh discipline of a global pandemic dramatically improved the free cash flow outlook in 2020, and we predict this will lead to a record ~$3bn of share buybacks in 2021. Back in October, buybacks seemed like an insurance policy for a tough macro environment. Today, there are signs that a constructive macroeconomic backdrop in 2021 could support a much-improved financial picture.

Natural Resources: As a result of COVID-19, the 2020 global economy is expected to shrink by 4-5%, yet many commodity prices have risen, in contrast to historical correlations. In stark contrast to the rest of the world, in 3Q 2020 Chinese GDP grew by 3% on a year over year basis. For many commodities, China represents a disproportionately large percentage of global demand, supporting commodity prices despite global economic contraction.

Download new 2020 white paper here: Recurrent's 2020 Midstream/MLP White Paper.
Download our white paper on the "dispatch curve" that governs the oil market here.

Other white papers are available at www.recurrentadvisors.com.

December 2020 Performance Summary and Market Commentaries

Please find below performance and market commentary for our two strategies – MLP & Infrastructure and Natural Resources. Performance follows at the bottom of the commentary. For additional information, please contact us at (832) 241-6400 or info@recurrentadvisors.com.

MLP & Infrastructure

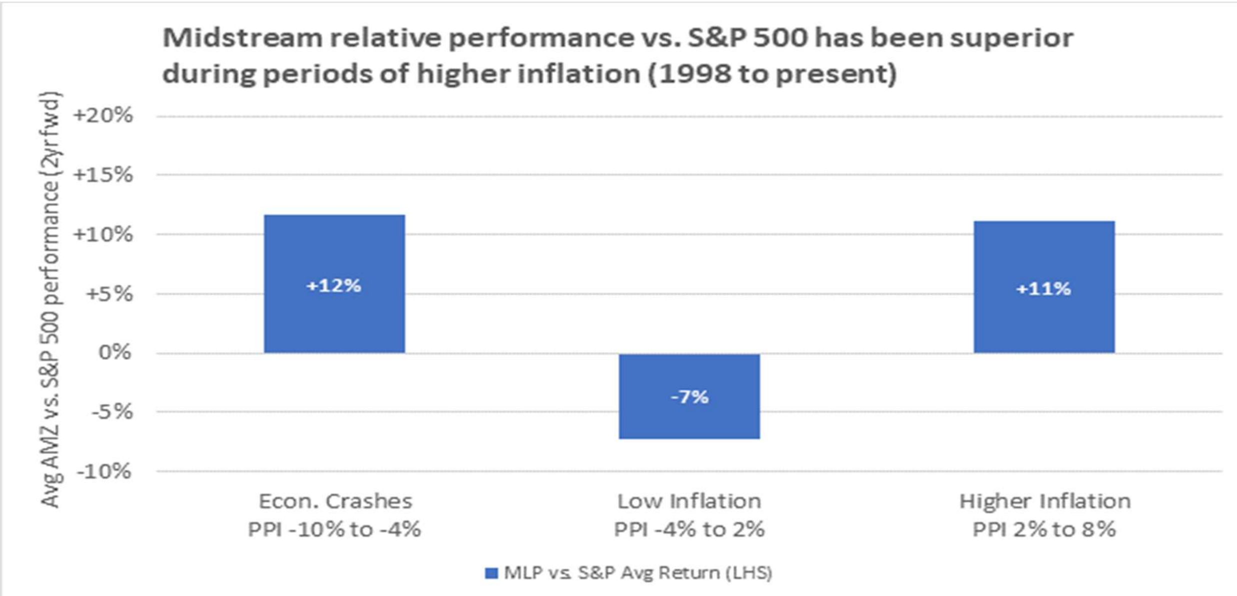
Performance review

During the month of December 2020, the MLP & Infrastructure Strategy generated net returns of +3.88%, exceeding the +2.51% return of the Alerian MLP Index (AMZ) by +1.37%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.68% (annualized, net of fees). Please see the performance section at bottom for more detail.

