By Bill O'Grady and Mark Keller

The Case for Hard Assets: An Update

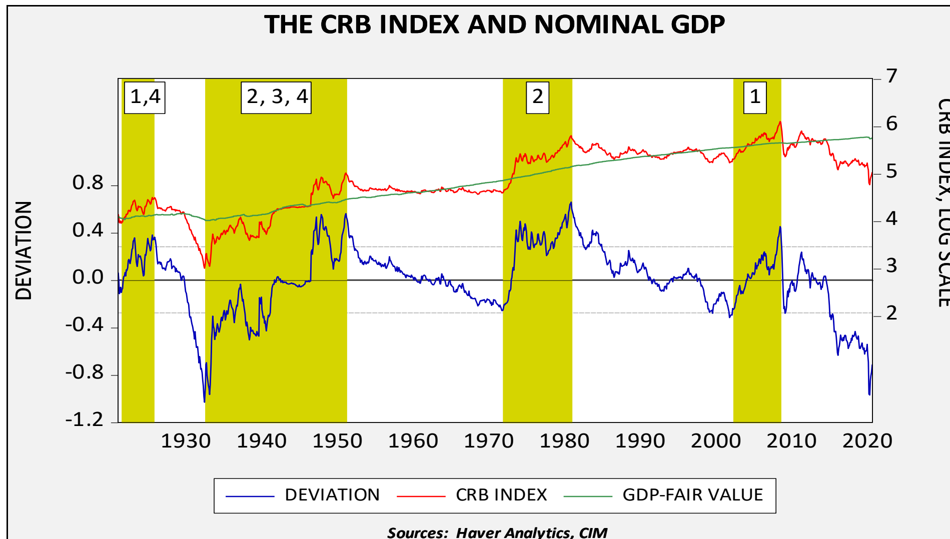
Background and Summary

In this report, we use the term "commodities" to imply "hard assets." In our definition, the latter is a commodity that requires multiple years to generate a supply response. This definition excludes agricultural commodities, which tend to create a supply response on an annual basis. That doesn't mean all agricultural commodities have short-term supply responses. Coffee trees, for example, take three to four years to mature. But, once a tree is mature, a new crop occurs annually. Compare that to a mine which takes years from inception to producing ore. Even oil wells take about a year to drill (from pre-drilling work and actual drilling). Thus, a portfolio based on hard asset commodities will tend to have less supply volatility compared to soft asset commodities.

Secular markets are defined as long-term trends in an asset. There are both secular bear and bull markets. 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 which lead to consistently rising interest rates.

Commodity markets have secular cycles as well. Commodity demand is mostly a function of economic and population growth. Commodity supply comes from agriculture, ranching, mining, and drilling. In capitalist economies, technology usually acts to reduce demand and increase supply. Over time, we have seen consumption per unit fall for many commodities. Technology tends to reduce our per unit consumption; we get more output from consuming less commodities. Technology also enhances production. For example, agricultural technologies have improved production and reduced inputs. The impact of shale technology has revolutionized the oil and natural gas industry. Although globalization and trade can improve commodity demand, it also can make supplies more secure and lead to reduced inventories.

As a general rule, peace, stable economic growth, and orthodox monetary and fiscal policy tend to act as depressants on commodity prices. War, unusually strong economic growth, a breakdown in global order, and unorthodox policy are usually bullish for commodity prices.



The above chart shows a model of the CRB index of commodity prices and nominal U.S. GDP. We have log scaled the data, which starts in 1921. The red line shows the CRB index and the green line shows the part of commodity prices explained by U.S. economic growth and inflation. The lower line shows the deviation. When the lower line is above zero, commodity prices are higher than what is justified by nominal economic growth; when the lower line is below zero, the opposite condition exists.

The shaded areas on the graph are what we designate as secular commodity bull markets. These are defined by a steadily rising deviation line that rises above one standard error. Historically, secular bull markets in commodities have been caused by four factors:

1. Unusually strong growth in a large economy;
2. Breakdown in global order;
3. Unorthodox fiscal and monetary policy;
4. War.

We have put numbers in the shaded sections that show what caused the noted secular bull market. As the chart suggests, the majority of the time, commodities are in secular bear markets. In addition, secular bull markets tend to be shorter than secular bears.

