



**MARATHON**

RESOURCE ADVISORS

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## **Marathon Macro Thoughts:**

### ***The Road Ahead for Natural Resources, January 2021***

Investing in Natural Resource Equities over the last decade has been a rather thankless slog through varying degrees of disdain, disgust and apathy towards our chosen sector. We believe this negative sentiment will begin to shift as we move into the early stages of a fundamental, cyclical upswing in commodity prices, driven by plummeting capital expenditures and resulting in constrained supply. As well, while many see the "Green Wave" of renewables as solely an existential threat to traditional resources, there are considerable opportunities to invest in the materials critical to its growth at a fraction of the valuation bestowed on the headline beneficiaries. We are also increasingly comfortable making a case for a secular rise in inflation that, while neither 70s-like nor "hyper," should prove both inconvenient for most asset classes and highly supportive for resource equities.

Should any one of these themes play out, we think the current starting point of generationally depressed valuations and broader investor indifference offer considerable upside. In the event that most or all come to pass then several-fold appreciation is not only reasonable, but most likely conservative. After all, such a rally would still leave the sector trading near its most depressed levels of the last 50+ years.

We have been admittedly early in expressing this view, though with our focus on dividend and income generating equities across the natural resource spectrum, our strategy has still managed solid gains in an environment where the sector and most of our competitors have sustained considerable losses. After a decade of fighting significant headwinds, we suspect a significantly more supportive and profitable road lies ahead.

# Frank Lloyd Wright and the Essence of Portfolio Construction

In 1915, the man who would later be called "America's Greatest Architect" was, to tell the truth, in a bit of a slump. The popularity of his Prairie Style homes was waning as the modernist movement gave 20th century clients a vision of a sleeker, more high-tech future. Personal scandal and tragedy took a toll on business, and his aggressive spending habits were distinctly out of step with his declining revenues. He was, in short, badly in need of a win.

He had visited Japan several times in his 40's and developed a bit of an obsession with the balance, simplicity and "unity" of its architecture. He aggressively pursued the commission of the new Imperial Hotel, which was to replace its predecessor as Tokyo's most prestigious venue for foreign visitors. The complexities of the project, from the language barriers to cultural design considerations to sourcing local workers and materials, were substantial. All of that, however, paled next to the engineering challenges of designing a massive structure on top of unstable soil in one of the most active earthquake zones on earth.

Four years before Wright embarked on his Japanese odyssey, the Woolworth Building in New York City became the tallest building in the world and was viewed as a model of pioneering steel frame construction. Many of the buildings rising in Tokyo at the time employed a similar design, with the thought that superior rigidity and natural fire resistance would protect them from the common temblors and their resultant infernos. Wright, however, had something different in mind. His intuition told him that trying to outmuscle an earthquake sitting on 100 feet of effectively liquefied soil would not have the results he was looking for.

Wright arrived in Tokyo in 1917 to start construction of a building based on a wildly out of consensus view: that it was better to move with the earthquake than to try and stand against it. "Why fight the quake? Why not sympathize with it and outwit it?"\* He separated the foundation into multiple sections, all of which were set on top of 60-foot pilings and moved independently from one

another. This would enable the structure to "float, like a boat"\* over the unstable footing beneath it. Plumbing, electrical, and other infrastructure all floated freely within channels that would minimize potential damage. Walls were made thicker at the base and tapered to thinner tops, to better withstand the horizontal stress that they would likely experience. The floors were designed, not to be carried between walls where they could drop if the walls shifted sufficiently, but cantilevered over central support slabs like a waiter carrying a tray. Heavy roof tiles had killed thousands of Japanese during prior upheavals, so he had light copper tiles fabricated instead.

Money was running short as they neared completion, and the Board of Directors called Wright in to tell him to eliminate the decorative pool in the entry courtyard. His response was steadfast. He threatened to leave the project and return home to the US if they followed through, as the pool was integral to protecting the hotel in case of a major earthquake. The city water mains were highly vulnerable to seismic activity and would likely shut off during any significant event, and while the hotel was mostly brick, the minor wood necessary for doors, window frames etc. would all need defending from the subsequent fires from the buildings around them. The pool stays, he said, or I go. They relented, and the hotel was finished, pool and all, in 1921.



Two years later, the Great Kanto earthquake of 1923 struck Tokyo. At the time it was considered the greatest natural disaster in the history of Japan, killing over 100,000 people and destroying or severely damaging (by many estimates) over 70% of the major structures in the area. This included scores of newly built steel frame buildings. The quake struck around noon, a particularly inauspicious time as many were cooking their lunches over open flames which quickly spread, complicated further by a strong typhoon which struck around the same time and accelerated the inferno. News traveled slowly back in those days, and early reports were that the Imperial Hotel was destroyed along with dozens of other major structures.



Desolation of Nihinbashi and Kanda as seen from the roof of the Dai-ichi Sogo Building

Ten days after the quake, a cablegram arrived.

***Frank Lloyd Wright***

***Olive Hill Studio Residence B 1645 Vermont Avenue***

***Hollywood California***

***Following wireless received from Tokio today:***

***Hotel stands undamaged as monument of your genius Hundreds of  
homeless provided by perfectly maintained service  
Congratulations- Okura Impeho (manager)***

The thoughtfulness of the design of the Imperial Hotel, and the subsequent accolades Wright received for it, were critical in launching the second and most prolific phase of his career. His willingness to adapt to the unique circumstances of the project proved to be the difference between triumph and catastrophe. If not for his success in Japan, the world may well have been deprived of the Guggenheim Museum in NY, the Johnson Wax Building, and the spectacular private residence Fallingwater.

\*From Frank Lloyd Wright's Imperial Hotel by Cary James

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## Today's Uncertain Financial Setting

There are many important factors to incorporate into successful architecture, but perhaps the most critical is an understanding of setting. Portfolio management is no different. The challenge for capital allocators is that, unlike the physical world, the financial setting is constantly evolving. Usually, this manifests itself in gradual changes over years or even decades, resulting in prolonged periods of relatively consistent investment themes. Periodically, its shifts can be significantly more abrupt, and major turning points are typically marked by extended periods of elevated volatility coupled with a change in market leadership.

It is our belief that the setting of today's market is increasingly perilous, with record debts coupled with decelerating or even declining revenues to service them. The traditional signals provided by financial markets, through the levels of interest rates, credit spreads and currency crosses, have been fouled by relentless central bank intervention. Market "plumbing" has moved away from the traditional commercial bank channels and increasingly relies on a multitude of lesser regulated entities whose dedication to orderly markets is based more on temporary convenience than long-term vested interest. Liquidity flows, now dominated by passively managed mandates, appear to be driving a self-reinforcing concentration in the largest index components and threaten to magnify the amplitude of both rallies and corrections. It is our opinion that the underpinnings of global financial markets are as unstable today as at any time

in the last 100 years.

Asset managers are being asked to construct portfolios upon this unstable footing using primary building blocks (asset classes) that are, by almost any measure, unprecedentedly expensive. ZIRP and NIRP interest rate policies have driven fixed income values to stratospheric levels, thus pulling equities, real estate, art, and collectables along for the ride. Cheap funding has driven a universal "carry trade," incentivizing those with access to inexpensive capital to borrow as much as possible to invest in increasingly expensive assets.

| <b>S&amp;P 500 Valuations</b>                        |                          |                              |
|------------------------------------------------------|--------------------------|------------------------------|
| <b>Model Factors</b>                                 | <b>Most Recent Value</b> | <b>Historical Percentile</b> |
| Median EV to Sales (Ex-Financials)                   | 4.0                      | 100%                         |
| US Total Market Cap to GDP                           | 170%                     | 100%                         |
| EV to Free Cash Flow Margin-Adjusted (Ex-Financials) | 48.8                     | 100%                         |
| Median Price to Sales                                | 2.8                      | 100%                         |
| Median Price to Book                                 | 3.9                      | 100%                         |
| Median EV to EBITDA (Ex-Financials)                  | 15.0                     | 100%                         |
| Aggregate EV To Sales                                | 3.0                      | 100%                         |
| Aggregate EV to Trailing 12M EBITDA                  | 17.5                     | 100%                         |
| Aggregate EV to 2021 EBITDA Estimate                 | 15.9                     | 100%                         |
| Aggregate Price to 2021 Book Value Estimate          | 3.8                      | 100%                         |
| Aggregate Price to Tangible Book Value               | 12.8                     | 100%                         |
| Aggregate Price to Earnings                          | 27.9                     | 98%                          |
| Cyclically Adjusted P/E (CAPE)                       | 32.9                     | 97%                          |
| Aggregate Price to 2021 Earnings Estimate            | 25.6                     | 97%                          |
| Aggregate Price to Book                              | 3.9                      | 91%                          |
| Source: Bloomberg, Yale/Robert Shiller, John Hussman |                          |                              |
| *Numbers as of November of 2020                      |                          | ©2020 Crescat Capital LLC    |

It is our belief that we are near the end of an era where the financial setting simultaneously raises valuations across the majority of asset classes. As well, the race to ZIRP has squeezed virtually every ounce of defensive characteristics out of fixed income, depriving investors of a large and liquid market for hedging and facilitating aggressive posturing elsewhere. The persistently declining interest rate lever, aggressively wielded by central banks to counter any financial downturn, has rewarded every buyer of "dips" and inflated the valuation of virtually every major component of traditional asset allocation. If we are correct, then the portfolios composed of the richly valued

building blocks of the greatest bull market in history are ill suited to the environment that lies before us. It may well call for different materials, ones that might even seem distinctly out of step with the majority of today's financial market positioning.

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## The Foundational Support for Commodity Markets and Natural Resource Equities

***"When the whole world is running towards a cliff, he who is running in the opposite direction appears to have lost their mind." - C.S. Lewis***

The natural resource sector has faced pervasive and well-documented headwinds over the last decade. They include a 50% decline in the CRB commodity index due to lingering oversupply from the 2000-2010 China-powered bull market, multiple demand side shocks, a recognition of generally poor corporate governance, and a cheap capital bubble driven by low rates and overfunding by energy/infrastructure private equity. These factors have been compounded by the rapid rise and broad impact of both passive investment flows and the ESG movement, which have served to reinforce their underperformance (thus underweighting, leading to more underperformance, and so on). As a result, in a decade of spectacular returns for virtually every asset class, resources have been justifiably excluded from the party.

## Lost Decade for Resource Equities

Source: Bloomberg



The impact of such dreadful underperformance is what, in our humble opinion, lays the foundation for recovery and subsequent outperformance. It is often said "the cure for low prices is low prices," and when those low prices have been augmented by the few remaining active investors in the sector demanding debt paydown, capital return and spending restraint, the results are not terribly surprising. Capital expenditures for public natural resource companies, in spite of the most accommodative broader capital markets in history, have fallen by over 60% since peaking in 2012 to levels not seen since the early 2000s. It is worth noting that over that time frame broad commodity consumption has risen 35%. It is our belief that this growing base of demand is being severely underfunded.

