

*Key Takeaways:*

- *The inflation cycle has thus far included both a cyclical and a structural component. The former is likely to fade, while the latter is likely in its early stages*
  
- *Investment gains from cyclical inflation will be minimal comparable to long-term gains from structural inflation*
  
- *Tighter financial conditions and slower real economic growth will impact cyclical markets disproportionately, but markets are pricing in a universal reversion to the pre-existing economic backdrop*
  - *Markets are pricing in a return to a pre-2020 economic backdrop, which we find extraordinarily unlikely*
  
- *The past 40+ years of financial markets and economics are shifting with large implications for asset allocation*
  
- *Quality, hard asset companies with efficient business models are distinctly positioned to thrive during this transition period, and for decades thereafter under the new regime*
  - *These companies earn very high returns under various economic backdrops and do not require ever rising inflation to generate strong shareholder returns*

## *Introduction:*

Financial markets thrive on predictability, as greater certainty about the future permits greater risk tolerance, which promotes economic growth, ergo growth in wealth. The past decade, if not decades, of modern central economic planning have sought to reduce economic uncertainty, largely by intervening in free markets by providing liquidity support through monetary (interest rate) and fiscal (spending) measures. The requisite magnitude of financial support to stimulate the economy has grown in excess of nominal economic growth and financial leverage within the system, creating reliance on a rapidly increasing amount of stimulus. This cycle of ever greater financial stimulus may have recently culminated (temporarily), after U.S. money supply<sup>1</sup> grew approximately 45% between January of 2020 and April 2022. This translates into approximately 31% of the total U.S. Dollars in existence having been “created” within the past 26 months. It should come as no surprise that an unintended consequence of decades of policy aimed at supporting asset and economic growth is inflation. “Inflation” first came in the form of financial asset inflation (i.e. stocks, bonds and private assets), followed by consumer and producer goods (e.g. CPI, PPI), and now, seemingly, everything.

The U.S. Federal Reserve is no longer denying that inflation is extremely unlikely to abate on its own, and it has begun raising interest rates aggressively in order to combat rising price levels. Tighter money can only combat inflation by reducing demand, as interest costs consume more of businesses’, individuals’ and governments’ cash flows<sup>2</sup>. Contractions in demand are often associated with economic contraction, i.e. recession. Fear of economic/demand contraction is driving irrational price action in financial markets, as investors underestimate structural trends and rely on heuristic analysis of past cycles. It may shock many people to learn that commodity prices and broader consumer prices can, in fact, rise during a recession. To quote Zoltan Pozsar of Credit Suisse, “*You can print money, but not oil to heat or wheat to eat.*” This quote summarizes the dilemma that central banks face, as decades of underinvestment in indispensable raw materials are coinciding with growing demand, specifically from emerging (non-OECD<sup>3</sup>) markets. Further, there is a growing risk that aggressive central bank policy aimed at reducing inflation via curbing demand will achieve its goal in reducing growth, but without impacting structural inflation, thus resulting in stagflation.

This leaves the global economy in a very uncertain position, where restrictive bank policies are in direct conflict with slowing global growth. We do not have any unique insight into what will catalyze this dynamic to shift, or how or when it might occur, but we do believe we have an informed opinion about what the ultimate economic and investment implications are. In short, the current paradigm of investing, which has reigned for decades is shifting – and at warp speed due to the policy mismatch. This change will be uncomfortable, and many individuals and institutions will surely reduce exposure due to the uncertainty, which will pressure asset prices. However, this short-term orientation fails to recognize the difference between cyclical and structural inflation, hence missing investment opportunities in secular inflation beneficiaries.

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<sup>1</sup> M2 Money Supply

<sup>2</sup> Cash Flow: Cash Flow is the increase or decrease in the amount of money a business, institution, or individual has.