Looking into 2021 – credible signs of inflation are emerging – historically positive for midstream

With so many calls for higher inflation failing to materialize since 2008's Great Financial Crisis, it is perhaps not surprising that such calls have become quieter in recent years. And yet, Treasury inflation breakevens have moved above 2% - currently above the 20-year trailing average – despite the recessionary environment. Manufacturing surveys – historically-reliable leading indicators of PPI inflation – have already risen to levels consistent with 2-3% PPI inflation and are almost certain to surge in late 2021 as the global economy normalizes.

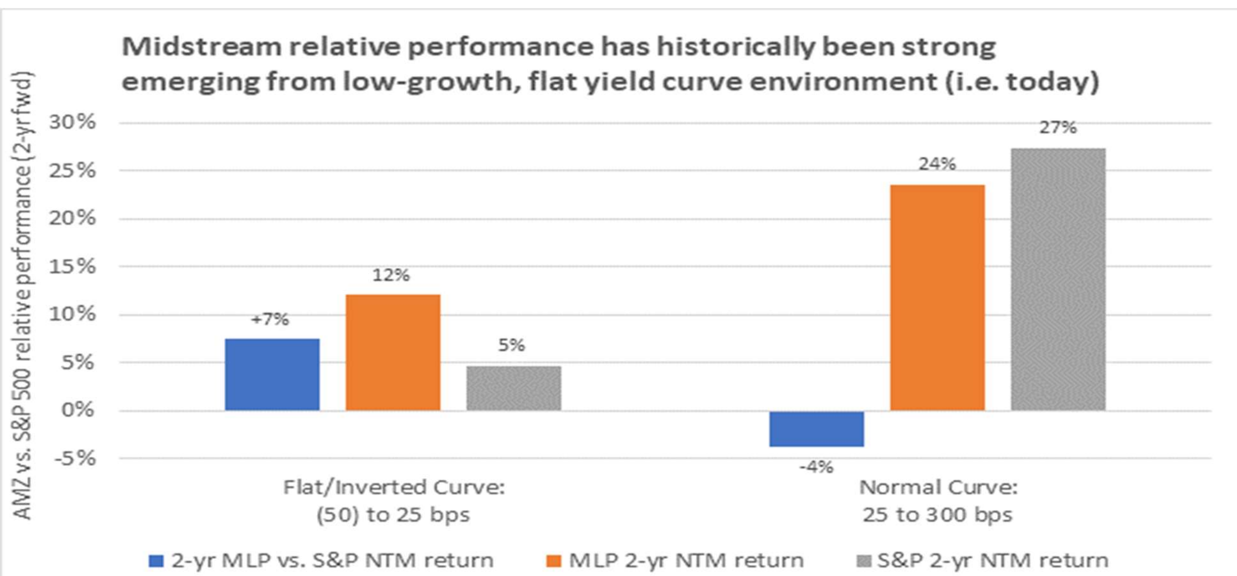
If these emerging indicators prove accurate, and inflation continues to rise as the economy recovers, that would offer encouraging signals to midstream investors, as midstream stocks are one of the few sources of yield that has generated robust returns as interest rates and inflation rise – in contrast to utilities and bonds. Below, we show that midstream relative returns have been consistently stronger in **periods of higher inflation**.



Source: Bloomberg data, Recurrent research.

Looking into 2021 – an economic recovery should steepen yield curves – historically positive for midstream