## Total Capex by Current S&P Global Natural Resource Index Constituents

Source: Bloomberg, Our World in Data, International Copper Study Group

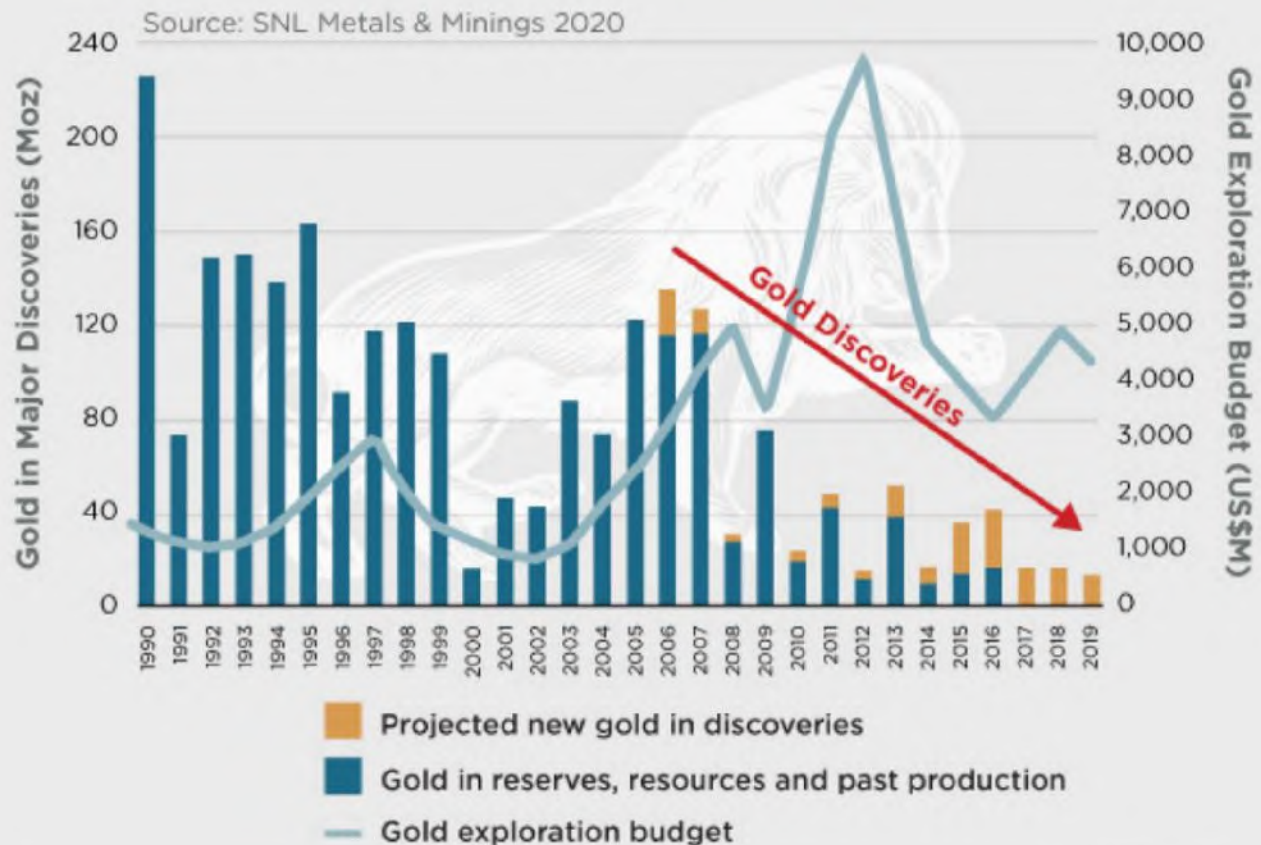


An optimist regarding resource supply would respond to the chart above by positing that industry capital efficiency must have risen so much that the costs of replacing reserves and producing commodities have declined dramatically. That is not the case.

The gold sector is a prime example, where despite spending actually holding up better than most of the rest of the resource sector, one can see below that incremental capital is not yielding significant additional discoveries. In fact, major gold company reserves have fallen by 35% since 2012 (source: TD Securities), and Katusa Research recently noted that while 65% of total capital expenditures of the last 30 years have come since 2010, that had yielded less than 15% of the total gold found.

## Major Gold Discoveries Have Declined Significantly

1990-2019



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The energy and base metals markets are no different, as the resource sector as a whole has found it increasingly challenging to replace reserves. In their excellent Q3 research update, Goehring and Rozenchwajg analyzed incremental productivity in the oil patch. As we have noted before, US shale has provided virtually all of the growth in global production over the last decade, so its relevance to the global oil balance should not be underestimated.

During the 2014-2016 decline, shale drilling activity fell by 50%. Operators reacted by high-grading their drilling, resulting in a 65% increase in productivity of the average well. This left production only down 20% and facilitated a rapid rebound when prices recovered as both companies and private equity extrapolated those higher returns and flooded the sector with capital.

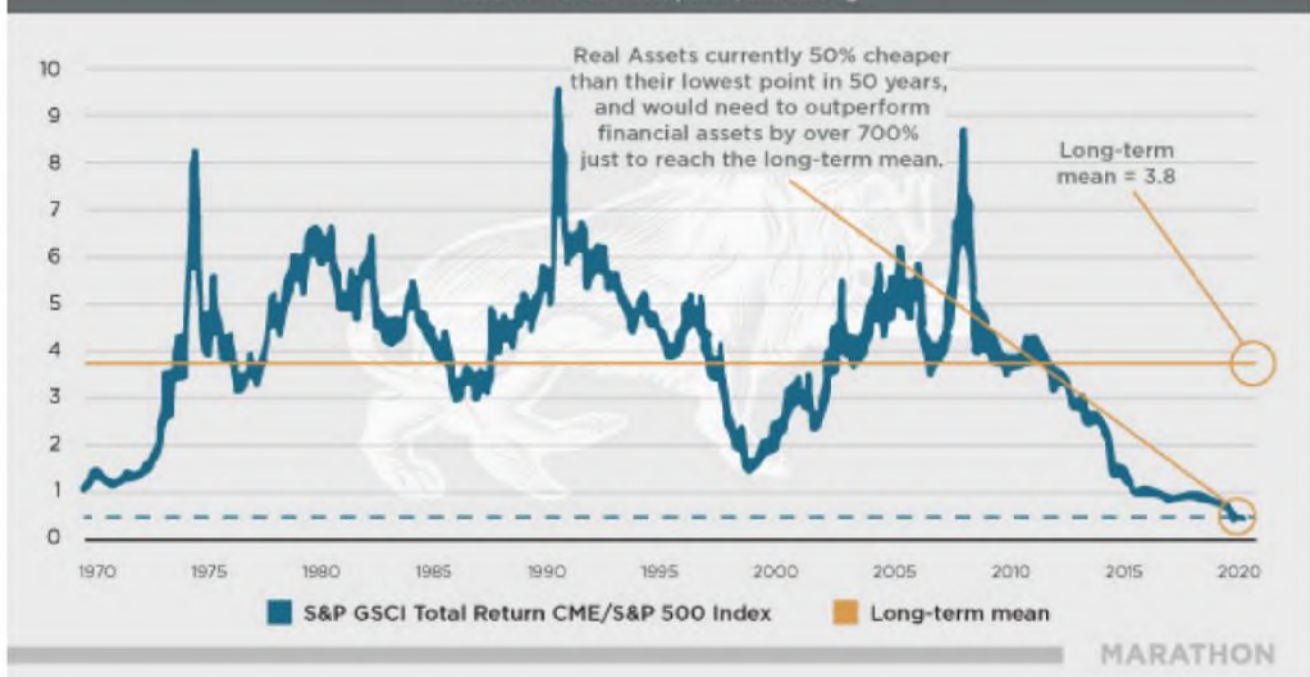
The most recent pullback in drilling has been very different, as the 75% decline in the rig count in 2020 has been coupled with **declining** productivity across all three of the major U.S. shale basins, strongly implying that acreage quality has peaked. This has left producers nursing damaged balance sheets and private equity abandoning the sector in favor of, amongst other things, alternative/renewable SPACs. In other words, **the main engine of global oil growth is unlikely to be able to maintain, much less grow, production for the foreseeable future.**

The inconvenient truth is that while advancing technologies such as horizontal drilling, multi-stage fracking, enhanced reservoir development and others have made some new resources both available and economic, in general those improvements are losing ground to the deterioration of marginal geology. More simply said, most of the easily accessible, high quality economic deposits in stable jurisdictions have already been exploited, and the industry is having an increasingly challenging time finding and developing new ones large enough to replace the retiring giants found in 1980-2010.

The impact of dwindling reserves is beginning to be felt, as the modest recovery in global economic activity over the last six months has been more than sufficient to tighten up the majority of commodity markets. At the same time, resource capex has crashed and will undoubtedly decline more once 2020 totals are reported. The ramifications of this starvation of capital on the ability of the industry to deliver incremental production over the coming decades will be profound. Meanwhile, the rapid Government and Central Bank monetary and fiscal responses have channeled almost exclusively into financial assets, resulting in commodities plunging to their lowest levels relative to equities in the last 50 years.

## Commodities to S&P Ratio

Source: Variant Perception | Bloomberg



It is our belief that, in the not-too-distant future, global commodity demand will recover to levels that outstrip dwindling supply. The combination of natural decline rates as well as marginal capacity closures could well mean that the levels of demand needed to do so are below those that prevailed pre-Covid. Should that be the case, we would note that **the most durable and powerful commodity bull markets are those built, not on rapidly rising demand, but on structurally constrained supply.** We are reminded of the quote from Hall of Fame Basketball Coach Marv Harshman on his preference for tall players over fast ones: "*Quick guys get tired. Big guys don't shrink.*"

# Energy

*Falling through the floor, and into the basement you never knew you had.*

Sundial Research recently noted that the performance of the Energy sector versus the S&P through Q3 2020, calculated using relative performance from 3-year highs, was the single worst showing by any S&P sector since 1928. In our 30+ years of investing, we feel like we have witnessed firsthand some brutal stretches for various sectors, including Tech/Telecom in 2000 and Financials in 2008, yet Energy has somehow managed to outdo not only those two extremes but every other one in the last 90 years. Between the profound dislocation caused by C-19 shutdowns and headlines like the ones below, it is not surprising that its weighting in the S&P500 has fallen by over 85% since 2014.