<sup>3</sup> OECD: Organization for Economic Co-operation and Development

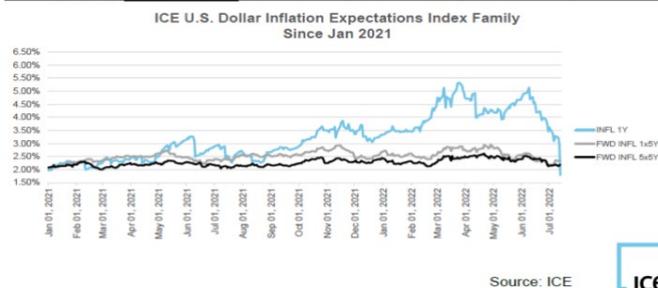
The past 40 years can be characterized as an era of abundance, driven primarily by globalization, technological innovation, and declining interest rates. These supporting trends simply cannot be sustained, and most are either stalling or outright reversing. This will result in a markedly different investment environment for the next decade as compared to the past – yet most investment “models” rely on historical performance and correlations based on 10, 20 or 30 years of data, which is no longer a valid analog. Specifically, we believe that the changes in these trends, in conjunction with underinvestment in raw materials, will result in a new era not of abundance, but of scarcity. In short, the new era will place a primacy on existing high quality, hard assets – which stands in stark contrast to the prevailing primacy on intangibles and cheap investment capital.

### Market Backdrop:

The Fund was launched in early January of 2021, when the trailing 12-month CPI<sup>4</sup> for December 2020 registered 1.4%. We spent a great deal of our first year in existence arguing that higher inflation was imminent. By April and May of 2021, with successive CPI readings of 4.2% and 5.0% we found ourselves

**ICE U.S. Dollar Inflation Expectations Index Family**  
Published Jul 14, 2022 using previous business day closing prices.

Settings	Current value Jul 13, 2022	Previous day Jul 12, 2022	One month ago Jun 13, 2022	One quarter ago Apr 13, 2022	One year ago Jul 13, 2021
Calendar Year 2022	6.55%	6.51%	7.82%	6.04%	2.61%
Day on day change	+0.04%				
Calendar Year 2023	2.74%	2.64%	3.54%	3.34%	2.52%
Day on day change	+0.10%				
1Y (Next 12 Months)	1.79%	2.92%	4.78%	3.98%	2.41%
Day on day change	-1.12%				
Forward 1x5 Years	2.34%	2.35%	2.49%	2.67%	2.43%
Day on day change	-0.00%				
Forward 5x5 Years	2.19%	2.17%	2.40%	2.46%	2.14%
Day on day change	+0.02%				



Source: ICE



refuting the consensus view that inflation would be temporary, or, in media and economist parlance, “transitory.” Now, with the June 2022 CPI reaching 9.1%, the narrative has shifted towards a recession (induced by the Federal Reserve) ending inflation, with some pundits even suggesting outright deflation. We remain in disagreement with the majority and believe that higher price level growth will be a structural feature of the new paradigm. In the following section, we will provide background for this belief.

Investment success isn’t necessarily driven by being correct in absolute terms, but rather by understanding what the market is pricing into assets and basing investments off the implicit values. To this end, consider the inflation expectations based on the ICE U.S. Dollar Inflation Expectation Indexes<sup>5</sup>. The market is pricing in a 6.55% CPI level for the full-year 2022, and 2.74% for 2023, but 1.79% for the next 12 months (i.e. through July 2023). Furthermore, the 5-year (i.e. July 2027) is 2.19% which is essentially back to the Fed’s stated target level and not materially higher than the pre-2020 trend.

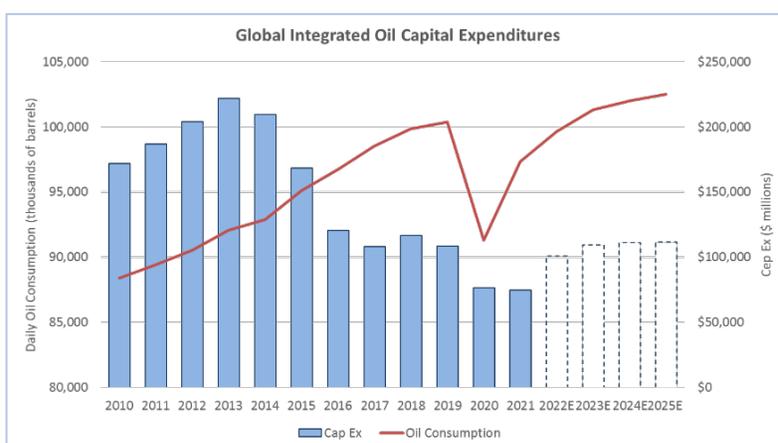
There are nuances to each time period in question, such as the “base effect” and implications of a possible recession, but the important takeaway is that the market is pricing in an eventual mean reversion to the

<sup>4</sup> CPI: The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

<sup>5</sup> Data provided as of July 14, 2022

pre-2020 economic order. We find this outcome to be highly unlikely (as we will elaborate further below); this view leads us to find tremendous opportunities today, because the market is generally pricing many hard asset companies as if there will be imminent and enduring mean reversion. We stand to earn outsized returns to any degree that this reversion does not occur, or only partially occurs.

