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The Case for Hard Assets: An Update

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Background and Summary

One of the key trends we perceived in 2008 (when we started our firm) was that the US domestic political consensus to maintain American hegemony was fraying. Prior to that point, fears of global communism had fostered a political consensus that encouraged Americans to bear the costs of hegemony. Those costs were tied to the two primary global public goods that the hegemon provides. These goods are:

1. *Global security* — the hegemon develops a military of global reach and often projects power into conflicts unrelated to its own security. As part of this role, the hegemon also protects global sea lanes, supporting international trade.
2. *Global financial security* — the hegemon provides the financial architecture of the global financial system. This includes providing the reserve currency and reserve asset and intervening in financial crises in other nations.

American hegemony was exercised differently than its predecessors. European hegemons used colonies to project power, in part because they were engaged in a "great game" against other competing European powers. In contrast, the US was engaged in an ideological contest, to not only prove to be a stronger power than the Soviet Union, but to be a ***better*** power. George Kennan's famous "long telegram" became the blueprint of American policy against communism. Essentially, US policy was designed to outlast the Soviet Union by containing it and demonstrating that democratic capitalism offered better results than communism. And so, US foreign policy had a strong element of soft power,[1] where the US opened its economy to imports, which allowed allied nations to prosper in the post-WWII environment.

The US created a set of international organizations that built an order based on rules.[2] It also contained longstanding conflicts in Asia (China versus Japan) and Europe (Germany[3]) by providing security to both regions. Thus, Asian nations no longer had to fear Japan's militaristic attempts to secure resources as the US Navy protected sea lanes and allowed commodities to flow freely. In Europe, nations no longer had to fear German insecurity because the US

[1] For a recap of the American way of hegemony, see our three-part *Weekly Geopolitical Report* series from 2018, "The Malevolent Hegemon," Part I, Part II, and Part III.

[2] This didn't mean the US always abided by the rules, but US administrations did generally try to operate within them. For example, when the Bush administration was planning to invade Iraq, it did attempt to get UN approval.

[3] See our *Weekly Geopolitical Report* from July 27, 2009, "The German Problem."

demilitarized the country. This policy was costly, but it was designed not just to secure American hegemony, but to defeat communism.

On the domestic front, American society generally allocated the costs of hegemony broadly. As John Kenneth Galbraith described in *The New Industrial State,*[4] large firms tended to roll out technology at a measured pace so as not to disrupt the labor markets. Unionization was supported, and high marginal income tax rates tended to narrow inequality. When inflation became uncontrolled in the 1970s, policymakers opted to deregulate and globalize in order to expand supply. This action did disrupt the Cold War consensus with labor. What is unknown, however, is if the Soviet Union had not fallen, would there have been a return to the labor/capital allocation that was seen before 1980? Once communism fell, though, the need to maintain the Cold War consensus diminished.

In the post-Cold War world, the American foreign policy establishment was committed to maintaining its hegemony but was unwilling to allocate the costs of hegemony equally. To provide the reserve currency/reserve asset, the US was forced to run persistent current account deficits. This was especially the case since the US was the first hegemon to operate a reserve currency/reserve asset system under fiat currencies. Prior hegemons operated under gold standards, and although the hegemon's currency (and its assets denominated in that currency) was often used for reserve purposes, gold remained a constraint on the hegemon's ability to expand the global money supply.

Once the Bretton Woods system ended, the gold constraint was lost. Thus, the only limit to how many dollars the US would create was the appetite of foreigners. And since the trade deficit represented employment in foreign economies, there was a large appetite for US financial assets. The most effective economic development strategy that emerged after WWII was export promotion, which relied on access to the US consumer. The persistent current account deficits led to a deterioration of the American manufacturing base, creating pockets of poverty in the so-called "rust belt." This unwinding of US manufacturing accelerated at the end of the Cold War as globalization expanded.