The collage features several headlines and social media posts:

- BP drops a cluster bomb on Big Oil**  
Bernard Looney's decision to reinvent BP as a green energy giant will save the FTSE 100 firm from a death spiral.
- Expect More Venezuelas in the Post-Peak Oil Era**  
Producers that aren't able to diversify in time will face economic collapse.
- Exxon Used to Be America's Most Valuable Company. What Happened?**  
The oil giant doubled down on oil and gas before the pandemic crushed demand.
- 'Oil is a perma short,' says Jim Cramer**  
PUBLISHED WED, SEP 9 2020-10:08 AM EDT | UPDATED WED, SEP 9 2020-11:43 AM EDT
- The slow death of Big Oil**  
The industry must reinvent itself to survive in a low-carbon era.
- 'Farewell, fossil fuels?'**  
What oil's demise will do to the world's leading economies
- BP boss admits 'socially challenged' fossil fuel industry is seen as 'bad' as he vows to slash production by 40% in drive to become carbon neutral by 2050**
- Oil sector could face even more distress during coronavirus crisis as it struggles to draw investments**
- Jim Cramer @jmcramer**  
fossil fuels are going away, they are in long-term decline
- dan egger @danduo382**  
Replying to @jmcramer  
Jim question. I have a positions in oix and xom for some time now. Why is the energy sector lagging the other sectors each and every day. I'm holding to these positions while stocks around me are flying high... do I take the loss and move on? Thanks Dan

The political class around the world is now engaged in a bidding war to see who can commit to carbon neutrality and EV-only autos faster. What only months

ago were 2050 targets seemingly leaping the 2040 decade and now reside in 2030 with little regard to the financial, technological and logistical challenges associated with completely revamping global energy systems.

We believe that renewables like wind and solar will grow very rapidly over the next 30 years, and that's a good thing. Electric and hybrid vehicle sales will ramp aggressively as well, as governments encourage rapid adoption. Even so, a realistic look at the existing global energy infrastructure leads us to firmly believe that fossil fuels will remain a significant part of the mix up to and beyond 2050.

There are two seemingly unacknowledged truths in the climate debate. The first is that it is extremely difficult to move away from the current cheap, abundant and entrenched energy supply system. While many focus on transportation and the EV market, close to 80% of oil & natural gas consumption are in non-transportation uses such as plastics, building materials, and lubricants where alternatives are much slower in coming. Norway is the poster child for going green as they are endowed with both prodigious hydropower as well as oil & gas riches to fund their transition. While EV/Hybrid autos now currently account for almost 90% of new car sales there, fossil fuel consumption has not declined measurably in the last 20 years. This is despite funding climate friendly alternatives to the tune of 6% of GDP annually and levying enormous taxes and disincentives on fossil fuels, both measures that poorer countries lack the flexibility to enact.

Fundamental challenges aside, where there is a will there is a way, and we have no doubt that trillions of dollars will be spent in these areas. In the table below, Bloomberg New Energy Finance estimates Wind, Solar and other renewable technologies will account for virtually all of the electric generation capacity growth over the next 30 years. It is worth noting, however, that at the same time they estimate natural gas demand will almost double.

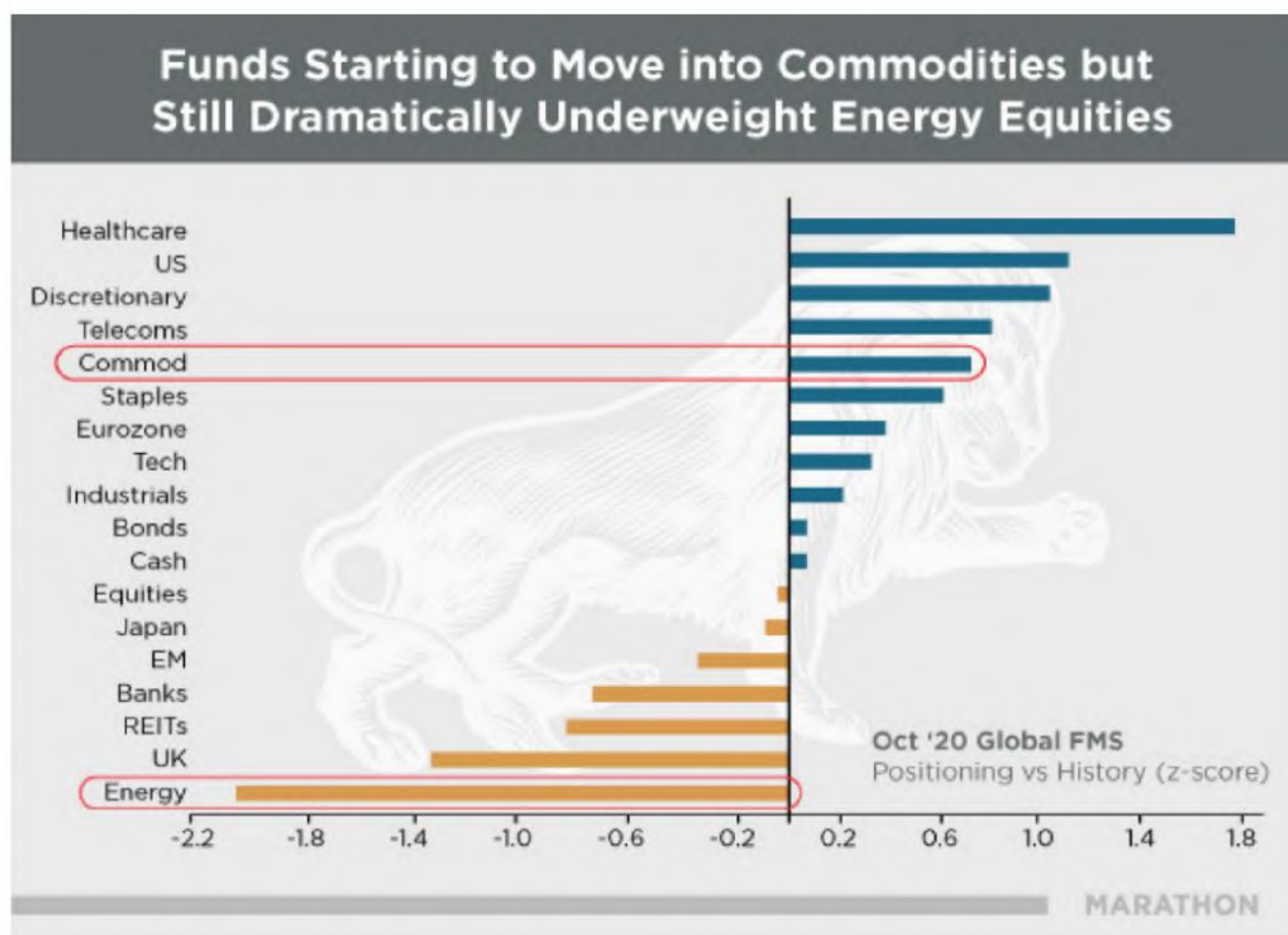
|              | Gen Share   |             | Installed Capacity |               |       |
|--------------|-------------|-------------|--------------------|---------------|-------|
|              | 2019        | 2050        | 2019               | 2050          | CAGR  |
| Coal         | 28%         | 7%          | 2,118              | 1,427         | -1.3% |
| Gas          | 23%         | 15%         | 1,740              | 3,059         | 1.8%  |
| Oil          | 4%          | 1%          | 303                | 204           | -1.3% |
| Nuclear      | 5%          | 2%          | 378                | 408           | 0.2%  |
| Hydro        | 15%         | 7%          | 1,135              | 1,427         | 0.7%  |
| Wind         | 8%          | 20%         | 605                | 4,078         | 6.3%  |
| Solar        | 11%         | 38%         | 832                | 7,749         | 7.5%  |
| Storage      | 4%          | 8%          | 303                | 1,631         | 5.6%  |
| Other        | 2%          | 2%          | 151                | 408           | 3.2%  |
| <b>Total</b> | <b>100%</b> | <b>100%</b> | <b>7,566</b>       | <b>20,391</b> |       |

In a similar vein, the US Department of Defense and Ward's Auto Data estimate EV sales to rise **30X** by 2035, to 150M units. They also estimate Internal Combustion Engine (ICE) units to rise from 1.2B to 1.9B over the same time frame. Both the power generation as well as the auto mix projections are from amongst the most optimistic sources on renewables penetration, and as we have pointed out on a number of occasions the consensus in these areas has routinely proven to be wildly overoptimistic versus reality. Perhaps we need to check our math on this, but we find little in 80% more natural gas for power generation and a 71% rise in gasoline powered auto fleet over the next 30 years to make us fear the imminent demise of the fossil fuel industry.

The second unacknowledged truth in the climate conversation is that significant climate-friendly progress can be made by simply adjusting the existing fossil fuel mix. We hear very little about the fact that the US has reduced CO2 emissions by 13% over the last decade, yet at the same time increased fossil fuel consumption by 12.7% according to the IEA. This was achieved in large part by replacing coal generation with natural gas. Asia in general and China in particular could follow a similar path with LNG and significantly reduce emissions while still growing traditional hydrocarbon consumption. We expect that will be part of the answer, as will re-embracing nuclear power. We also

believe that there are many areas of real assets that will benefit from the growth in renewables that offer considerably more value than the wildly popular wind, solar and hydrogen stocks. We discuss many of these critical components in more detail below.

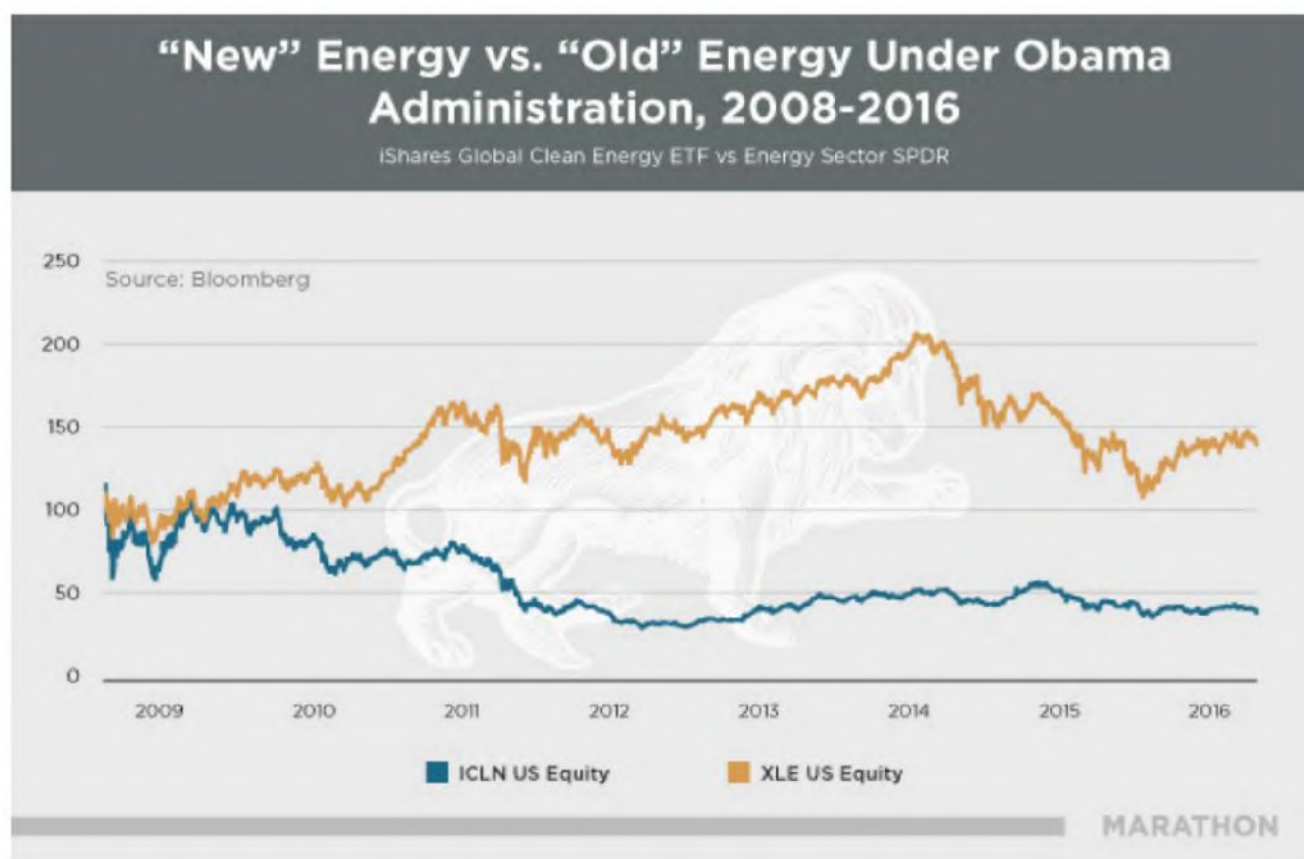
It is our belief that as a more rational and balanced view of the energy transition evolves, investors might begin to hate traditional energy a little less. As one can see from the portfolio positioning below, while PM's are warming up to commodities as a whole, their distaste for energy equities remains quite strong. ***"People are always asking me where the outlook is good..."*** said legendary investor John Templeton, ***"but that's the wrong question. The right question is 'where is the outlook most miserable..."***