Notwithstanding short-term economic concerns and market volatility, raw material underinvestment is one of the most important factors driving structural price pressures worldwide, and it is most pronounced in the energy sector. Capital expenditures from the 12 leading global integrated oil companies<sup>6</sup> have fallen by 66% relative to peak spending in 2014. This is despite global oil (liquids) consumption rising by 7.2% over this period of time, with further



Source: Bloomberg, EIA, McKinsey

growth of 3% expected through 2025. While capital investment is expected to recover modestly, it will remain below 50% of 2014 levels, even as exploration costs are rising and established well production declines are increasing. Based on our assumptions, we believe that the current capital expenditures of global energy companies cannot even sustain current production levels.

The period between 2014 and 2020 corresponded to nearly 7% global population growth, including 7.63% population growth in non-OECD countries<sup>7</sup>, which have a higher propensity to consume energy as GDP per capita is growing far more rapidly than western markets. To this end, oil consumption in non-OECD countries grew at a 3.1% annual rate between 2009 and 2019, compared to a 0.3% rate for OECD countries. Additionally, non-OECD oil consumption increased 2.69% and 5.46% respectively in 2008 and 2009 despite the global financial crisis and oil prices rising to over \$140 per barrel<sup>8</sup>.

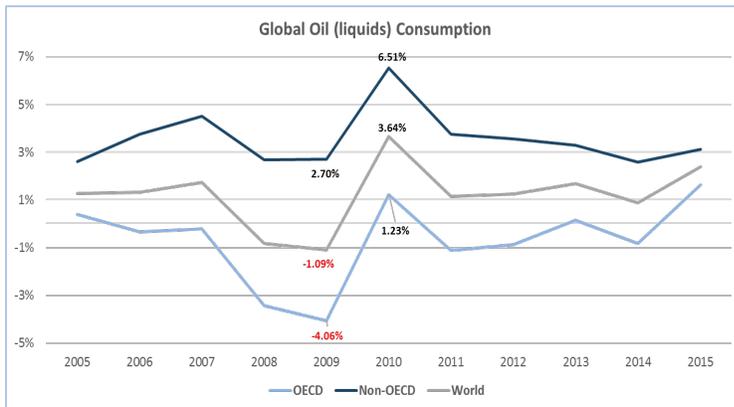
The elasticity of energy demand is subject to great debate today given recession fears; however, historical examples suggest that demand is very resilient. Consider that, in the global financial crisis, when global GDP declined by approximately (0.70%) in 2009<sup>9</sup>, the aggregate decline in global petroleum liquids consumption was approximately (1.09%). The non-OECD world consumption actually grew 2.70% through the 2007-2009 period, and total aggregate global consumption recovered to a new all-time high level by 2010.

<sup>6</sup> Exxon Mobil, Chevron, Total, Equinor, BP, Petroleo Brasileiro, Suncor, Eni, Cenovus, Imperial Oil, Repsol, YPF

<sup>7</sup> World Bank, World Development Indicators

<sup>8</sup> BP Statistical Review, 2021

<sup>9</sup> GDP standardized to PPP using constant 2017 international dollar in order to avoid distortions from current U.S. Dollar strength

