Midstream and Natural Resources: despite strong earnings reports and signs of economic acceleration in Europe and Asia, the market is fixated on bank failures leading to a slowdown in the US economy. 2022 showed that commodities could weather a slowdown in global GDP… but how will natural resource and energy investments fare amid recessionary and inflationary cross-currents? The mid-1970s – a period of inflation and low energy capex – might offer a useful analog.

Nearly 50 years ago, the US experienced a steep recession in the wake of an inflationary foreign war. Sound familiar? In the 1970s, hopes for a "transition" away from oil, recession fears, and government interference reduced investment in fossil fuels. As a result, the mid-70s inflationary recession didn't stop inflation, it actually prolonged it. Capex remained low, and inflation returned with a vengeance as the economy reaccelerated in 1976. As we show below, the 1970s showed that a recession was not enough to permanently kill inflation.

Click here for the latest white paper on the long-term relationship between inflation and capex
Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG

MLP & Infrastructure

Performance review

During the month of April 2023, the Recurrent MLP & Infrastructure Strategy generated net returns of +0.14%, lagging the Alerian MLP Index's (AMZ) +1.72% return by -1.58%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +3.40% (annualized, net of fees). Please see the performance section at bottom for more detail.

Natural Resources

Performance Review

In the month of April 2023, the Recurrent Global Natural Resources fell -0.85% net of fees, lagging the S&P Global Natural Resources Index's -0.25% return by -0.60%. Since its June 2018 inception, the Recurrent Global Natural Resources strategy has outperformed the benchmark by 2.76% per year on an annualized basis, net of fees.

50 years ago, markets prematurely declared victory over inflation

With bank failures posing a risk to US economic growth - is the commodity inflation cycle over?

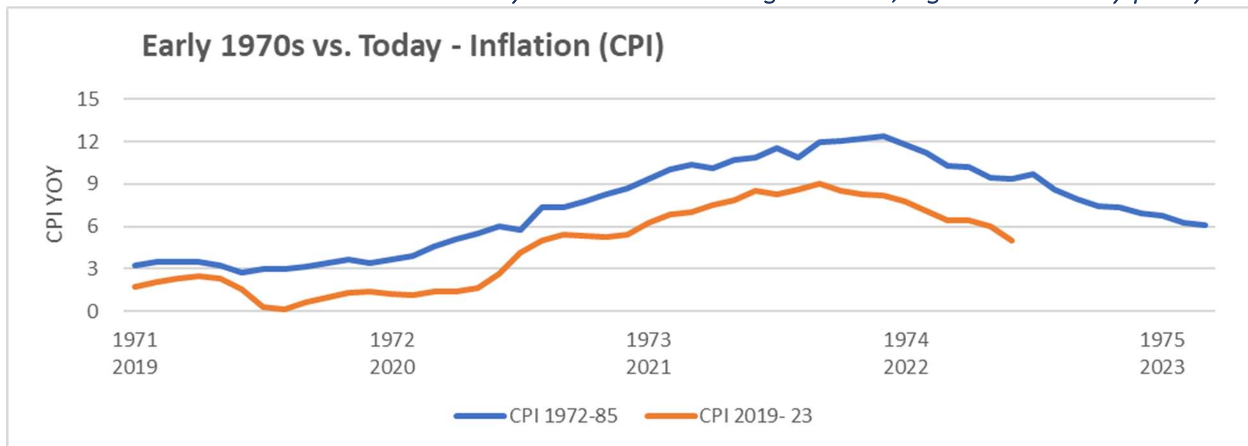
While there were signs in 2022 that food and energy costs and fiscal and monetary tightening were slowing the global economy, the failures of major US regional banks have increased concerns that we are entering a period of sharper economic contraction. Could this be the end of the inflationary cycle?

For much of the last 3 years, Recurrent has drawn parallels between the early 2020s and the early 1970s. In both periods, low interest rates, significant deficit spending, and geopolitical conflict contributed to core inflationary indicators rising rapidly into the double-digits. In our white paper titled "The Great Inflation Misdiagnosis", we explained that the Fed and recessions could slow inflation, but historically only CAPEX could stop it for good.

This month, we examine the striking parallels between today and the early 1970s to examine whether or not it is likely that the commodity inflation cycle has been secularly impaired by a potential economic recession. As we show below, the 1970s analogues suggest it is much more likely that a US recession offers a short respite (and buying opportunity) before the inflation cycle resumes.

To begin the comparison of the 1970s and 2020s, in the chart below, we look at the progression of CPI in the two eras. After years of muted inflation, year-over-year CPI inflation steadily rose, peaking in 1974/early 2022.