One thing for certain is that there is no misery in the ESG/Renewables segment, where massive inflows and boundless capital raising are flooding into anything related to wind, solar and EVs. That said, we can't help but draw

parallels between another period, not so long ago, where the combination of an economic crisis, an incoming Democratic administration with lofty climate aspirations and tremendous investor enthusiasm for beneficiaries of the "energy transition" resulted in soaring renewables and crashing energy stocks.

In many ways they were right, and over the 8 years of the Obama Administration global solar installed capacity grew 20-fold and wind power quadrupled. Yet the excessive enthusiasm for renewables equities in the runup to 2009 discounted all of that future growth and then some. In fact, old world energy trounced "green" energy over that span by over 10,000bps!



In short, while we readily acknowledge the rapidly expanding role of renewables in the global energy mix, we dispute the belief that there are no attractive investments left in traditional oil & gas. In fact, the forced diverting of capital away from the latter virtually assures growing profitability every bit as much as the tsunami of green investment flows will suppress economic returns in the former.

We're not particularly tempted to invest in the major oil companies whose expensive pivot to renewables, while both socially admirable and politically pragmatic, is unlikely to enhance their profitability. Similarly, we find little value in the midstream MLPs as the realities of capital starvation means volumes on their "toll roads" will not recover any time soon. This, coupled with bloated balance sheets, accelerating maintenance capital and the dissolution of its concentrated investor base remain as formidable headwinds.

We do, however, find considerable value in Oil & Gas royalties and select upstream operators that combine low cost structures, large inventories and a predisposition to generously share cash generation with shareholders. With investor revulsion resulting in multi-generational lows in valuation, we believe the margin of safety is orders of magnitude higher than any other sector of the market. One can now acquire 15-20% free cash flow yielding energy equities, valued as if prices could not possibly go up and that fossil fuels themselves will not survive the next decade. Should that prove not to be the case, we think outsized profits are in store for those who invest in the sector. Should any incremental catalyst prompt investors to reach for hard/physical assets, we suspect those returns should be amplified many times.

We would like to reiterate that we are not anti-renewables. We simply are challenged to find reasonable value in most of the companies involved in the "Green Wave." That said, assuming the recently espoused vigor for accelerating renewable/EV adoption remains in place and is coupled with the considerable capital required to achieve it, there are many traditional resource companies that may well be amongst the biggest beneficiaries.

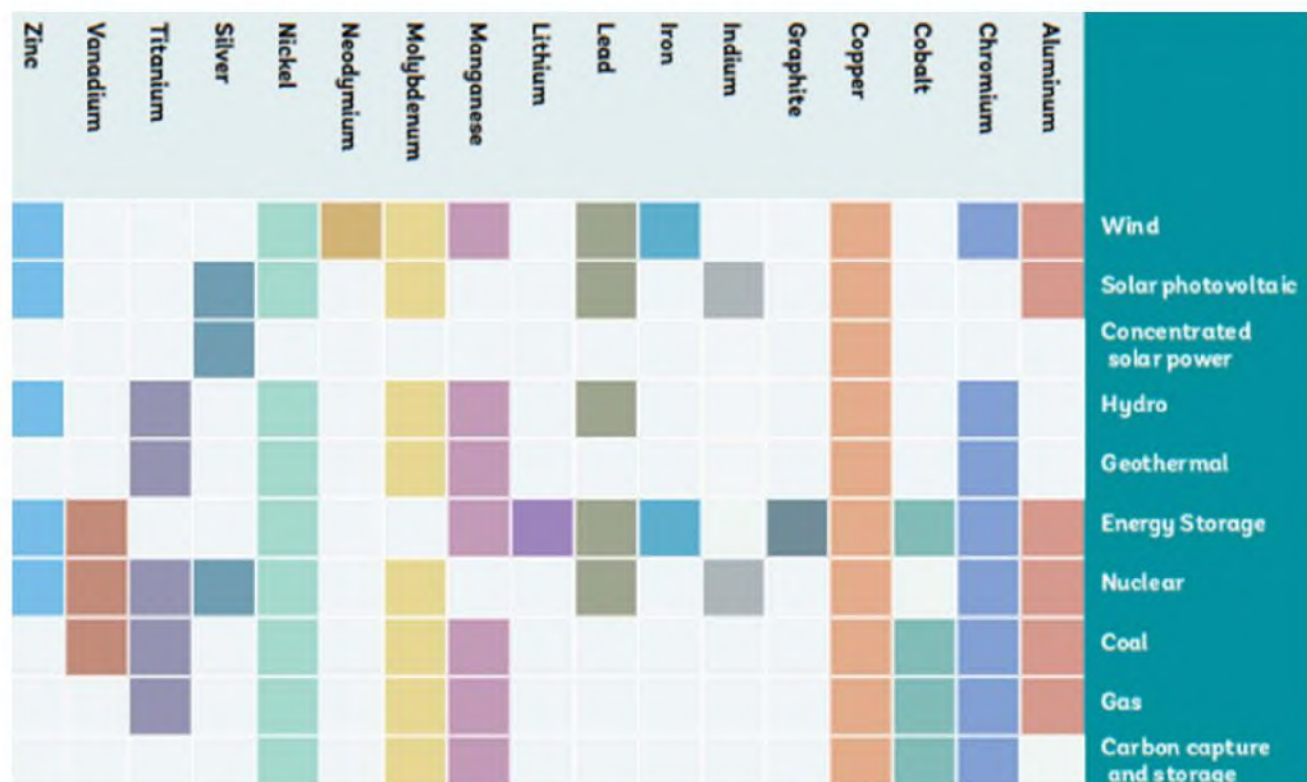
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## **"Green" Doesn't Mean Commodity-Free**

The UK Government recently supplemented its pledge to mandate 100% EVs in 2050 by declaring that all sales of new cars would need to be electric by 2035. A paper published by a group of British scientists, and chaired by the head of their Natural History Museum's department of Earth Sciences, pointed out that in order to meet those goals, the island nation would require incremental

materials equating to 50% of the world's annual copper production, 75% of its lithium output, 100% of several rare earth metals including neodymium and almost twice the current annual output of cobalt. Extrapolated over the next 15 years, that would singlehandedly result in increases of 3%, 5%, 7% and 15% respectively, of total global consumption annually for those commodities. This is in industries where annual capacity increases average 1-3%, and as we have noted above, capital expenditures have been plummeting for over a decade. In other words, the climate aspirations of a nation representing less than 1% of global population outstrip the mining industry's current ability to deliver incremental supply by 1-5x.

The broad-based enthusiasm to fight climate change coupled with governments and investors willing to commit trillions of dollars to the cause leaves little doubt that wind, solar, hydrogen and other "greener" technologies will grow as fast as their individual ecosystems will allow. As such, there are pinch points ahead for a broad swath of critical renewable materials. This is clearly recognized in industry as well, with the head of Toyota recently predicting an exhaustion of the supplies of key metals as soon as 2025. The table below illustrates the intensive use of a broad array of metals and materials critical to the development of renewable energy alternatives.



It is our belief that one of the most attractive ways to express optimism regarding the growth in the green economy is via equities with exposure to large economic deposits of copper, cobalt, nickel, rare earths, silver, platinum, tin and other materials. As we noted last year, the tsunami of capital into ESG funds has flowed mostly to the same top 25 tech and commerce names that the average S&P index fund holds. The fraction that has found its way into companies actually involved in the greening of the economy have driven those company valuations into overdrive. The 10 largest EV manufacturers sport \$2T in market cap, or 50% of the global auto industry, despite selling less than 1% of the cars and collectively losing money. A simple Bloomberg screen of the top 250 renewables companies reveals over \$750B in market capitalization versus less than \$5B in trailing earnings. We now have watched a particular fuel cell company boom and bust over three cycles add \$30B in market cap over the last 2 years on estimates that they will grow revenues by 25%, or \$100M over that same time period.

Meanwhile, many resource companies that own the materials that are essential to these same industries remain painted by the "commodity" brush and trade at profoundly cheap multiples. The largest platinum producer in the world, poised to benefit from the assumed exponential growth in hydrogen fuel cell demand, trades at less than 4X 2021 EPS. The world's largest nickel producer is only modestly more expensive at 7X 2020 EPS, and several base metals royalty companies generate 10%+ free cash yields despite tremendous leverage to demand growth and higher prices for renewable energy inputs. It seems clear to us that either the market will reward these companies as their earnings, cash flows and reserve values accelerate, or the renewable companies will use their richly valued paper to secure access to their bounty via buyouts. Either way, we see highly convex outcomes from current levels.