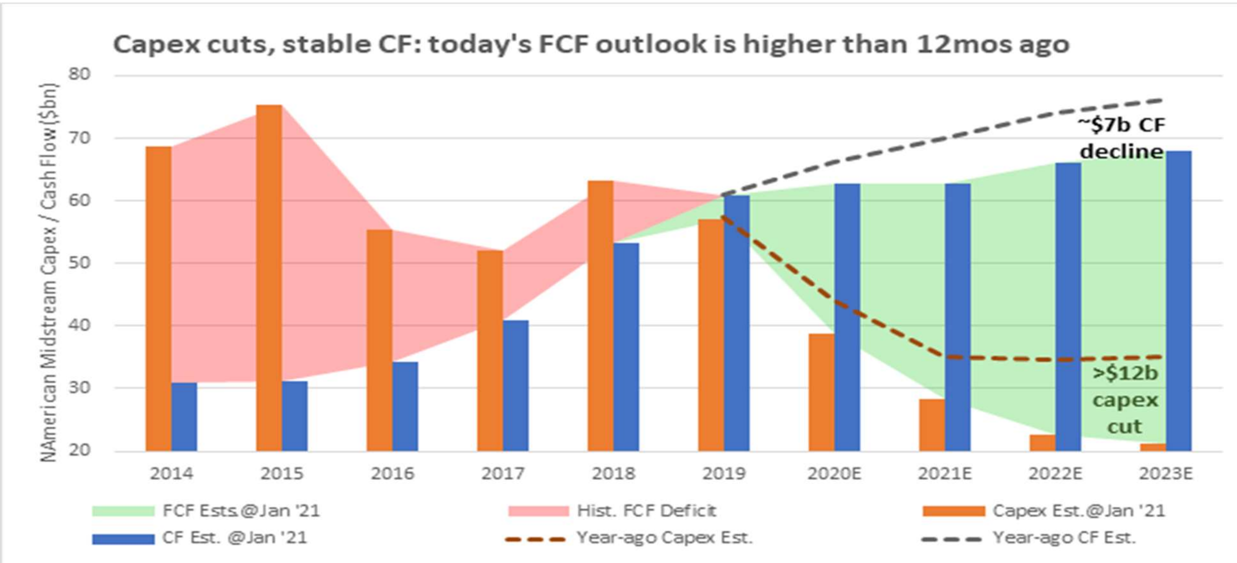
Historically, some of the best times for relative midstream performance vs. broad equities (as measured by the S&P 500) have followed after periods spent in slow-growth environments, typified by flat yield curves. While the 5-year Treasury briefly yielded less than the 2-year Treasury in 2019 due to growth concerns surrounding the "Trade War" between China and the US, yield curves have remained flat through 2020. Two previous yield curve inversions – 2000 and 2006 – preceded powerful multi-year rallies where midstream outperformed the S&P 500. Yield curves have steepened above 25 bps only several days ago.



Source: Bloomberg data, Recurrent research.

Looking into 2021 – consistent fundamental improvement leaves midstream positioned to capture improving macro backdrop

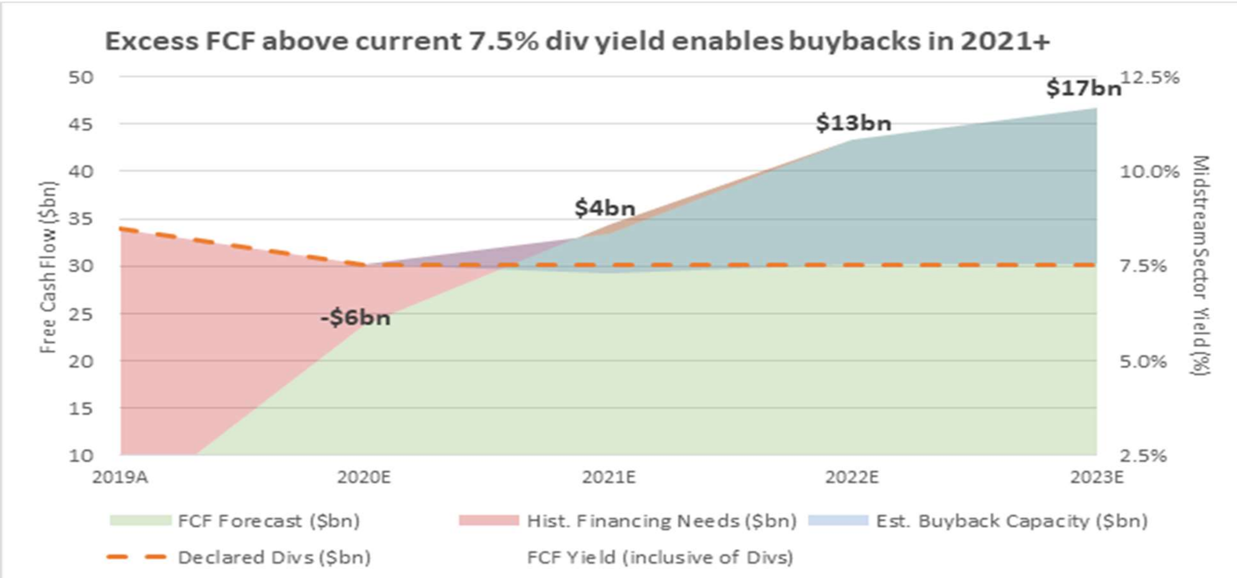
At risk of beating a dead horse, we recap below the fundamental improvements that have pushed the free cash flow (FCF) outlook higher. As we discussed in our previous monthly, midstream FCF revisions have been among the highest of any sector in the market, coinciding with a 12-month period that was the worst stock performance time period for midstream in history. If our outlook proves correct, 2021 will undo much of the equity market damage from 2020.