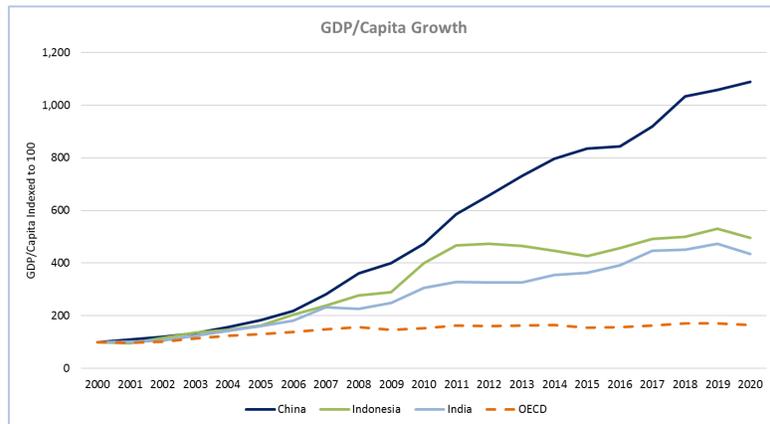


Source: BP

A complete analysis would include various contributing factors to the 2007-2010 period, compared to today. Specifically, the U.S. Dollar was much weaker against other global currencies and refining margins were much lower during the global financial crisis, and China was still investing heavily in fixed assets. However, there are an additional 1.09 billion people in the world today, 980 million of whom reside in non-OECD nations with far higher growth in per capita economic growth and energy

consumption. Furthermore, the oil prices recovered from the global financial crisis to spend much of the 2011-2014 period above \$100/barrel, only to have a new wave of production growth and capital expenditures related to U.S. shale balance the market. We do not believe that such a potential offset exists today.

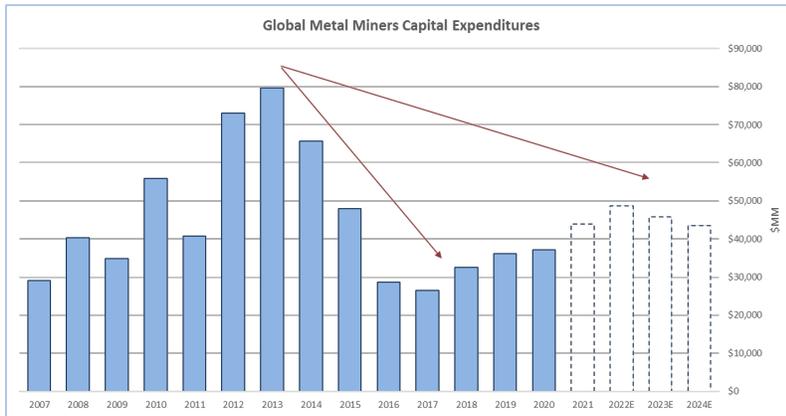
The importance of non-OECD demand cannot be understated – the non-OECD world accounts for over 82% of global population, but approximately 52% of global oil demand. Energy consumption grows rapidly with growth in per capital economic growth, markedly so off a low base (i.e. incremental increased standards of living off a poverty standard). China, India and Indonesia are three of the largest countries by population, with the highest growth rates in GDP/capita.



Source: World Bank

Over the past 20 years China, India and Indonesia have compounded GDP/capita growth at 12.7%, 7.6% and 8.3% respectively, compared to 2.6% for the OECD world. However, while the OECD world has a GDP per capita of approximately \$38,000, India is slightly below \$2,000, Indonesia slightly below \$4,000 and China slightly over \$10,000. Thus, as these emergent nations grow into more industrialized economies, with higher standards of living, the requisite energy, materials and food consumption will become an increasingly large portion of the global share.

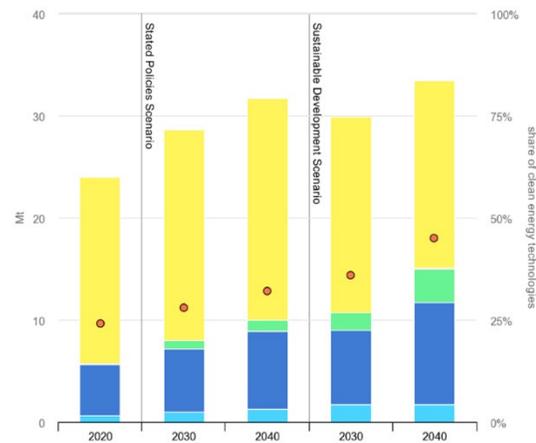
One of the largest contributing factors to the industrialization of the non-OECD world will be the electrification of these countries. While the World Bank estimates that nearly 90% of the global population



Source: Bloomberg

has access to some electricity, which is up from 78% in 2000, power grids need higher generation and transmission capacity as nations develop industrially. The development of this “electrification” will require extraordinarily large quantities of industrial metals such as copper, nickel and steel (iron). This core demand will only be supplemented by similar needs for higher capacity electric grids in developed nations seeking to decarbonize.