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# The Case for Accelerating Inflation

## *Part 1- Fundamental Drivers*

***Rule No. 1: Most things will prove to be cyclical.***

***Rule No. 2: Some of the greatest opportunities for gain and loss come when other people forget Rule No. 1.***

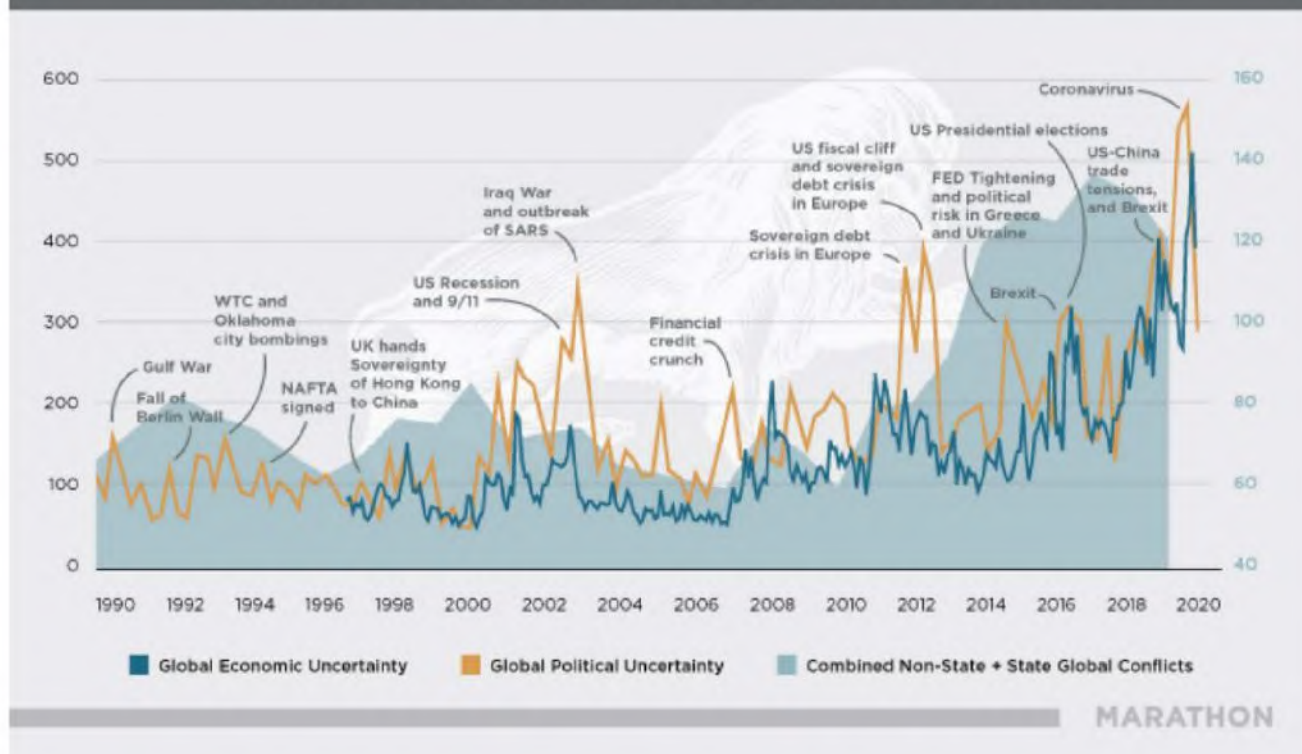
***-Howard Marks***

We would like to state from the outset of this conversation that we don't believe we are on the cusp of a 70's style inflationary environment, much less anything resembling "hyperinflation." That said, we do believe that several of the most important deflationary levers of the last several decades are reversing. At the same time, the delivery channel of combined monetary and fiscal stimulus is evolving in a way that may well finally birth the inflation that central banks so urgently desire. If we are correct, the extraordinary complacency regarding inflation and the resulting extreme positioning of investors in deflation-driven assets places us on the cusp of the most significant regime shift in financial markets in a generation or more.

The globalization of supply chains has been the defining characteristic of the economy for the last 20+ years. Manufacturers have been able to choose from a global palate of cost minimizing options in sourcing raw materials, manufacturing and distributing goods throughout the world. At this point we take this very much for granted, but we also pay little attention to what made it possible. Peter Zeihan's recently released *Disunited Nations: The Scramble for Power in an Ungoverned World* details the "Global Order" which resulted in unprecedented flexibility, stability and certainty worldwide. The United States, in return for free and open trade globally, took up the role of global enforcer to keep peace around the world. It has become clear over the last decade that the US is retreating from this role, and the stability that came with it has been receding as well. For those harboring doubts that change is afoot we think a quick read through "*United States Strategic Approach to the Peoples Republic of China*" released by the National Security Council several months ago and the numerous Chinese state responses since would be worthwhile.

## Economic Uncertainty vs Political Uncertainty vs Global Conflict

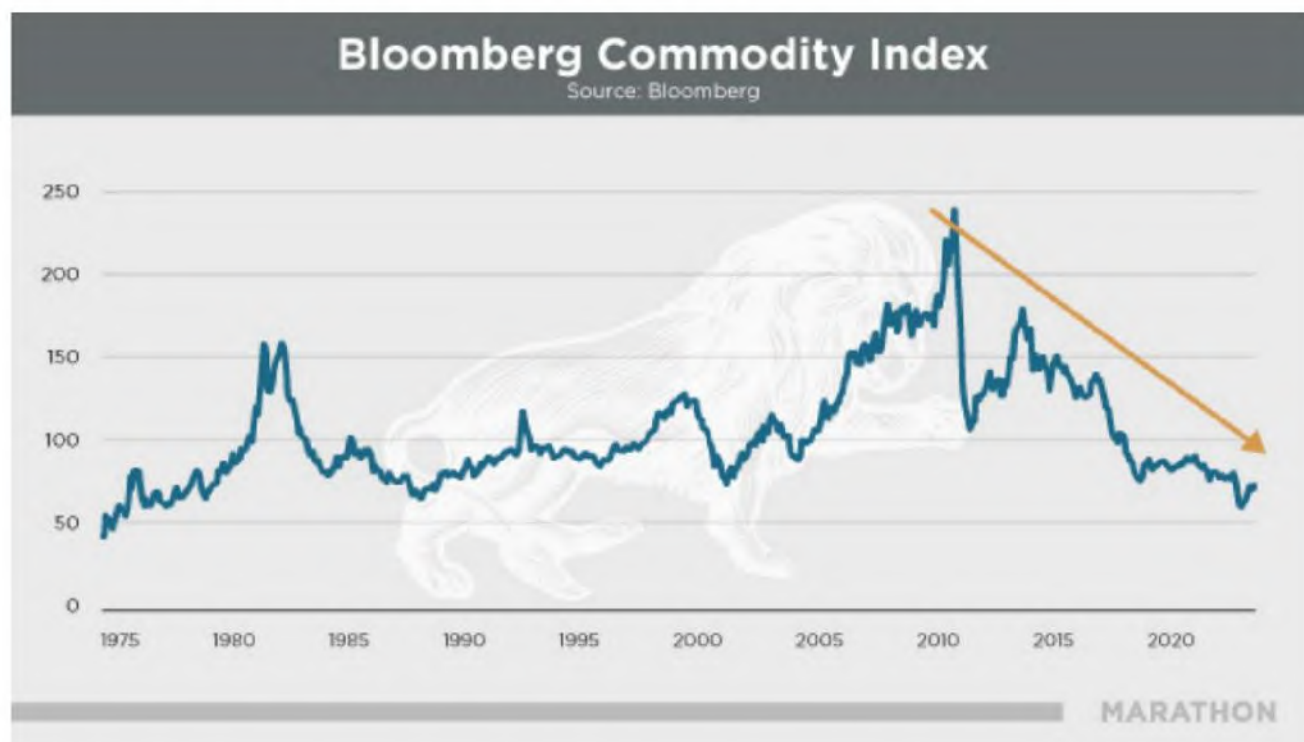
Source: Ahir, H, N Bloom, and D Furceri (2018), "World Uncertainty Index", Stanford mimeo | UCPD 20.1 data



The acceleration of both geopolitical and economic uncertainty, which may feel very recent in nature, not only predates C-19 but also the outgoing U.S. administration. This has led to increasing state and non-state conflicts, which threaten to hasten the inflationary de-globalization trend. National rivalries necessitate reestablishing supply chains for reasons other than cost. This results not only in increasing prices due to higher transportation/manufacturing cost, but the addition of significant new expenditures for redundant infrastructure that would not have otherwise been necessary. China's political ascendancy, the fraying of relations between the US and its traditional allies, and the C-19 pandemic's impact on necessitating politically secure supply lines are both symptoms and drivers of a continuation of this trend.

The second deflationary lever we believe to be reversing is the downward trend in raw materials/commodities prices. If we are correct about the impact of declining capital expenditures illustrated in the section above, then the decade-long downtrend shown below has run its course. Should this prove to be the case, it will compound the conflict and uncertainty trends we highlight. An

onset of raw materials inflation, whether it be in old economy oil and iron ore or new economy metals such as copper, nickel, platinum, cobalt, lithium and rare earths, would add significant economic strains to the existing geopolitical ones. While this may take a period of sustained recovery to fully manifest itself, we believe the ability to position ourselves in inexpensive, positive carry (yield) companies positions us to be patient.



When one considers the combined deflationary impact of unrestricted globalization and relentlessly declining input/commodity prices over the last decade, it becomes clear that even a moderating of these trends would be incrementally inflationary. Should they reverse in force, it would likely bring out an additional effect of expanding inventory holdings, further exacerbating the inflationary impact. We consider these to be the fundamental underpinnings of reaccelerating inflation. While on their own they may lack sufficient force to overcome the powerful demographic and debt headwinds discussed below, other factors at play may well finally tilt the balance to the upside.

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# The Case for Accelerating Inflation

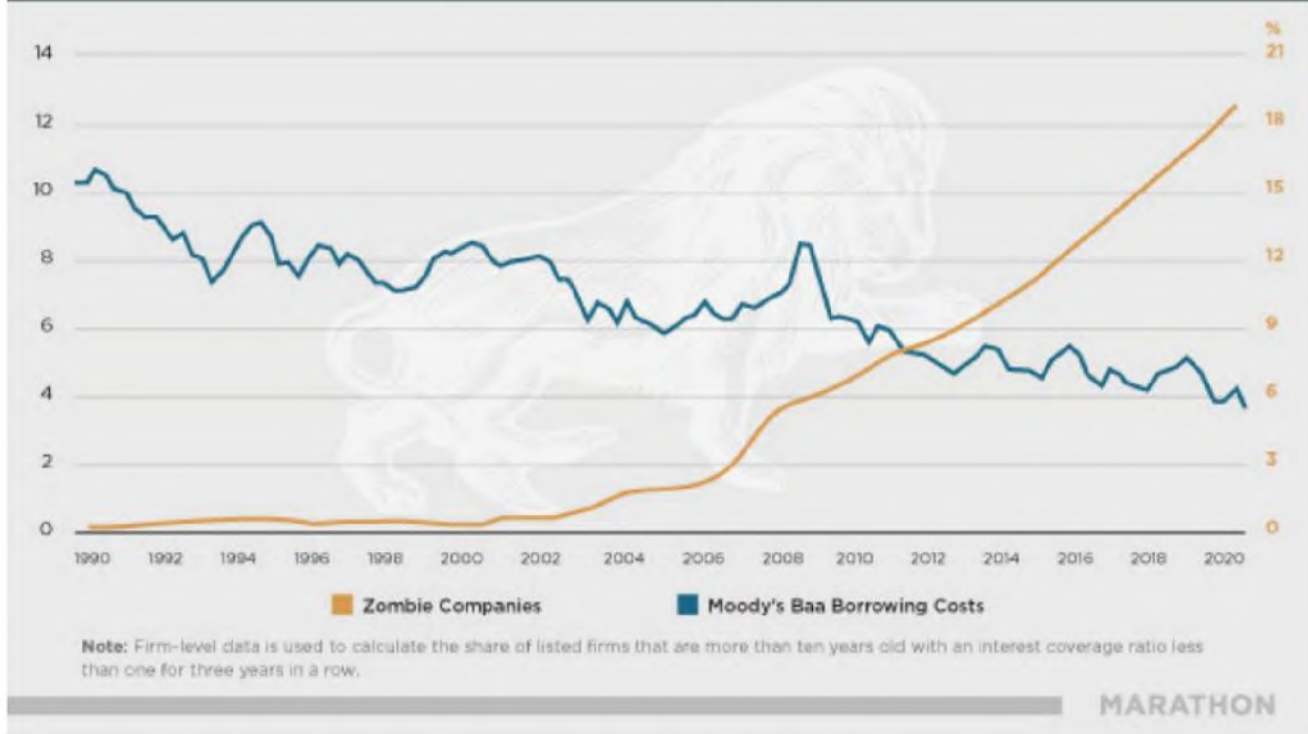
## *Part 2- Monetary & Fiscal Drivers*

We are the first to admit that the market has every right to be skeptical about the ability of monetary and fiscal stimulus to drive inflation. In the aftermath of the Global Financial Crisis, inflation expectations rose to their highest levels since the early 1980s. And yet, despite trillions of USD/Euro/Yen central bank and government injections, no meaningful inflation materialized.