Here is a quick history of secular bull markets in commodities:

1. The 1920s: The U.S., the largest economy in the world, experienced a boom in growth. The U.S. industrial base emerged unscathed from WWI and its overall losses were small relative to Europe. U.S. monetary policy was kept easy to support Britain's attempt to restore the gold standard, but the primary factor in the commodity boom was strong U.S. economic growth. In addition, Britain's hegemonic status was under question after WWI, raising global uncertainty.
2. The 1930s: The combination of unorthodox monetary and fiscal policy along with a breakdown in the geopolitical order that led to WWII brought a massive recovery in commodity prices following a major crash. In 1933, President Roosevelt took the

U.S. off the gold standard, allowing for persistent easing of monetary policy. Fiscal policy was expanded to counteract the Great Depression. The onset of WWII led to extraordinary consumption of commodities as part of the war effort. During the war into the early 1950s, the Fed was forced to fix the Treasury's borrowing costs, leading to a massive expansion of the balance sheet. And, of course, the war effort was, in itself, a major fiscal expansion. By the 1930s, it was evident that Britain was no longer sufficiently able to project power to be the global hegemon and the U.S., which did have the ability, lacked the desire. This development led to a breakdown in the global order, not only causing war but encouraging inventory accumulation, which is bullish for commodities.

3. The 1970s: President Nixon took the U.S. off the Bretton Woods gold/dollar standard and the Federal Reserve engaged in persistently accommodative monetary policy. The debasement of the dollar was one of the factors that led to the 1973 spike in oil prices; the Fed's accommodation of the price pressures brought by higher oil prices led to persistently high inflation.
4. The 2000s: China's extraordinary economic growth boosted the demand for commodities. Adding to price pressures was the financialization of commodity markets and fears of scarcity of supply, especially in energy.

Where are we now?

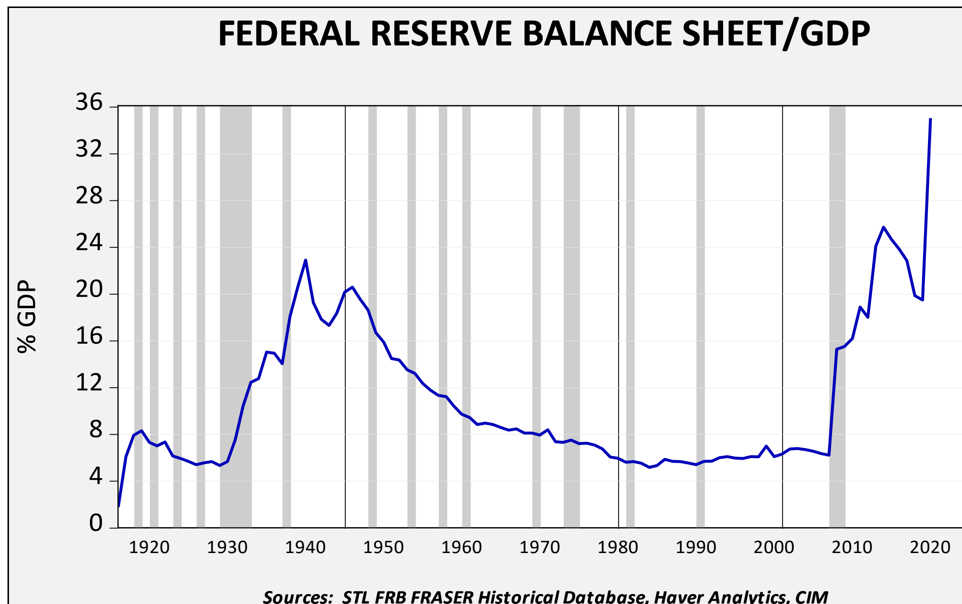
Although commodities did partially recover in 2011 due to the deployment of unorthodox monetary policy (quantitative easing, persistently low interest rates, and negative nominal policy rates in Europe) and massive Chinese fiscal stimulus, the gains failed to hold. The impact of monetary policy faded over time and China was unable to maintain its degree of fiscal expansion. The pandemic has led to a drop in commodity prices relative to nominal GDP that is similar to the trough in the CRB index shown in 1933, but commodities had been under pressure for some time.