Source: Bloomberg estimates, Recurrent research, public filings; Notes: Includes companies in Alerian Midstream Energy, Alerian MLP Index.

Midstream FCF outlook exceeds dividend requirements, leaving >$4bn available in 2021, expected to triple in 2022

In our October 2020 performance update, we noted that midstream buybacks could go a long way to offsetting any potential capital outflows from the midstream sector, after record outflows from midstream funds and ETFs in 2019-2020 (exceeding $4bn in 2020 alone). Below, we see that in 2021, even after paying out a nearly 8% yield, the midstream sector will have enough excess FCF after dividends to offset even these record outflows, and the pace of buybacks should accelerate ratably in 2022-23, even without meaningful cash flow growth. The result will be a midstream equity market where supply and demand for stock is much more balanced than the painful forced selling seen during COVID.



Source: S&P Indices, Alerian Indices, Bloomberg estimates, Recurrent research

Accordingly, our key prediction for the midstream sector in 2021 is that **aggregate midstream buybacks will reach $3bn, more than double the historical maximum of $1.3bn of sectorwide buybacks**. Even if our timing proves optimistic, we think the long-awaited arrival of buybacks funded by free cash flow, at a time when inflationary pressures are mounting, bodes very well for midstream energy stocks in 2021.

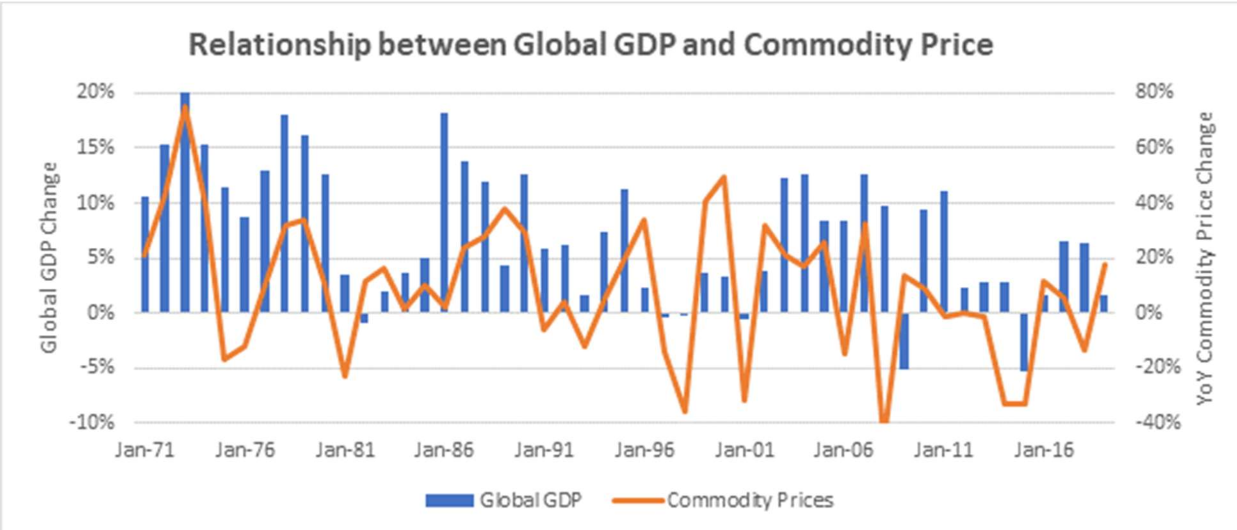
Natural Resources

Performance Review

