

Embracing a Changed World

If you happen to be in Marin County, California on a warm night, you might find us debating the consequences of rising debt as a percentage of GDP over a bottle of wine. We realize that others do not always find our economic banter enjoyable, but our backgrounds in economics have proven useful for the times we live in. Our parents are happy to know all the money they spent for those liberal arts educations did have practical applications!

How the world has changed...

The current Democratic agenda changes both the amount of money we spend and how we spend it. As advertised, Biden's \$4 trillion plan addresses perceived inadequate investment in the following areas:

- Infrastructure – roads, bridges, broadband, electricity grid, semiconductor foundries
- Human capital – education, early childcare, health care
- Protecting the environment – solar power, electric cars, green building

The prospect of government spending, on top of previous direct payments to Americans, has stoked inflation fears, particularly as the economy reopens with a concomitant surge in economic activity. Estimates of economic growth this year range from 6% to 10%, the highest since 1984 (or even 1951). Fed Chair Jerome Powell repeatedly states we have a long way to go to get to full employment and believes inflation will be transitory. Others are concerned inflation may be longer lasting. There are cases to be made for both arguments.

Causes of pandemic related transient inflation - which will likely subside over time:

- Supply shortages due to manufacturing restrictions (fewer people working further apart)
- Shipping bottlenecks (also labor related), not to mention the Suez Canal blockage
- Shale market shutdowns leading to lower oil and gas production
- One time surge in consumer spending from the recent direct distributions of \$1400
- Reopening surge in spending on travel, restaurant dining and other social activities

Reasons inflation may be higher and more persistent than after the financial crisis (see [2nd Quarter 2020](#)):

- The Fed has specifically targeted above 2% inflation until employment goals are met
- The Federal Reserve balance sheet grew larger and faster than post financial crisis
- The 2020/2021 fiscal stimulus is much larger than post financial crisis
- Cash was deposited directly in bank accounts which makes it more likely to be spent
- Shifting political attitudes to supply chains means "just in case" rather than "just in time" approach to inventory management
- Politically motivated de-globalization is here to stay (think semiconductors, antibiotics, PPE)
- Regulation of oil and gas and promotion of clean energy, while good for the environment, raises the cost of fossil fuels.
- Higher U.S. debt and new Chinese cryptocurrency will pressure the dollar and its status as a reserve currency. A lower U.S. Dollar is inflationary as it makes the costs of goods from outside the U.S. more expensive.

Countervailing trends which could offset inflation:

- Productivity growth from broad based technology investments in 2020 – a new report from McKinsey suggests the U.S. may see a post-pandemic productivity surge with as much as a 1 percentage point increase in annual productivity growth over next four years.
- \$3 Trillion in proposed tax hikes (if enacted) will likely slow economic growth in 2022 and 2023, possibly offsetting the Federal Reserve's easy monetary policy. The tax increase proposal will be the largest since 1968.

- Rather than raising prices, companies may absorb some of their increasing costs to remain competitive. Although this would mitigate inflation, raising prices potentially hurts profit margins, earnings and stock prices.
- Aging U.S. demographics leads to lower rates of consumption
- Future productivity growth from new investments in infrastructure and human capital

Whether inflation is transitory or not, we won't know the outcome until possibly mid-2022. In the meantime, we have taken steps to hedge our portfolios from higher inflation.

What to do about it...

We believe that commodities participate in a rebounding global economy, preserve returns in an inflationary environment, and provide a role in diversifying your portfolio. Further, commodities likely protect your portfolio from a weakening dollar that we believe is inevitable given the United States' ever-increasing debt.

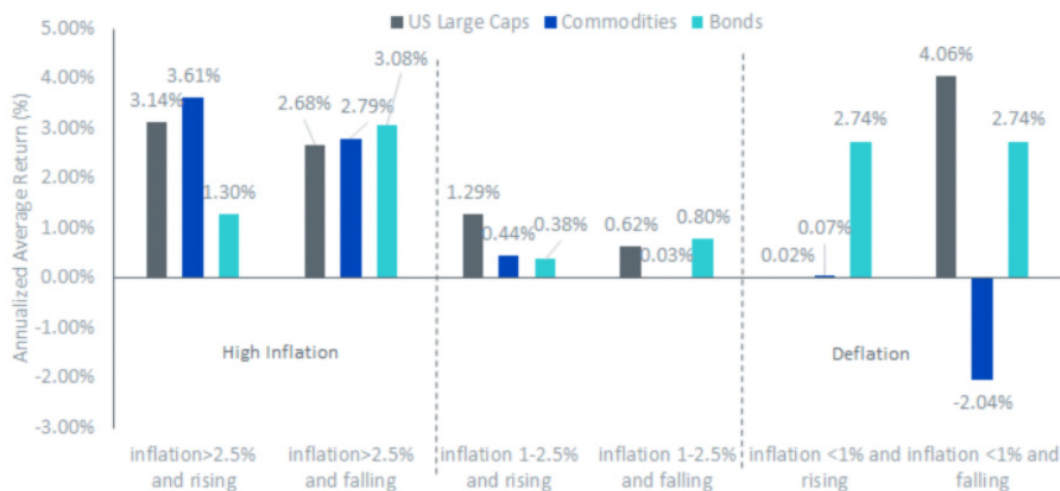
Commodities as a Hedge Against Inflation¹