Given that commodity prices relative to U.S. nominal GDP are at historically low levels, is there a case for prices to recover? Here is our argument for a new secular bull market in commodities:

Unorthodox monetary policy is being implemented. During the Great Financial Crisis, the Federal Reserve engaged in a plethora of new policies. Not only did the policy rate fall to just above zero, but the central bank actively bought Treasuries and mortgages, expanding its balance sheet. The FOMC attempted to normalize policy through a series of interest rate hikes from December 2015 through December 2018 and a reduction in its balance sheet from Q4 2017 until August 2019. In retrospect, this tightening was premature. Although labor markets had improved dramatically, there was no evidence that inflation was becoming a problem. In September 2019, repo rates spiked and dealer liquidity became scarce, prompting the Fed to rebuild the balance sheet. The FOMC had already started to reduce interest rates in June 2019.

However, the response to the pandemic has been historic. The central bank has created a myriad of special facilities to support mortgages, money market funds, municipal bonds, and corporate bonds (both investment grade and high yield), and has established a small business

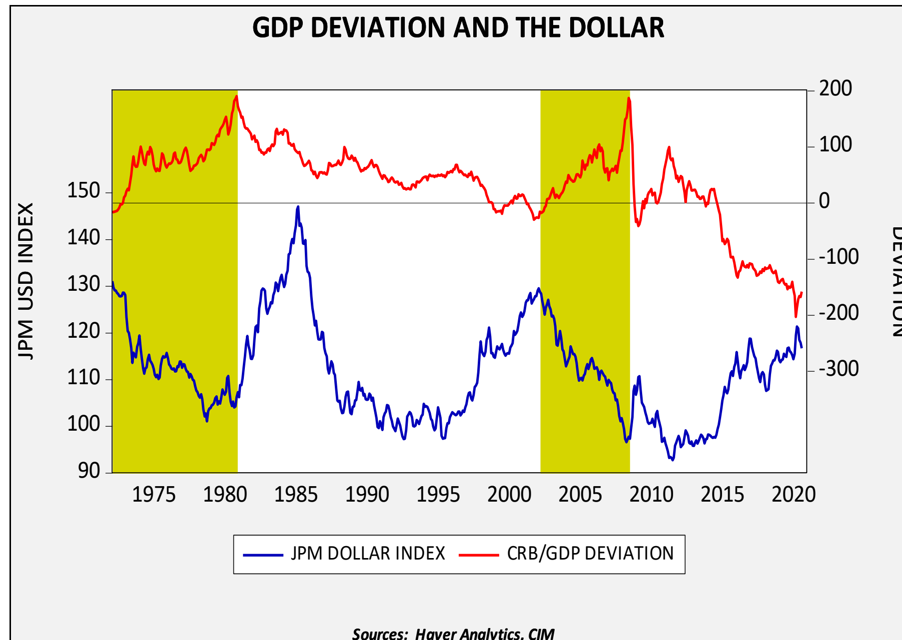
loan facility. The totality of the actions has led to a historic expansion of the Fed's balance sheet. Central banks, traditionally, are considered the lender of last resort. In 2020, the Federal Reserve has become the *dealer of last resort*. It is uncertain how low this expansion of policy will last, but the FOMC is indicating that easy policy should remain for the foreseeable future.



The global geopolitical order is in question. Since the end of the Cold War, the U.S. has struggled to develop a workable foreign policy. Seemingly endless wars and economic disruption triggered by globalization have soured many Americans on the superpower role. As Americans tired of the role, presidents have promised to reduce America's foreign involvement, only to find themselves pulled into events. President Clinton intervened in Serbia; President Bush ran on a "humbler" foreign policy until 9/11 and the Iraq/Afghan wars. President Obama tried to "lead from behind." And President Trump has removed the U.S. from numerous international conventions, including the WHO and the Paris Climate Accords, and threatened to leave other treaties, such as NATO. When the world lacks a hegemon, expanded wars become more likely as the hegemon is no longer there to prevent regional conflicts from expanding. Global trade is usually undermined as well. The hegemon's power projection protects global sea lanes, allowing for global trade. It also fosters global finance through providing the reserve currency. Without a hegemon, trade tends to decline, which leads companies and nations to hoard key commodities, boosting the demand for these goods and lifting their prices.