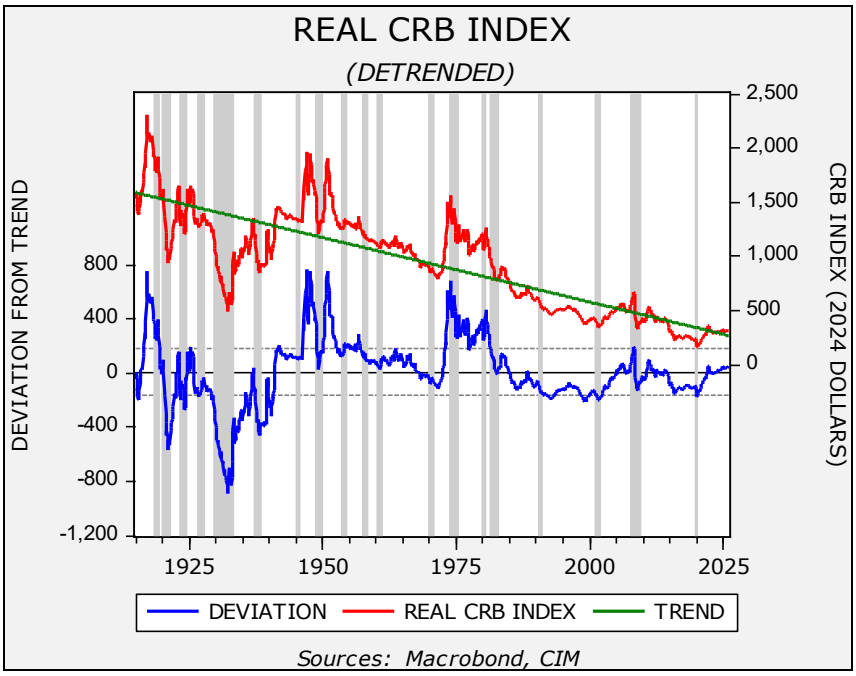
In the post-Cold War era, as real wages declined, consumption was supported by rising asset prices and household debt. The 2008 Global Financial Crisis ended this resolution. Household debt declined relative to the size of the economy; however, the retrenchment was painful and resulted in political fracturing. It was our contention that the most likely resolution to this fracturing was an end to the post-WWII hegemonic consensus. We were not sure what would replace it, and we still don't know. But our primary task isn't to predict what hegemonic conditions will emerge; it's to manage investments within this newly evolving world order.

We did feel confident that Charles Kindleberger's theory of hegemonic stability, as expressed in his book *The World in Depression, 1929-1939,*[5] would still hold true. A world without a clear

[4] Galbraith, John, Kenneth. (1967). *The New Industrial State*. Princeton, NJ: Princeton University Press.
[5] Kindleberger, Charles. (1973). *The World in Depression, 1929-1939*. Berkeley and Los Angeles, CA: University of California Press.

hegemon would be prone to conflict and disrupted supply chains. In his book, Kindleberger uses the historical example of the Great Depression, which he argues occurred because Britain was unable to maintain global hegemony and the US refused to accept the mantle. It was only after the horrors of WWII that Washington accepted the role.

Faced with this scenario, we postulated that in a world where global hegemony was unclear, hard assets would perform well. Why? First, the expected global fracturing due to hegemonic uncertainty would lead to economic agents scrambling to secure key commodities. Second, hegemonic insecurity would raise questions about the stability of the US dollar reserve currency/US Treasury reserve asset system. Finally, years of generally depressed commodity prices had led to lower investment, which under conditions of rising demand would bring sharply higher prices.



This chart shows the CRB Index, a broad-based commodity index, deflated by US CPI and beginning in 1915. We have regressed a time trend through the data, and the negative slope of the trend makes it clear that, after taking inflation into account, commodity prices fall over time. In some respects, this is a key feature of capitalism — firms and consumers constantly use less commodities to generate growth.

However, as the deviation line on the chart shows, there are periods where the CRB Index moved sharply above the trend. World Wars I and II are obvious as is the Korean Conflict. Major wars are bullish for commodities for three reasons. First, the buildout of war materials boosts demand. Second, a fractured world disrupts trade flows, causing insecurity of supply that commonly triggers shortages and prompts the hoarding response. Third, during wartime, monetary discipline is foregone to pay for the war effort. The debasement of the currency leads economic actors to hold commodities as a store of value.

The rise of trend from the early 1970s into the early 1980s was less about the Vietnam War and more about debasement. President Nixon's decision to close the gold window on August 15, 1970, broke any remaining tether of money to gold. Moving from the quasi-gold standard of Bretton Woods to a fully fiat, floating exchange rate system led to monetary and price instability. Commodity prices remained above trend until Federal Reserve Chair Paul Volcker restored order by dramatically (and unexpectedly) boosting interest rates.

Although the fiat currency system remained in place, the Volcker consensus that emerged was that monetary stability could be maintained with central bank independence and a clear inflation target. With the end of the Cold War and the expansion of globalization, inflation moderated and commodity prices languished. As the above chart shows, the China commodity bull market, which ran from 2003 to 2008, paled in comparison to early bull markets. This is likely because during this period, there were no major conflicts and no threats to the international financial system.