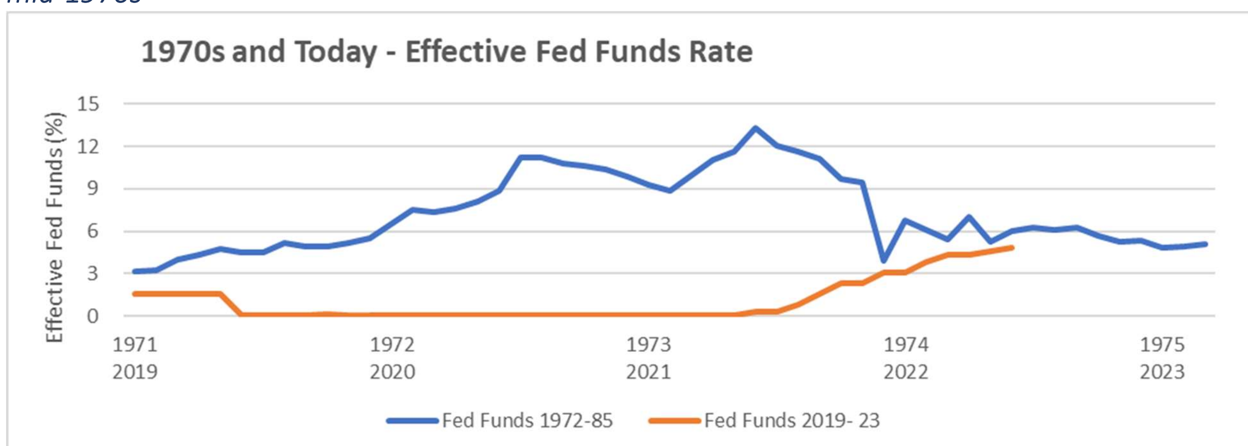
Exhibit 1: CPI moderates as the economy slows to absorb higher costs, tighter monetary policy



Source: Recurrent research, St. Louis Fed/FRED, Bloomberg

In both periods, the Fed significantly increased interest rates. In the early 1970s, Fed Funds Rate increased from roughly 3% in early 1972 to approximately 13% in the summer of 1974. Similarly, in response to high inflation, the Federal Reserve increased interest rates from nearly 0% in late 2021 to more than 5% at the end of April 2023.

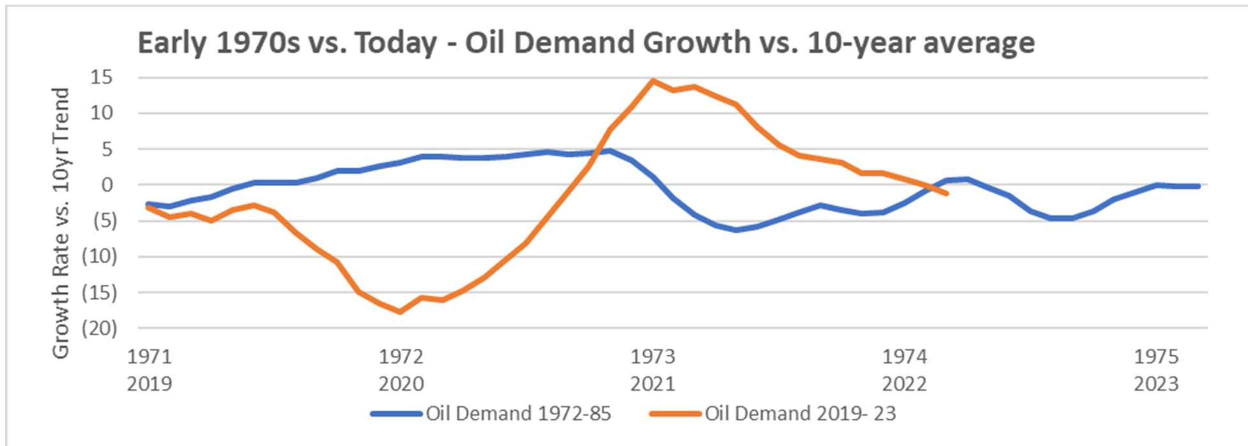
Exhibit 2: while COVID caused a delay in monetary tightening, current policy is comparable to mid-1970s



Source: Recurrent research, St. Louis Fed/FRED, Bloomberg

As seen in Exhibit 3, In the face of higher inflation and interest rates, in both periods, oil demand growth peaked and fell to negative YOY growth. Interestingly, despite below-average growth rates, oil prices remained above long-term averages, in large part due to below-average CAPEX stunting supply.