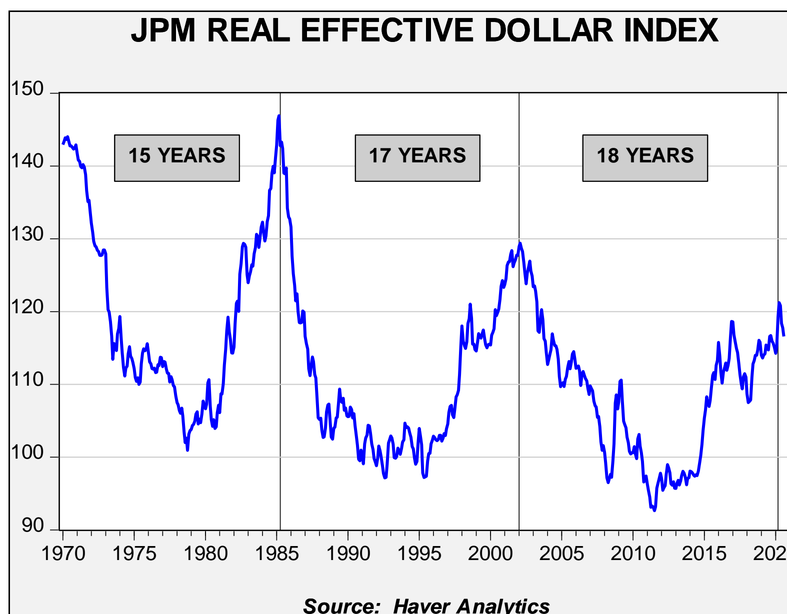
Contributing Factors

The dollar's long-term trends. Most commodities are priced in dollars. For commodity consumers, a stronger dollar means the costs of such goods rise, which depresses demand. For foreign commodity producers, a rising dollar is supportive of higher production. Why? Because these producers receive dollars when they sell their goods but pay their expenses in local currency. A stronger dollar means their margins increase, likely leading to higher production.



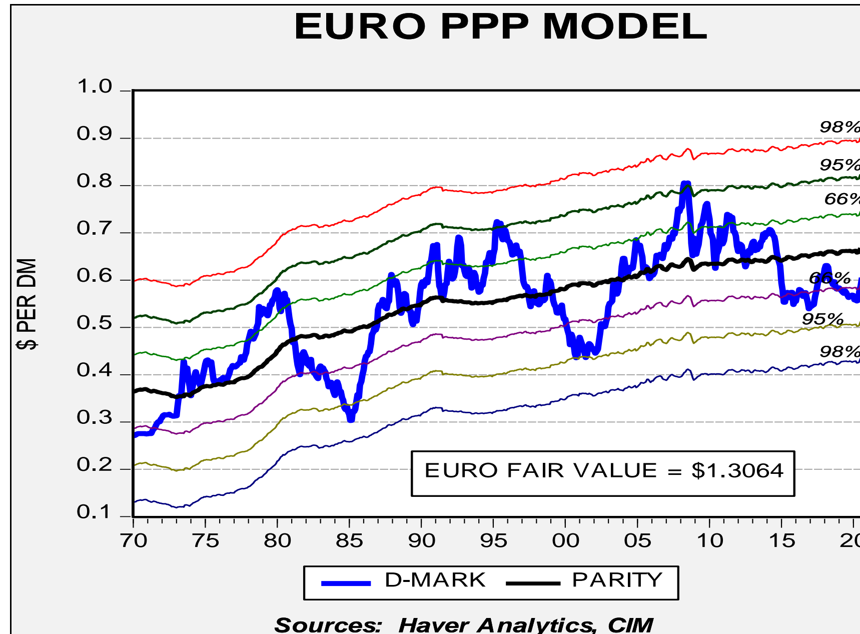
This chart shows the CRB/GDP deviation from the first chart along with the secular trend shading. Because the dollar only started to float in the early 1970s, the relevant time frame is shorter. A dollar bear market doesn't necessarily lead to stronger commodity prices. The drop in the dollar after the 1985 Plaza Accord may have slowed the decline in commodity prices but did not arrest the downtrend. But, clearly, the last two secular bull markets were aided by dollar weakness.

We expect the dollar to begin a significant decline in the coming years. There are three reasons. First, based on long-term cycles, the dollar should be ready for a retreat.



Dollar peaks tend to occur every 15-18 years. As true of all major macroeconomic factors, trends create winners and losers and, in general, a persistently strong dollar creates political resistance that leads to a reversal of the trend.

Second, based on valuation measures, the dollar is overvalued.