The Structure of Trends

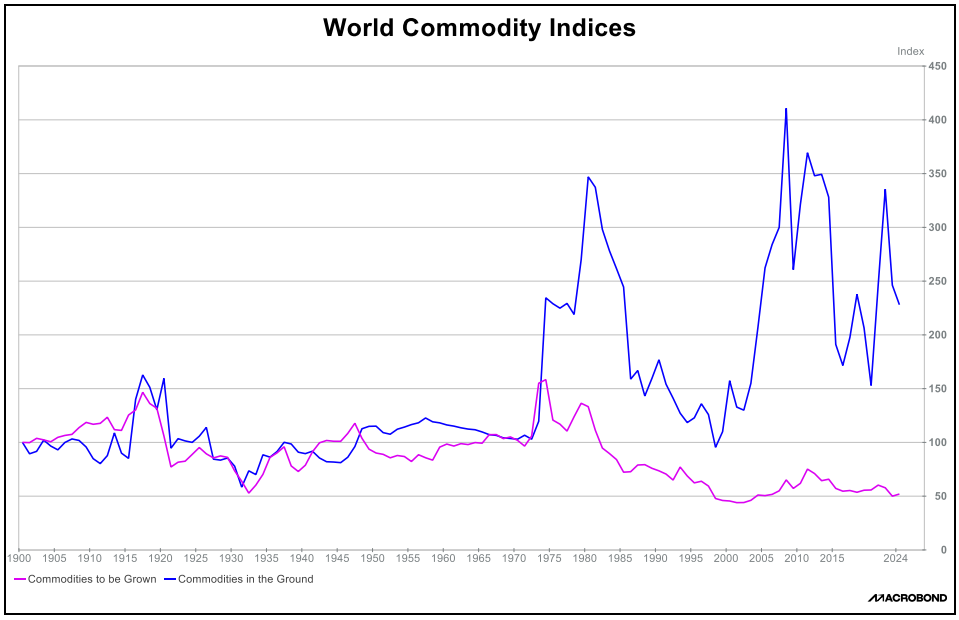
Secular markets are defined as long-term trends in the price of an asset. There are both secular bear and bull markets. In most markets, there are also *cyclical* bull and bear markets, often tied to the business cycle, and in some markets, there are *seasonal* bull and bear markets that are usually tied to annual production or consumption cycles. For example, a secular bull market in bonds is characterized by falling inflation expectations that trigger steady declines in interest rates. A secular bear market in bonds is caused by the opposite condition — rising inflation expectations that drive interest rates consistently higher. In comparison, a cyclical bull market in bonds is often related to the business cycle and monetary policy.

In general, secular cycles tend to last a long time. Using bonds as an example, we have likely concluded a four-decade secular bull market which encompassed several cyclical cycles. The length tends to be tied to specific characteristics of each market.

Commodity markets have secular cycles as well. Commodity demand is mostly a function of economic and population growth, whereas commodity supply comes from the acts of agriculture, ranching, mining, and drilling. As the chart on the next page shows, commodity producers face a serious secular headwind — capitalist economies tend to persistently improve their efficiency in producing finished goods from raw commodities. Commodity production is also subject to steady improvement in productivity.

In terms of commodity supply, sectors have varying capacity to respond to changes in demand. For example, agriculture markets can react rather quickly. In the major grain markets, there are two main growing seasons, April through September in the Northern Hemisphere and October to March in the Southern Hemisphere. If a problem develops in one growing area, there is a chance to resolve it a few months later. Softs markets are similar to grain markets in this regard, although tree crops, such as coffee or cocoa, can take a few years. With livestock, the rate is a few weeks (poultry) to a couple of years (cattle). Energy markets usually take at least 18 months to respond and can take years to develop large and complex oil fields. New mining supply can take up to a decade.

Given the slow response from the "hard" assets (e.g., energy and minerals), we favor these assets. They are more likely to experience multi-year price trends due to the slower supply response.



The data for this chart was generated by David Jackes, an economics professor at the National University of Singapore. He examined the difference in commodity prices from commodities that are generated from the ground compared to commodities that exist in the ground. As the chart shows, since the 1970s, the prices of commodities that exist in the ground (fossil fuels, minerals) have outpaced grown commodities (agriculture, softs). Obviously, the divergence was supported by the power of OPEC to lift oil prices. But this divergence has continued, likely because the supply response from commodities in the ground is much longer than those that are grown. This divergence supports the case that if one is going to hold a position in commodities, hard assets, which are primarily "in the ground," have a higher likelihood of success over the long run.

Hard asset mining is dictated by geology and the location of quality ore. The long supply response for hard assets is exacerbated because they are often found in remote and inhospitable geographies that make long-duration investing difficult. These projects require substantial upfront investments in exploration, permitting, feasibility studies, and delineation before capital is allocated to building the necessary mining infrastructure. Consequently, they often take more than a decade from the initial discovery to first production. This makes capital recovery more volatile, rendering expected production and capital costs crucial.

Even if significant economic mineral deposits are found, a lack of political stability, absence of established rule of law regarding concession seizure, inferior infrastructure, lack of power generation in remote areas, labor issues, and environmental concerns can derail an otherwise great investing opportunity.