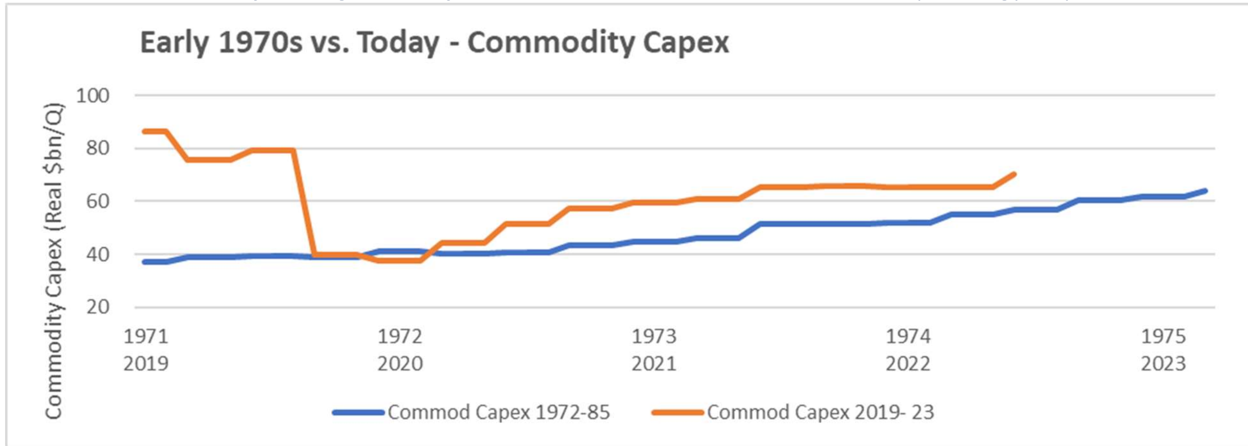
Exhibit 3: then and now, high prices and slowing GDP temporarily pushed demand below its long-term trend



Source: Recurrent research, St. Louis Fed/FRED, Bloomberg

Despite persistent commodity undersupply and elevated prices, comparable factors reduced energy CAPEX in the 1970s and are restraining it today. Misguided government incentives (and disincentives), hopes for an accelerated "energy transition" (then it was to nuclear power; today it is to renewables), and fears of a recession kept commodity CAPEX low, in the 1970s and again 50 years later.

Exhibit 4: recession fears, gov interference, environmental concerns keep energy capex low

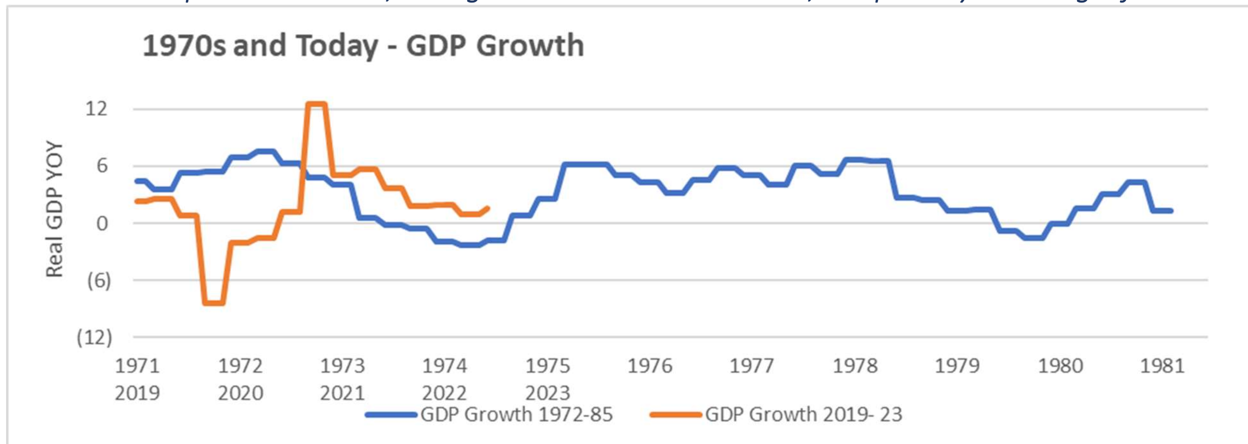


Source: Recurrent research, St. Louis Fed/FRED, Bloomberg

By the late 1970s, it was clear that recession hadn't stopped inflation – it actually prolonged it