Despite the obvious structural demand, global investment in industrial metals (namely copper and iron ore) has also fallen 45% based on 12 leading global mining companies<sup>10</sup>. The IEA expects copper demand to grow from a base of 24 million tonnes (Mt) in 2020, to a range of 28 to 36 Mt in 2030 and 32-45 Mt in 2040 depending on the pace of decarbonization spending, but with base demand being driven by non-OECD electrification. Even in the event that substantial capital was committed to securing additional supply immediately, the IEA estimates that a new “greenfield” copper mine requires over 15 years to reach production.



Source: EIA

In summary, energy, industrial metals and other essential commodity (i.e. grains) price levels are likely to remain elevated for an extended period of time due to structural supply limitations, inelastic demand and resilient demand primarily from non-OECD nations. This dynamic is unlikely to shift absent either a surprise from the supply side (exceedingly unlikely) and/ or a protracted, severe global recession. Regarding the latter, the dual-mandate of the Federal Reserve is to promote full employment and stable price levels. In the event that economic and employment data deteriorates significantly, with or without inflation, back to the 2019 trend, we would imagine that policy will quickly shift towards supporting the economy and employment. In truth, it is not an “if” but more “when” there is an eventual recession, hence an increase in unemployment. It is very hard to envision a recession without some collateral financial market damage, which could turn into the next economic crisis. It is even harder to envision such a crisis being remediated without the return to the stimulative measures that helped produce the current

<sup>10</sup> BHP Billiton, Rio Tinto, Vale, Glencore, Anglo American, Freeport-McMoRan, Southern Copper, Zijin Mining, Grupo Mexico, China Molybdenum, Teck Resources, Antofagasta

inflation. If this is the ultimate policy “end game,” the question should be how to prepare for it, not how to time each development within the longer paradigm shift. Specifically, we believe that the focus should be upon structural versus cyclical inflation components.

### *Portfolio Positioning:*

The portfolio remains positioned in hard asset companies that we believe will benefit from the new world of secular inflation and scarcity. We group the companies into three categories which broadly define the business models: companies with direct exposure to hard assets, companies with indirect exposure to hard assets, and companies with opportunistic exposure to hard assets. These companies universally have characteristics by which revenues can grow with rising volume/price levels, yet with minimal growth in expenses. Therefore, these companies can grow profit margins even in a world where profit margins are very likely to contract in aggregate. The ability to not only increase revenue, but also to control costs, will be critical in determining business success.

The direct exposure companies are in the following sub-industries: energy royalties, precious metals royalties, industrial metal royalties, pharmaceutical royalties, and land. These companies all benefit from rising price/volume levels in their respective assets/industries but have minimal variable cost structure. As an example, the incremental cost of a royalty generating an additional \$1 million of revenue is effectively zero, considering that there is no direct cost associated with generating that revenue. This is because royalty revenues are generally a percentage of revenue generated from 3<sup>rd</sup> party operators, with zero cash cost associated with the royalty holder. These businesses are extremely capital efficient (50%-90% operating margins), and generally have longer reserve lives as compared to direct operating companies. Thus, these incumbent assets will be working for investors for decades to come at similar or higher profit margins.

The indirect exposure companies are in the following sub-industries: financial exchanges, brokerages, real estate/asset management, data/research and defense technology. These companies have very similar operating profiles to the companies with direct exposure, specifically the low/no variable costs. As an example, the core business of a financial exchange is to act as an intermediary between buyers and sellers in financial instruments. Exchange trading is now almost exclusively automated, hence the marginal cost of processing an additional \$1 billion in notional trading volume is simply computational power, which approaches zero with scale. Similarly, brokerages benefit from higher transactional volume and pricing, with a percentage-based commission paid to salespeople, but with little overhead cost growth to the company itself.