In hindsight, there were several things the inflation bulls (ourselves included) missed. The first was underestimating the secular deflationary headwinds the economy was facing. In addition to the globalization and falling input price trends mentioned above, there remained stout demographic headwinds in the developed markets in terms of household formation and working age adults. As well, falling interest rates led to increased debt levels, which while driving some short-lived consumption, ended up producing a record number of "zombie" companies whose lingering legacy hinders overall growth. While we firmly believe that globalization and falling commodity prices are in the process of reversing, we are equally sure that debt and demographics remain as powerful deflationary drivers.

## Despite Decline in Borrowing Costs, an Increasing Percentage of Companies Can't Service Their Debt

Source: Datastream, Worldscope, DB Global Research



Perhaps the most significant "miss" by the inflation bulls was too much focus on the amount of stimulus being generated and not enough on where it was flowing. The crisis of 2008 was one of financial institution liquidity, and much of the "printing" that went on was simply re-liquifying the TBTF banks. The majority of these flows were then re-deposited with the Fed to earn risk-free spreads, thereby failing to reach "Main Street." And while the suppression of interest rates did successfully blow massive asset bubbles in virtually all financial markets, the "trickle-down" of that money into the real economy was fairly limited. Real wages never rose, and record wealth inequality clearly illustrates the lopsided impact of that round of printing.

It is our belief that this time will be different, knowing full well that those words represent some of the most dangerous in modern finance. The clear failing of government efforts to address the perilous financial situation of the majority of their constituents, in our opinion, played no small part in the outbreak of civil unrest in the U.S. in 2020. This has put authorities on notice that "Main Street"

fully understands the inequity of their efforts thus far, and it appears to us that the message is beginning to be heard.

If one were to craft the optimal recipe for social unrest, it might well be the world of 2020:

- A rapid acceleration of wealth inequality, which was already near record levels, driven by a stark bifurcation between the financial and real economies
- Significant financial distress/uncertainty for a large swath of the working population
- Polarized media (both traditional and social) shining a spotlight on not only every injustice and how bad things are for the "have nots" but also revealing the luxury and frequent hypocrisy of the "haves"

It is one thing to suffer when you feel like everyone is suffering with you. It is something else entirely when you see firsthand how inferior your situation is. The latter violates the core understandings of fairness and empathy that we have as homo sapiens, as Frans de Waal's excellent Ted Talk from 2013 ([LINK HERE](#)) demonstrates. It brings to mind the Arab Spring movement in 2010, where fallout from the Global Financial Crisis coupled with the advent of social media started with a single shopkeeper in Tunisia lighting himself on fire and ended with regime changes in some of the areas longest-standing authoritarian states. The political class is nothing if not pragmatic, and with both public will and Federal Reserve providing ample cover and staunch tailwinds, we think support for the working class is coming.

One could argue that the global financial elite have seen this coming, as an October 2019 SUERF paper titled "Dealing with the Next Downturn, From Unconventional Monetary Policy to Unprecedented Policy Coordination" explains. In it, two prominent former Central Bankers advocated moving outside the traditional blunt interest rate and reserve requirement tools to advocate fiscal measures whereby CBs can channel money directly to consumers. In September of 2020, Fed Governor Loretta Mester outlined how a "US Digital Currency" should be used to do exactly that. Lacy Hunt, arguably the staunchest deflationist of the last 40 years, has stated on many occasions

that "the Fed can lend, but they cannot spend." Fed Direct and other similar measures threaten to obliterate that distinction and would be a regime change in Central Banking.

The conversation around Modern Monetary Theory has gained significant traction in recent months, and while we won't delve into the specifics of the debate here, we think it is a sign that the last tenuous ties to fiscal discipline are failing. We can understand the rationale, as even the gargantuan \$3T+ deficit for 2020 has failed to wake the inflation beast. It is our opinion that the major programs thus far have only served to provide sufficient liquidity to offset the profound economic shock of the pandemic lockdowns, explaining why broad inflation measures remain subdued. Much more will be needed to offset the solvency issues that remain across the economic spectrum, so we expect most, if not all, of the following to gain momentum soon:

- The continuation/expansion of direct salary replacement leads us towards the introduction of Universal Basic Income (UBI) to support workers, whether it is those displaced by the pandemic or by future advances in automation.
- Marshall Plan style infrastructure spending that will dwarf the post-GFC versions, including a "Green New Deal."
- Student loan forgiveness has featured prominently in the recent political debate and, if enacted, would result in increased spending power in the hands of those most likely to use it.
- State finances are imploding, and they will increasingly look to the Federal Government for support. As well, it is increasingly clear that many of the state pension funds are flirting with insolvency. Should another bout of market weakness occur, we believe politicians will find it politically expedient to print enough to make them solvent.
- Several CBs are now officially backstopping consumer loans through the banking system, effectively eliminating the credit risk that causes banks to hoard cash. We expect Federal Reserve loan guarantees to facilitate a rapid expansion in consumer loans similar to what is already occurring in the UK, Australia and elsewhere.

- The Fed has clearly signaled its intent to address financial inequality via measures such as the proposed lending rules for poorer communities targeted by the Community Reinvestment Act. Once again, these are measures focused on getting money into the hands of those most likely to spend it.

Stephanie Kelton, author of The Deficit Myth; Modern Monetary Theory and the Birth of the Peoples Economy, sits at the vanguard of this movement. Her recent exchange with the former National Economic Council Director and Chief Economic Advisor to the White House, encapsulated below, leaves little doubt that the spending gloves are off. For context, it was not long ago that a \$1T deficit was considered a big deal.



**Stephanie Kelton**   
@StephanieKelton

...

Last week, during a Bloomberg panel w/Gary Cohn, I was asked how much \$\$\$ Congress should authorize. Conservatively, I suggested \$2T in immediate relief & \$3T in recovery. Took less than a minute for Gary to say deficits aren't a concern & he "could live with [Kelton's] numbers."

5:53 AM · Nov 23, 2020 · Twitter for iPad

**459** Retweets   **116** Quote Tweets   **2.5K** Likes



The lasting legacy of C-19 may well be that it finally destroyed the quaint notion that government spending needs to bear any relationship to government revenues. We cannot stress enough how differently both the scale and delivery mechanism of this response will impact the economy compared to what we saw

post-2008. We would also note that a number of the veteran market observers who have been both correct and consistent in their deflationary outlooks over the last 20 years (including the aforementioned Lacy Hunt, Russel Napier, Albert Edwards, Jean-Louis Gave, Jim Bianco and others) have either pivoted to, or acknowledged the possibility of, an end to that trend. In their extraordinary efforts to generate inflation, we think they will finally get just what they are looking for...and perhaps eventually quite a bit more.

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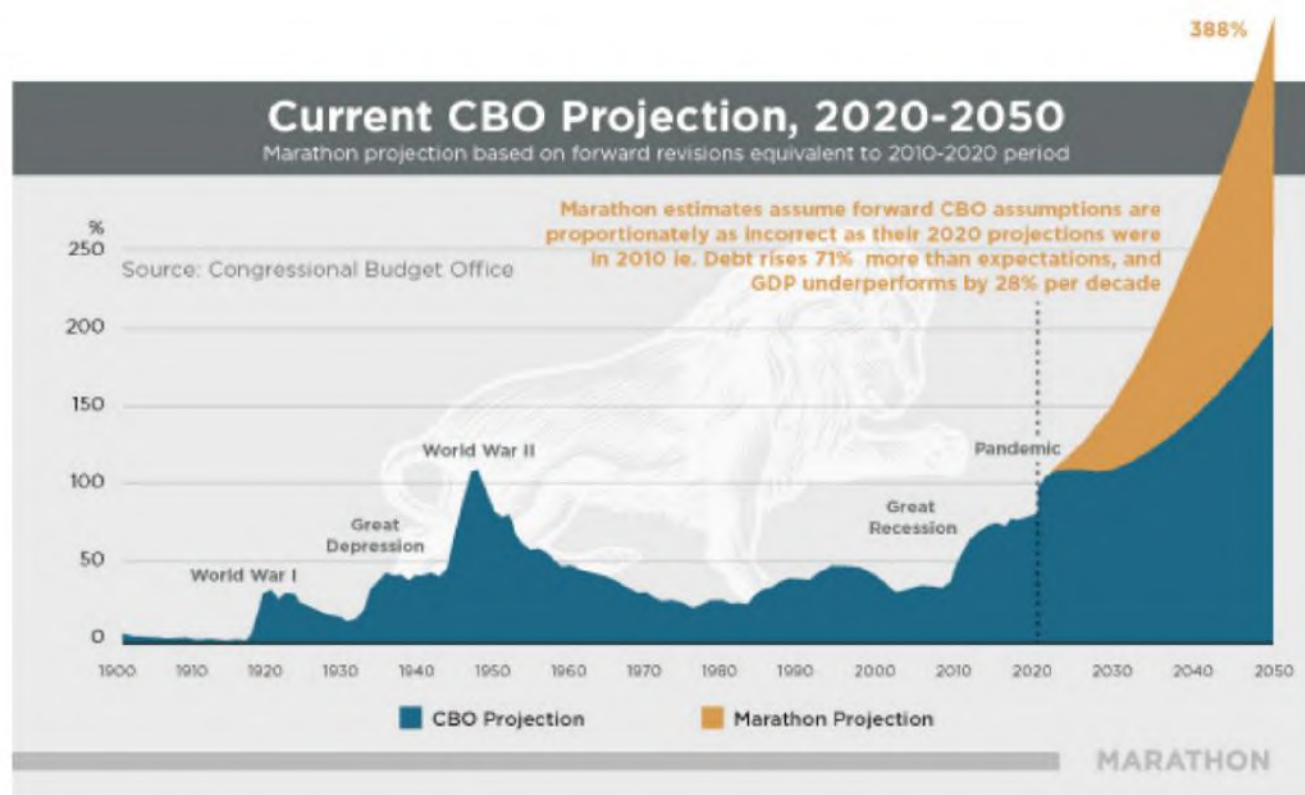
## Fiscal Profligacy and Financial Crisis

It is our belief that at some point fiscal recklessness will have consequences. Reinhart and Rogoff's "This Time is Different, Eight Centuries of Financial Folly" compiled an exhaustive study of government debt accumulation and the impact it had around the world. The results were quite sobering, noting that since 1800, 51 of the 52 countries with gross government debt greater than 130% have defaulted, either through restructuring, devaluation, high inflation or outright default. For the moment Japan remains the outlier and, for those wondering, the US is currently crossing the threshold making it #53.