Commodities have historically been one of the most straightforward ways to directly benefit from an increase in inflation. Their prices are largely determined by supply and demand. When economic activity picks up, production material utilization increases which causes an increase demand for raw materials leading to higher prices.

Stocks can help protect investors in the early stages of inflation, but if inflation persists, stocks fail to keep up. Over the last 50 years, in periods where inflation exceeded 2.5%, commodities generated the highest returns, outperforming stocks by approximately 30 basis points with lower volatility.

The chart below from WisdomTree is illustrative.

Asset Class Performance during Inflation Regimes



Sources: WisdomTree, Bloomberg, Morningstar, 1/30/1970–12/31/2020. Inflation proxied by IA SBBI U.S. Inflation Index, U.S. Large Caps proxied by IA SBBI U.S. Large Stock TR USD Index, Bonds proxied by IA SBBI U.S. LT Government TR USD Index, Commodities proxied by S&P GSCI Index (SPGSCI). Past performance is not indicative of future results. You cannot invest directly in an index.

¹ Why We're Bullish on Commodities in 2021 by Jianing Wu, Senior Analyst, WisdomTree 3/15/21

Commodities as an Alternative to Bonds

Given the current rising rate environment which causes negative returns in bonds, commodities are an appealing alternative. Bonds and commodities have similar low correlations to the S&P 500 (both near 0%). In high and rising inflation environments, however, commodities outperformed bonds by 2% to 3%.

Inflation > 2.5% and Rising		
	Correlation vs. S&P 500 Index	Average Annualized Return
U.S. Long-Term Govt Bonds	0.06	1.30%
SPGSCI Index	0.10	3.61%
BCOM Index	0.07	4.12%

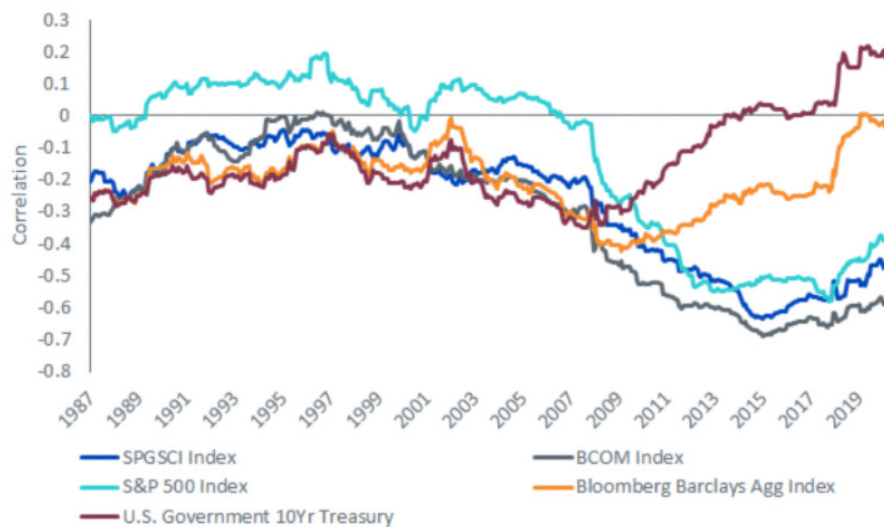
Inflation <= 2.5%		
	Correlation vs. S&P 500 Index	Average Annualized Return
U.S. Long-Term Govt Bonds	0.09	4.27%
SPGSCI Index	0.15	-1.51%
BCOM Index	0.12	-1.79%

Sources: WisdomTree, Bloomberg, 1/30/1970–12/31/2020. U.S. Long-Term Govt Bond proxied by IA SBBI U.S. LT Government TR USD Index. Past performance is not indicative of future results. You cannot invest directly in an index.

Commodities as a Hedge Against a Falling Dollar

Most commodity transactions are priced in U.S. dollars. As the dollar falls, commodities become cheaper in other currencies, which in turn increases demand from those buyers. Therefore, commodities have tended to have a negative correlation against the U.S. dollar as the chart below demonstrates.