Over the last few decades, copper and gold ore grades have steadily declined. This requires miners to process much more waste rock, thereby increasing the commodities' breakeven price. In addition, China has come to dominate the smelting and refining portion of converting raw materials into usable commodities. With less stringent environmental regulation and state-subsidized backing, they have bankrupted competitors and created a chokepoint. China has leveraged this capability in trade wars to restrict critical minerals, such as rare earths, which are needed by countries for their defense and communication systems. In order to maintain sovereignty, countries like the US are quickly trying to reshore their mining and processing industries.

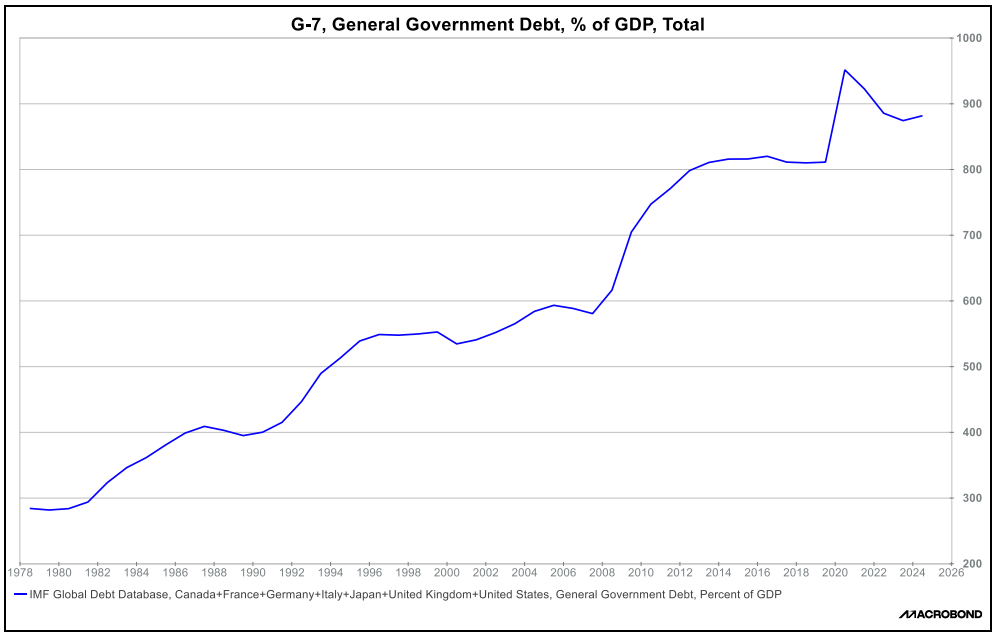
Commodities are unique because marginal production prices the entire commodity. Hard asset supply response in this cycle has tended to be more disciplined. Prior to 2015, investors allowed oil exploration and production companies (E&Ps) to spend heavily on reserve growth with little concern for production and operating efficiencies. Subsequently, investors revolted, forcing E&Ps to live within their operating cash flows. This incented them to grow free cash flow rather than drill marginal sites. E&Ps responded by growing profitability and returning cash to shareholders through dividends and buybacks as well as deleveraging.

We look at the cash costs of the top miners and producers and endeavor to exclude the high incremental cost producers from our portfolios. We expect the low-cost producers — those below the 90th percentile in cash costs — will benefit over the cycle, while the weaker competitors will go bankrupt or sell their assets.

As a result, the Confluence Global Hard Assets strategy focuses on commodities that require multiple years to generate a supply response. We invest in companies responsible for the extraction of these hard assets, excluding those firms involved in ancillary or support functions. In practical terms, this means mining companies rather than mining equipment providers. The portfolio may also hold exchange-traded funds that invest directly in commodities.

Concluding Thoughts

1. We consider the Global Hard Assets portfolio to be a strategic alternative asset. In other words, its function is to protect against the breakdown of US hegemony. Investors should remember that commodity prices are cyclical, and that even in secular bull markets, commodity prices will tend to decline during recessions.
2. The threats being made against the Federal Reserve will raise fears of debasement. Perhaps a bigger problem is the high levels of fiscal debt across the developed world. For example, the chart below shows the total government debt to GDP of the G7 countries.



Debt levels of this magnitude raise the potential for fiscal dominance, where the government's need for support to manage its debt service leads the central bank to conduct monetary policy with the goal of reducing government interest costs. This situation usually leads to currency debasement and is bullish for commodities, in general, and precious metals, in particular.

3. Another factor to consider is that as the world fractures, the potential for price arbitrage weakens. In other words, there will likely be situations where prices will diverge in different parts of the globe. Thus, investing not just in the most favorable commodity but in the most favorable location will likely become more important in the coming years.
4. This strategy isn't specifically an inflation hedge; we think that natural resources prices are protection against geopolitical unrest and currency debasement. However, if inflation does develop, as the retreat from globalization tends to foster, we would expect the Global Hard Assets strategy to benefit.

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Confluence Investment Management LLC

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