The US Congressional Budget Office releases a long-term projection every year, and the outlook continues to deteriorate markedly. The solid blue area in the chart below illustrates debt to GDP breaching the 100% mark; however, these figures exclude roughly \$6T in intergovernmental debt (~30% of GDP) which is rightly included by Reinhart & Rogoff. Moreover, CBO's estimated trajectory, according to its own base case, actually doubles U.S. debt/GDP by 2050. By any measure, this is a dire scenario.

The most alarming aspect of the CBO's forecast is perhaps rooted in its historical inaccuracy. The organization has managed to be consistently (and stupendously) over-optimistic in its predictions of both debt levels and the economy. In fact, if one looks at its 2010 estimate for the most recent decade, they somehow managed to vastly underestimate debt growth while simultaneously overestimating GDP growth, to the tune of 71% and -28% respectively!

It is an interesting (and terrifying) exercise to calculate the numbers should the CBO turn out to be just as wrong going forward as they were in the most recent decade. The trajectory illustrated in the gold area below would carry debt/GDP through 200% (including IG debt) by 2030, and north of 400% by 2050. The message to us is clear: at some point, this level of debt will matter, and both the words and deeds of governments and central banks around the world ensure that day of reckoning is being pulled forward at an accelerating pace.



It has been remarkable to witness the pivot by both central bankers and policy makers regarding the impact of excessive debt. Many of those who warned of severe dangers at levels and trends well below today's are now at work redefining how we should view debt. The recent paper presented by Jason Furman and Larry Summers at the Brookings and Peterson gathering is a perfect example of this, as it argues that historical metrics such as debt/GDP no longer matter in a zero interest rate world. It posits that we should be measuring not the level of debt but the debt service. Therefore, as long as you hold interest rates below the rate of GDP growth, the NPV of US GDP is

"infinite" and therefore **there is no level of debt that it cannot sustain.** When former senior Treasury officials with close ties to the incoming administration start talking like this, and current Federal Reserve Chair Powell takes the baton and mentions it in official testimony soon thereafter, we should all take notice.

It remains our belief that there is a certain gravity to economics suggesting it will not be "different this time." Justifying unlimited spending underpinned by the belief that interest rates will forever forward remain suppressed and the economy will never contract seem to us the pinnacle of hubris. And yet, it appears increasingly clear that emboldened policymakers around the globe will stretch the rubber band of monetary profligacy until it snaps. We find the short list of the asset classes that would benefit from said snapping eminently attractive, though it appears we have little company. This includes a certain "barbarous relic" that sports a few thousand-year track record successfully protecting its holders from the adverse ramifications of reckless financial policies: Gold.

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## Precious Metals

### *It is Springtime, yet Straw Hats are Still on Sale*

As we enter our fourth decade of investing in natural resource equities, we increasingly appreciate the balance that gold and precious metals bring to our investment mix. We have found through much trial and frequent error that while the supply side dynamics can vary significantly across the resource spectrum, demand for most GDP/industrial driven commodities tend to be fairly synchronized. Gold, on the other hand, has tended over the last 20+ years to benefit from a more monetary dynamic. While gold prices still decline during liquidity driven panics, its losses are increasingly shallow and subsequent recoveries more vigorous in response to the inevitable Central Bank liquidity injections. As we have written on numerous occasions, with fixed income looking like a fatigued portfolio hedge whose efficacy near the zero interest rate bound lies very much in question, we think gold is an increasingly

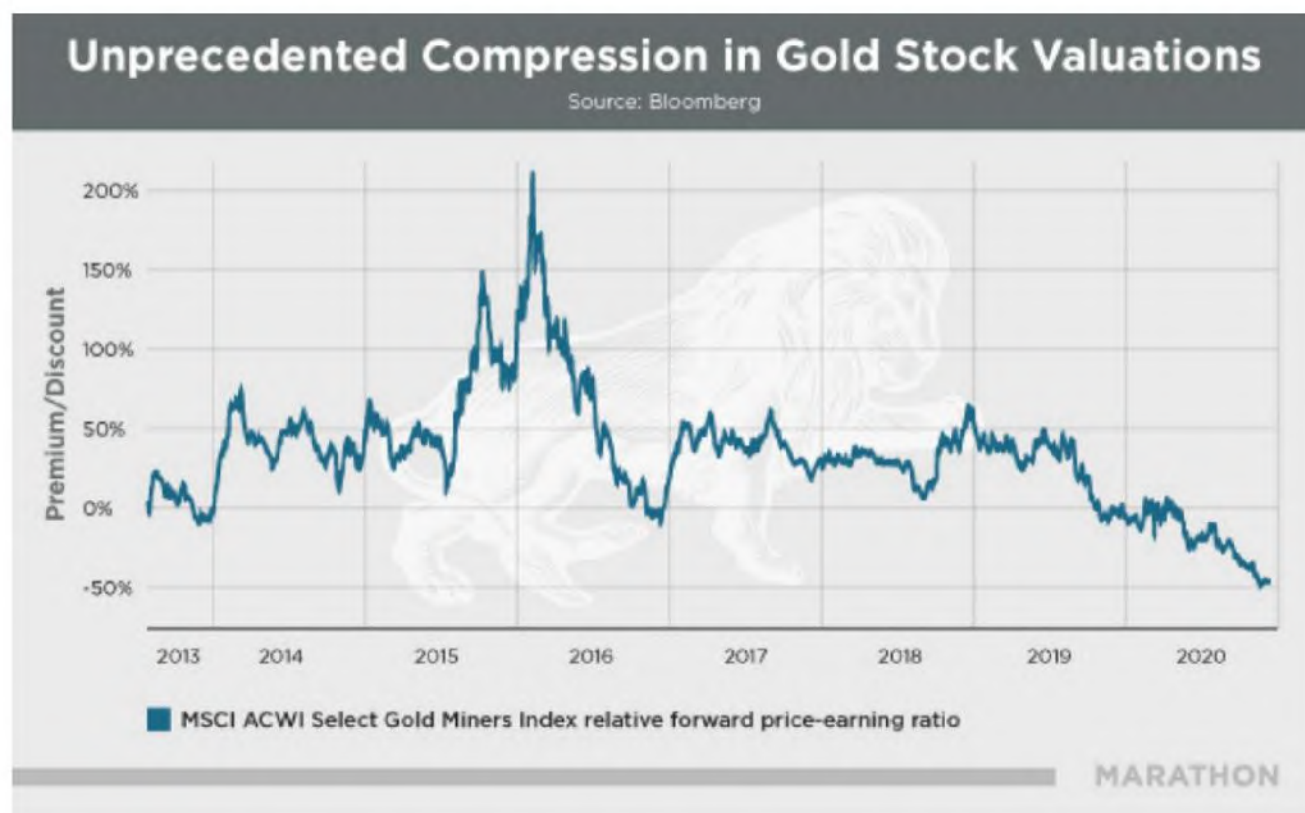
attractive compliment to/replacement for credit as portfolio ballast.

With that in mind, we find it increasingly puzzling that as central bank responses reach ever more extreme levels that the most levered way of expressing a positive view on gold has, without exception, never been cheaper. When we started investing in resource equities in the 1990s, gold stocks traded at many multiples of Net Asset Value and 12-15x cash flow despite the fact that gold had been falling and inflation had been trending down for almost 20 years. The rich multiples were investors way of valuing the optionality and leverage that the sector offered should those trends reverse.



Gold equities today are amongst the most profitable businesses in the entire market, with the 40% operating margins noted above roughly double the next most attractive sectors. Much of this cash generation has been channeled towards debt reduction, share buybacks and increasing dividends in a broader market that is going the opposite direction on all three. And yet they currently

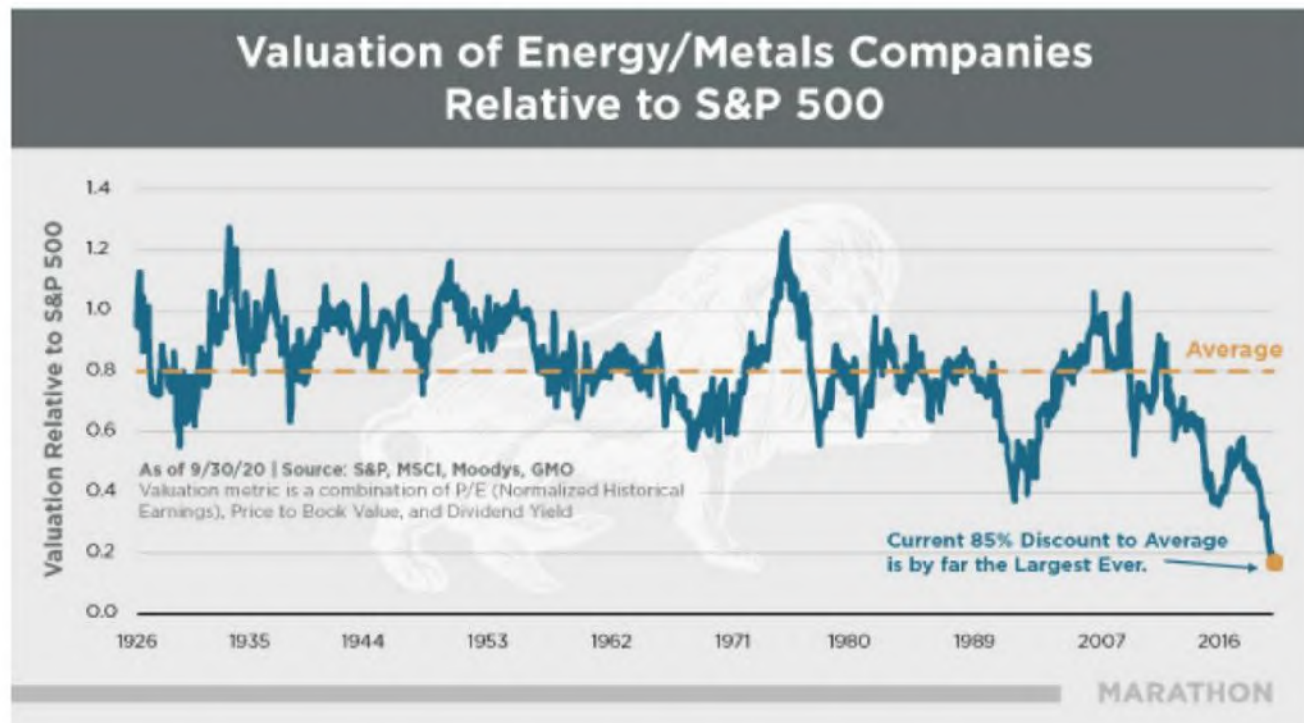
trade at 50%-80% discounts on a P/E basis. This has not always been the case, as the chart below illustrates the considerable contraction in the Sector's relative valuation over the last 8 years.