Rolling 10-Yr Correlation vs. USD



Sources: WisdomTree, Bloomberg, 1/30/1970–12/31/2020. U.S. Government 10-Yr Treasury proxied by RT 10 Index. Past performance is not indicative of future results. You cannot invest directly in an index.

At a macro level, we have provided the rationale for buying commodities, but there are other reasons unique to the commodities themselves. The increasing difficulty of finding commodities (and taking them out of the ground) coupled with years of lower prices have led to decades of structural underinvestment. We outline below the current supply/demand picture for several of the individual commodities we favor.

Oil and Gas

When looking at oil prices, analysts use the supply and demand forecasts from the IEA (International Oil Agency). For at least the last decade, the IEA has consistently underestimated global oil demand, primarily from non-OECD countries (The Organization for Economic Cooperation and Development). This year may be different, but the IEA's track record has not been good.

In 2013, the U.S. became the world's largest oil producer, rising to 19% of world production. U.S. shale production was ultimately responsible for driving down worldwide oil prices. Many geologists suggest that shale economics are different from other types of oil fields in that they are very productive initially with a faster tail off. Those ascribing to this theory believe shale supply may be much lower than expected.

Further, there is evidence that Saudi Arabia's reserves are overstated. This was first proposed by Matt Simmons in Twilight in the Desert and more recently mentioned in a speech by Leigh Goehring (a leading authority in global commodity investing). In fact, it has been suggested that production from Ghawar, the world's largest oil field in Saudi Arabia, is in decline.

"Non-OECD countries have gone from consuming 40% of all primary energy to 60%. As an emerging market gets richer, it reaches a tipping point and starts to consume more energy. Once an economy is developed, it reaches a saturation point and energy demand moderates."² In the near term, emerging market demand for energy continues to grow.

While energy markets often experience intermediate-term price gyrations, trends in supply and demand matter substantially over time. The supply demand picture we describe favors the long-term outlook for oil prices. The combination of a growing U.S. economy combined with an inability to restart shale oil production quickly argues for higher energy prices in the short term as well.

Copper

Growth in copper mine supply should be minimal over the next 5 years due to accelerating copper mine depletion and the lack of massive new copper mining projects.

Robust Chinese copper demand offset weakness in the rest of the world due to the pandemic. The World Bureau of Metal Statistics estimates that Chinese copper demand was 17% year over year for the first 11 months of 2020. Although there can be short term demand issues, such as the current desire to reign in Chinese housing speculation, China's desire to generate electricity from renewable sources and increase investments in data centers are copper intensive.

The increased concerns surrounding climate change and the desire to invest in clean energy coupled with diminished supply, bode well for copper pricing.

²) Ignoring Energy Transition Realities, Fourth Quarter Letter Goehring & Rozencajg

Gold (see blog [Why Gold Often Glitters](#))

Bank of Montreal points to a recent McKinsey webinar that sees mine supply dropping from ~3,400 tpa currently to just over 2,900 tpa through 2030. The increased difficulty of finding gold and the underinvestment in capex has slowed supply growth.

Gold prices are being affected by a number of cross currents, including:

- **Real interest rates.** Thus far this year, real interest rates increased due to a faster rise in inflation expectations than inflation itself. Gold and real rates are negatively correlated, so strong real rates are negative for gold.
- **Central bank buying.** After selling gold aggressively between 1992 and 2008, central banks over the last 12 years have turned into large buyers. The huge financial strain now being put on government finances (as a result of the COVID-19 pandemic) could mean a substantial period of weakness in central bank gold buying with many even turning into sellers over the next several years. Turkey, for example, who was one of the largest gold buyers over the past year, has now turned into a seller as a result of its steadily worsening fiscal and monetary situation. In Q1 2020, Russia announced the suspension of all gold buying. Low oil prices, COVID-19 related economic dislocations, and Ruble weakness are the most likely explanations. Meanwhile, Chinese gold buying returned in 2020 and consumer demand from India remains robust.
- **Concerns over the value of the dollar.** Most recently, crypto currencies have been become an acceptable alternative to gold.
- **Alternative investments.** As the U.S. economy improved, investors took profits in gold to invest in stocks that would benefit from a pickup of economic activity.

While all these crosscurrents exist, the primary driver of gold prices is real interest rates. If inflation starts to rise faster than current expectations, real rates will likely decline. This scenario typically benefits gold prices. Additionally, gold remains a good portfolio diversification tool as hedge against major global disruptions and inflation.

Congratulations! You have made it through our thesis. Come join us for a glass of wine!

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