Finally, the opportunistic exposure companies are in the following sub-industries: agriculture, timber, industrial metals and transportation. These companies are very similar to the first two categories of companies but have a higher requisite fixed cost structure. However, once this cost structure is covered, the businesses scale with volume/price. As an example, global agri-businesses crush and/or mill raw agricultural products (i.e. soybeans, wheat and corn) into intermediate or finished goods. These facilities and the related infrastructure have a fixed operating cost, however in the event that volume and prices rise, the cost of operating the fixed assets does not rise materially. We typically seek such investments in

industries with very attractive fundamentals (such as agriculture), yet which lack true “capital light” business models.

We believe that this mix of business models and sub-industries positions us very well for the coming years and decades regardless of the economic/inflation backdrop. These companies earn very high returns under current conditions, as they did in 2019 and are likely to do so in the years ahead. The businesses are likely to earn even higher returns under certain conditions, but certainly do not require higher price levels in order to be profitable investments.

### *Case Study:*

It is easier to understand the implicit pricing and range of potential return profiles of companies in the portfolio with an indicative example. The case study below provides context for the quality of the businesses in the portfolio, as well as the long-term nature of the assets and the value proposition. We would emphasize the returns even under far lower commodity inputs.

Energy Royalty A: This company’s revenue is expected to nearly triple (31% compound annual growth rate or CAGR) between 2018 and 2022 based on full-year projections for this year. During this period, the company has expanded operating margins by nearly 600 basis points<sup>11</sup>, and added significant additional acreage, while also increasing distributable cash flow per share by 76% (based on pro forma results for 1<sup>st</sup> quarter 2022). We estimate that the company can maintain current production levels for 25-30 years based on current drilling inventories, which is comparable to its inventory in 2018.

Despite the company’s growth in revenue, profit margins, and distributable cash flow per share, the company’s shares are nearly 40% lower than the 2018 peak level (excluding distributions). Furthermore, the company’s current distribution yield (based on 1<sup>st</sup> quarter pro forma production and commodity prices) is nearly 15%.

This illustrates the company’s positive gearing towards inflation (higher revenue and margins), yet with markets pricing in an imminent and structural decline in profitability. To the extent that distributable cash flow is halved from current levels due to falling energy prices – which would be well below the 5-year average excluding the 2020 disruptions – the yield would still be approximately 7.5% (with likely future production growth). Even at this depressed level, the valuation is far from demanding for a company with 70% cash flow margins, 25-30 years of drilling inventory (plus residuals decline production) and little to no need for capital expenditures.

We believe that the actual value in many of these companies resides in the incumbent asset base, which, in this case can be exploited for another 25-30 years, with decades of residual cash flow thereafter. This asset base, and the ability to exploit it at no cost to the company, will be a critical defining characteristic of the company over the fullness of time.

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<sup>11</sup> Basis points: Basis points are a common unit of measure for percentages in finance. One basis point is equal to 1/100th of 1%.

## *Conclusion*

It is abundantly clear to us that the short-term orientation of the financial markets is resulting in anomalous pricing in various hard asset companies. Investors are mistaking cyclical inflation related to supply chains and latent consumption with secular inflation related to insufficient supply in markets with highly inelastic demand. The former categories will almost assuredly be negatively impacted by slowing economic growth and tighter financial conditions, whereas the latter are likely to be marginally impacted by these factors and will take decades to rebalance supply.

Investors remain largely underinvested in sectors with hard asset companies which can benefit from this backdrop of structural inflation. We believe that investor focus will eventually shift towards companies that can i.) grow revenues on a real basis and ii.) manage costs associated with real revenue growth. The companies which can achieve these milestones will be rewarded with higher multiples, while those which cannot, will be penalized with lower multiples.

The future remains uncertain, but based on a range of realistic outcomes, the odds certainly favor a new economic paradigm going forward – one which favors incumbent assets and hard asset companies.

*“The measure of intelligence is the ability to change” -Albert Einstein*

## **IMPORTANT RISK DISCLOSURES**

***Please consider carefully a fund's investment objectives, risks, charges and expenses. For this and other important information, obtain a statutory and summary prospectus by contacting 646-495-7333. Read it carefully before investing.***

***Past performance is not a guarantee of future returns and you may lose money. Opinions and estimates offered constitute our judgment as of the date made and are subject to change without notice. This information should not be used as a general guide to investing or as a source of any specific investment recommendations.***

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