We suspect that the group's de minimis weight in the broader indices as well as the effective destruction of the precious metals investment niche over the last decade have been contributing factors, but we think something more basic is at work. It may just be that the current investment setting has endowed investors with considerable complacency regarding not just inflation but systemic risk and central bank omnipotence that leads to such a remarkable valuation dislocation. In many ways, that complacency is a necessary attribute for allocators to remain confident in holding the majority of their investments at historically unprecedented valuations. As we have noted at length above, with a number of reasons why that complacency may waver we suspect considerably more company in our enthusiasm for gold shares in the future.

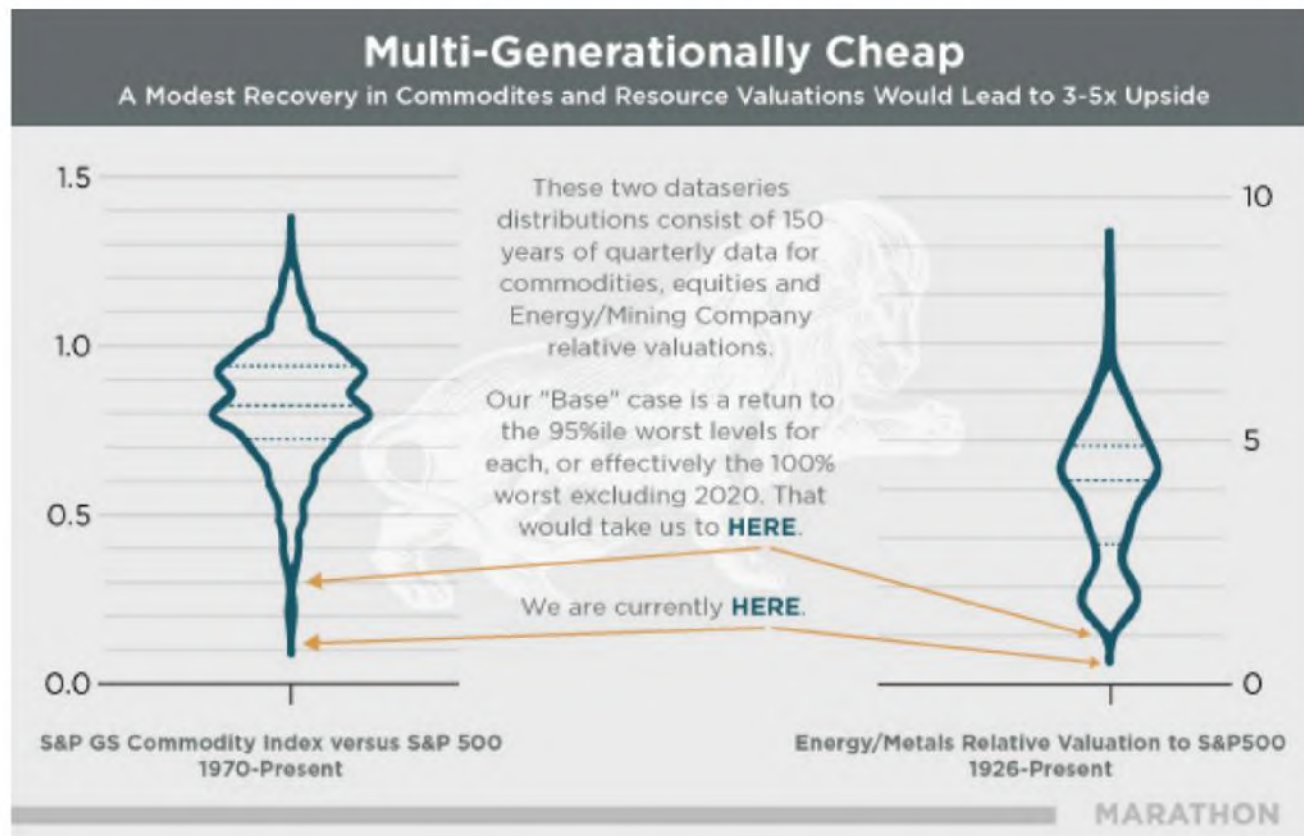
## Quantifying the Upside

In our "Foundational Support" section at the beginning of this letter, we pointed out that commodities are currently at their cheapest levels relative to financial assets in over 50 years. As illustrated below resource company **valuations** are at their lowest levels relative to the broader market in almost 100 years. The result of this flight in capital has been a collapse in resource capital expenditures, setting the stage for a fundamental recovery in the sector. What might that recovery mean for investors in resource equities? We're glad you asked.



In both analyses, the current readings (as of Q3 2020) represent the most significant discounts seen over the last 50 & 100 years, respectively. As the probability distribution below shows, 99%+ of the time both commodities and commodity company valuations have been significantly higher than today. And while we think it unlikely that investors will find reason to revert to premiums on either measure any time soon, we find it instructive to extrapolate what

merely a recovery to the worst levels experienced before 2020 might mean for the sector.



For this exercise we assume both the S&P 500 and the estimates for S&P 500 earnings remain flat which, while cases can be made for each to be much better or worse, nonetheless gives us a baseline for potential relative performance. In order for commodity prices to merely recover to the worst levels relative to the broader market pre-2020, they would need to double from current levels. Similarly, for energy and metals equities to rebound back to their lowest pre-2020 valuation relative to the broader market their multiples would need to double as well.

The impact of the former would be substantial, as a doubling of commodity prices would lead to earnings, cash flow and book values in the equities to rise anywhere from 2-5x. One can think of this in terms of an average oil company having costs of \$40/bbl, so when prices go from \$50 to \$100 their profits rise from \$10/bbl to something more like \$30+ after additional taxes, etc. When one takes the next step and doubles the multiple on those higher earnings and

cash flows, the end result is a rise of 300% (or much more) in the underlying equities. We must at this point reiterate, this does not get us back to peak relative valuation, or even average. This is the result of simply recovering to the worst levels ever recorded pre-2020. We can think of very few sectors with the ability to rise several fold and still be near the least expensive levels of the last 50-100 years.

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## The Path Forward

There have been two major tectonic shifts in the financial market setting over the last 25 years, with each impacting the resource sector in very different ways. Each bears some elements of similarity with today's environment, but important contrasts as well.

In 1998 an emerging markets demand shock and an untimely increase in oil supply crashed commodities just as the enthusiasm for "New Economy" tech stocks was beginning to gain significant momentum. The internet bubble brought us profitless (or even revenue-less) IPOs while established companies like Cisco and Sun Microsystems sported utterly unsustainable multiples. All asset classes rallied together through 1999 into early 2000 as rampant retail speculation, Central Bank Y2K accommodation and index flows into low-float favorites ramped markets to their glorious crescendo. Only with hindsight was it clear that the baton was being passed from tech and telecom to commodities and real assets. The deflation in the former in no way impeded the early rally of the latter, as the demand-driven Chinese industrialization wave powered resource stocks through the tech and broader market bust and onward for the better part of the next decade.

It was a very different financial landscape that prevailed in 2008. Resource stocks were fatigued at the end of 9 years of torrid outperformance, punctuated by a flurry of commissioning of new mega projects funded by soaring capital expenditures. Commodity supply was rising, balance sheets and costs were bloated, and the industry was supremely self-confident in its

future. Broader markets were powered by financials and real estate as once again aggressive Central Bank policies were encouraging aggressive risk taking, often via new creatively engineered financial products developed with a "rearview mirror" evaluation of potential risks. While many still argue over the precise pin that pricked the bubble, the result was a grueling, multi-stage decline that took few prisoners with the exception of the safest fixed income instruments. After declines of 60-90%+, resource stocks rallied into what proved to be an "echo" mini bubble, as Central Bank responses to the crisis fueled fears of accelerating inflation. Those proved premature, and after fits and starts over the ensuing decade resource stocks stumbled awkwardly towards their nadir in late 2020.

It is our belief that today's financial setting draws elements from both of these periods. The resource markets seem eerily similar to 1998, in the early days of finding their footing after a lost decade of underperformance. While we lack the prospect of the explosive industrialization push of China in the 2000s, the apparently blank check available for de-carbonization may well drive demand for key renewable materials at levels well exceeding commodity demand back then. Additionally, the dramatically constrained supply in non-green energy and base metals, as well as "bridge" fuels such as natural gas and uranium, offer tremendous opportunity. Across the resource spectrum, regardless of whether the outlook for the individual commodities is exceptional or merely "ok," the valuation point of entry for resource equities is the best in 50+ years.

The broader market financial backdrop also appears to combine elements of both experiences. The rampant speculation, retail enthusiasm, market narrowness and "Brave New World" outlook feel very 1999. On the other hand, the emerging fragility of the system due to rapid credit growth, passive flow dynamics and the shrinking role of trusted intermediaries facilitating aggressively expanding shadow markets feel very 2008.

We suspect that what lies ahead will bear similarities to both the Tech bust as well as the GFC but will also incorporate elements which are altogether new and different. It is with this in mind that we allocate capital in a way not dissimilar from Frank Lloyd Wright's Imperial Hotel. Our foundation is a portfolio that lies across commodity sectors that benefit from multiple themes

(traditional resource recovery, "Green" beneficiaries, quality royalties, niche transportation and infrastructure and counter-cyclical precious metals) allowing them to move independently through varied market evolutions. The common trait of free cash generation and income distribution lend these subsectors buoyancy even in times of volatility, as they don't rely on external funding for operations. This strategy has served us well over the last decade, enabling us to not only preserve but grow capital over a period where resource indices and most investors therein have suffered losses. This "positive carry" element, should we be correct in our belief in a gradual rise in inflation expectations, may well lead market participants to sharply revalue the building blocks capable of providing truly inflation protected income. The fact that they stand spectacularly undervalued relative to the ubiquitous and unprecedentedly expensive fixed income alternatives shows just how complacent market participants have become.

We state with total confidence that we cannot predict how the financial setting will evolve with any degree of certainty. However, having occupied a front row seat in markets for the last 30 years, we do think the shrillness of the current investment backdrop indicates change is coming soon. While we would prefer it to occur like it did in 2000, where whatever correction awaits the broader markets remains relatively orderly and largely spares the resource stocks, we have a sneaking suspicion it may not be that easy. It is with this in mind that we continue to seek ways to inexpensively and efficiently express long volatility within the portfolio as a last line of defense in keeping with Wright's reflective pool which doused the fires back in 1923. The ability to offset losses during periods of extreme market dislocations not only protected our partners capital in Q1 2020 but positioned us to take advantage of the multitude of bargains unearthed as a result. Regardless of what lies ahead we continue to believe a thoughtfully constructed portfolio of diverse resource equities offers both considerable value as well as convex protection from a modestly accelerating inflationary backdrop, the single development most likely to adversely impact broader markets.

**Robert Mullin**

*General Partner/Portfolio Manager*

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