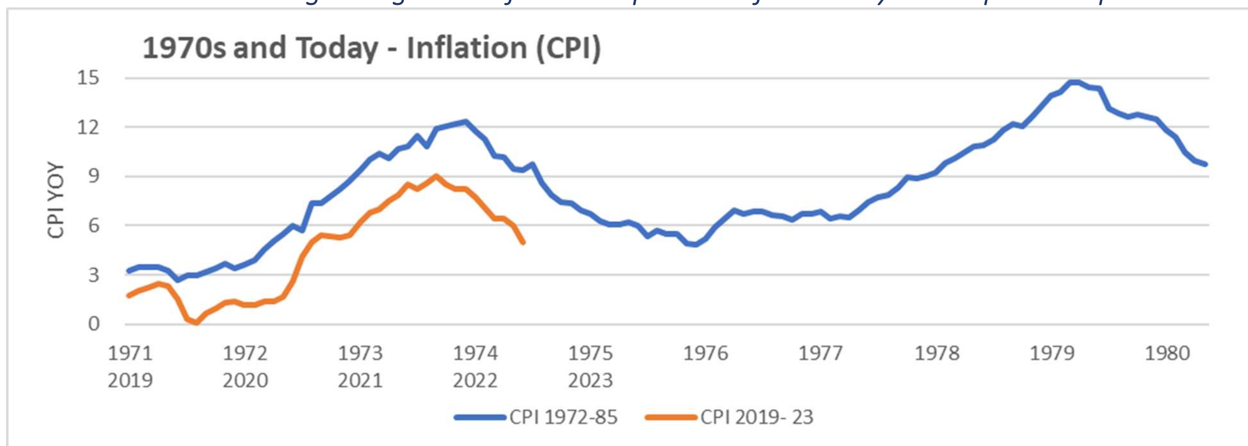
As seen below in Exhibits 5 and 6, the economic slowdown of the early 1970s – which closely mirrors the economic data in 2023 – gave way to a renewed bout of high inflation readings. By the mid-1970s, the Federal Reserve was forced to reduce interest rates to spur economic growth, accelerating dormant inflationary pressures. With commodity CAPEX muted, economic growth caused commodity prices to spike, and CPI reaccelerated beyond its early 1970s peak, even though real GDP growth in the late 1970s never reached the levels of the early 1970s.

Exhibit 5: in a parallel to 2023, GDP growth moderated in 1974, temporarily reducing inflation



Source: Recurrent research, St. Louis Fed/FRED, Bloomberg

Exhibit 6: Reaccelerating GDP growth after 1976 pushed inflation beyond its previous peak

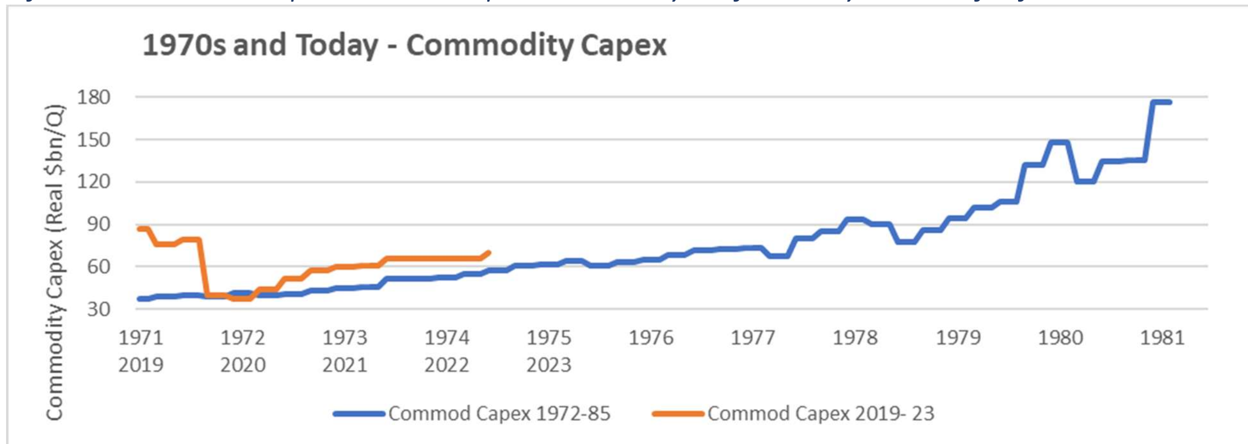


Source: Recurrent research, St. Louis Fed/FRED, Bloomberg

Commodity CAPEX remains well below historical averages...and in line with the 1970s experience

As we outlined in our 2022 white paper, the impact of interest rates has short-term impacts on demand, which can depress inflation in the short run. However, commodity inflation can rapidly return in the absence of investment to create new supply. Unsurprisingly, the trajectory of commodity CAPEX today is tracking that of the early/mid 1970s, far below historical averages.

Exhibit 7: ultimately, capex had to increase threefold from 1975 to 1981 in order to conquer inflation – a historical parallel that implies that today's inflationary battle is far from over



Source: Recurrent research, St. Louis Fed/FRED, Bloomberg

Early in 2021, we identified the potential similarities between the early 1970s and the post-COVID period. More than 2 years later, the evolution of economic and CAPEX data closely mirrors the early/mid-1970s. Given the below-average commodity CAPEX data seen in Exhibit 7, we continue to expect commodity undersupply to cause persistent inflationary pressures on the broader economy, reminiscent of the 1970s into the early 1980s.

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