Continued improvement in global economic prospects resulting from positive vaccine announcements and fiscal stimulus, the Natural Resources Portfolio rose by +6.18%, outpacing the S&P North American Natural Resources' +4.09% return in December 2020 by 2.10%. During the month, portfolio holdings ArcelorMittal, Plug Power, and Cenovus Energy rose by +25.7%, +28.5%, and +22.4% respectively, with stock selection in the Integrated Oil sector further adding value.

Commodity prices generally follow global economic growth trends

Historically, global commodity prices have shown a strong correlation to economic growth. This relationship makes inherent sense, given the changes in commodity demand as a result of changes in economic growth. As seen in the chart below, since the 1970s, the relationship has been fairly clear and consistent.



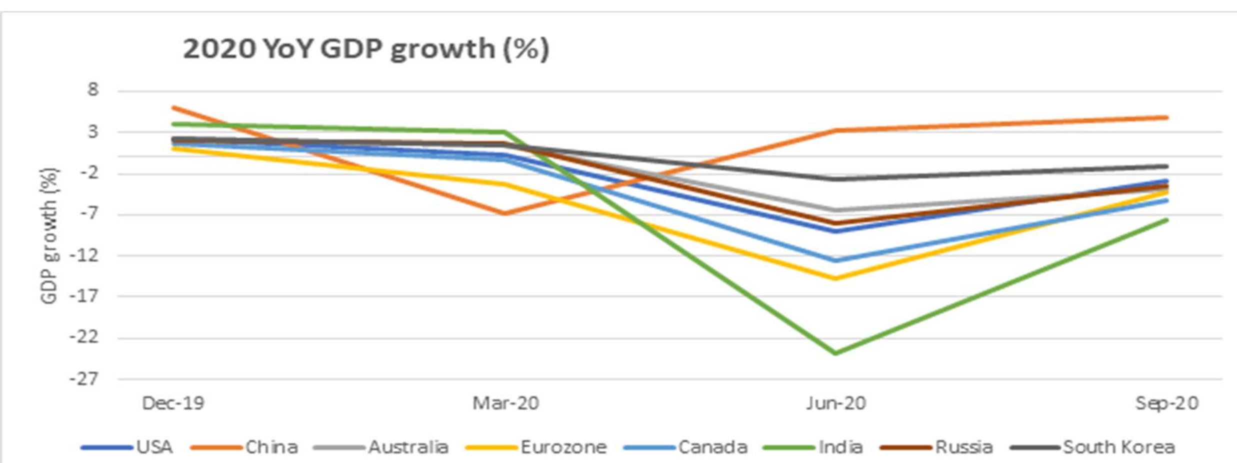
Source: Bloomberg, Recurrent research

Since the beginning of the COVID pandemic, commodity prices have fluctuated greatly as a result of changes in demand. As global economies closed to limit the spread of COVID, many commodity prices plummeted, highlighted by crude oil prices briefly turning negative in April.

As the effects of COVID continued throughout 2020, most leading global economies remain well below year ago levels, and global GDP expectations have fallen to -4 to -5%. Historical correlations, as shown above, would lead many investors to expect weak commodity prices, however, that has not been the case. Many commodity prices have actually risen considerably despite global economic weakness. Is there a unique circumstance which is causing the dislocation from this historical relationship?

Chinese GDP growth has greatly exceeded global peers

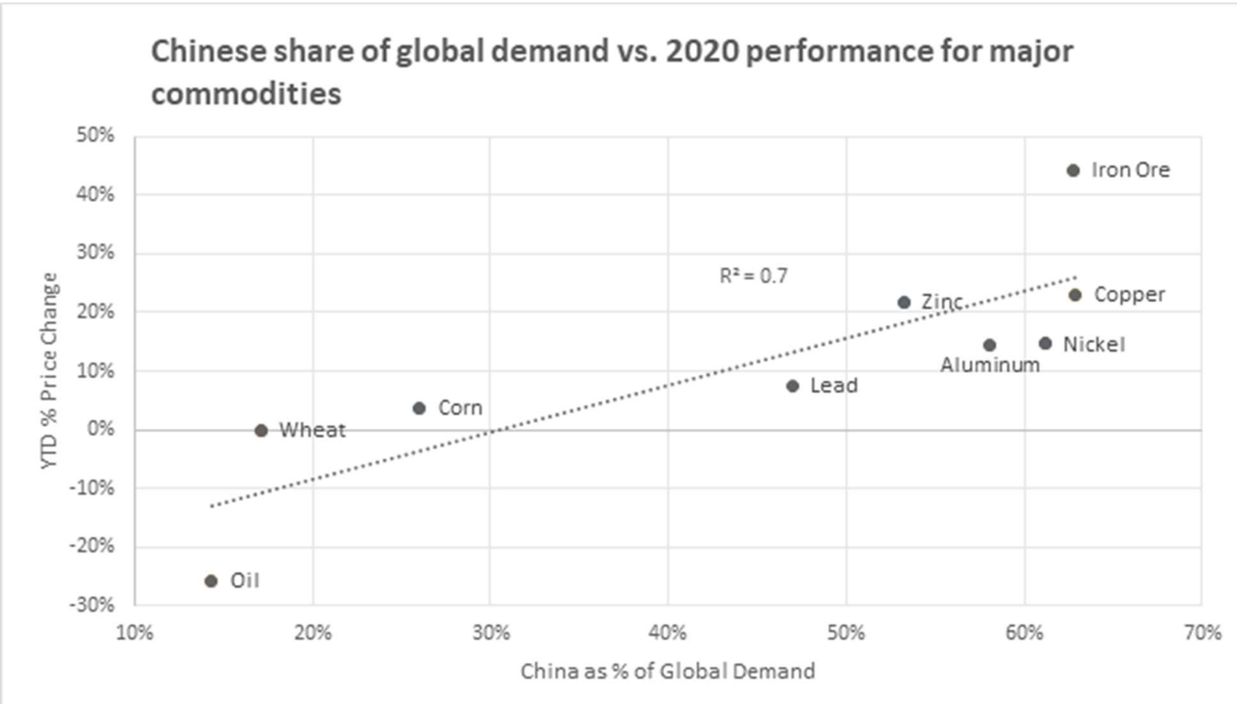
Interestingly, despite the impacts of COVID-19, Chinese GDP has fully recovered compared to 2019 levels. In 3Q 2020, Chinese GDP was more than 3% higher than 3Q 2019. From a commodity perspective, China plays a unique role.



Source: Bloomberg, Recurrent research

In 2020 commodity prices have shown a meaningful correlation to the percent of global demand represented by China

As a key global manufacturing center, Chinese industrial commodity demand represents a large percentage of global commodity consumption. As a result, Chinese 3Q 2020 economic growth alone greatly improves demand for commodities, which should support prices. In fact, in the chart below we look at the relationship between the percent of global demand represented by China, and the change in commodity price during 2020.



Source: Bloomberg, Recurrent research

The relationship between the two variables is fairly high, with an R^2 of 70%. Since Chinese economic growth leads the world, and China represents a high percentage of global demand, many of the commodities have moved to operating deficits, and prices have risen to incentivize additional investment in supply. Chinese demand for iron ore, aluminum, copper and nickel all exceed 50% of the global total, and the respective 2020 commodity price increases all exceed 20% since the beginning of 2020.

In the short term, the strength of the Chinese economy continues to buoy many global commodity markets. Through the course of 2021, improved global economic prospects resulting from accelerating vaccinations and reopening economies should further increase demand for commodities. Although many commodity prices have risen in 2020, they remain far below historical averages, offering opportunities for further appreciation.

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