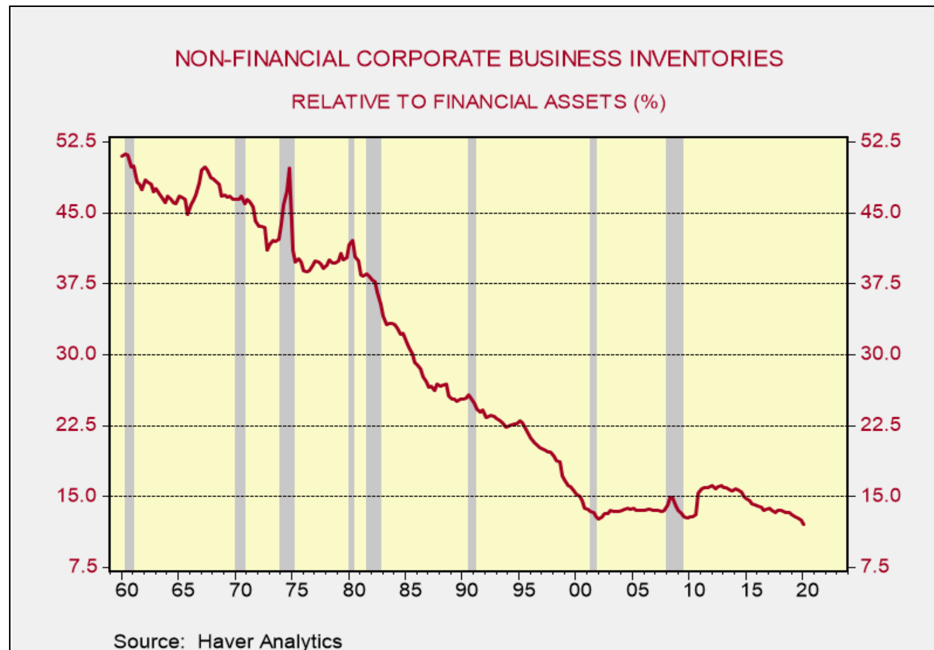


Based on relative inflation rates between Germany and the U.S., translated into EUR, fair value for the EUR is $1.2981. Historically, once a recovery develops from undervalued levels, it is common for a degree of "overshoot." A rise to the one+ standard error level would put the EUR at $1.45.

The third reason for dollar weakness is that the EUR has become a stronger competitor to the dollar's reserve currency status. There has been increasing displeasure with the expanded use of financial sanctions implemented by the U.S. for geopolitical goals. These sanctions are effective because the dollar's reserve currency status makes it difficult for a country to avoid touching the American financial system when conducting trade or international financial transactions. Up until now there has not been a realistic competitor for the dollar. But, the recent decision by the EU to issue a full-faith and credit Eurobond backed by all the members of the EU gives reserve managers an attractive alternative to the Treasury/dollar system. Without this new bond, a reserve manager had to choose one of the countries of the Eurozone; picking Germany meant maximizing safety at the cost of negative yields. Choosing a periphery nation increased the yield but carried renomination risk. The Eurobond eliminates this risk.

The role of inventory. In general, a household, business, or government faces an allocation decision. If given liquidity, how is the best way to hold it? Under conditions of supply security and negligible inflation, the most likely way to hold that liquidity is with a financial asset. On the other hand, if supply insecurity is present and/or inflation expectations are

rising, an economic entity may decide to hold inventory instead. Since 1960, inventory levels relative to financial assets for non-financial corporate businesses have been in decline.



The fall was moderate from 1960 to 1980, but the drop accelerated after 1980. Currently, inventories of these firms represent about 12.1% of financial assets. Under conditions of just-in-time inventory management and low inflation, the incentive to hold inventory has declined. If conditions change, where the security of supply is threatened and/or inflation rises, there is ample room, relative to history, for inventories to increase. Security of supply could be threatened if the U.S. relinquishes the hegemonic role and no other nation fills the void.

Concluding Thoughts

1. Since the Great Recession of 2008-09, the price performance of hard assets has been overwhelmingly influenced by deceleration in the rate of economic growth in China. The commodity bull market in the prior decade was driven by China's accelerating growth, which sent price signals to producers to dramatically increase supply. The resulting overcapacity contributed to the weakness in hard asset prices over the last decade.
2. We believe prospects have improved for a *secular* upturn in hard asset prices. Our reasons for this view are: a) unorthodox monetary policy is being implemented worldwide, but especially in the U.S.; b) the global geopolitical order is in flux, the result of the end of U.S. hegemony; and c) the U.S. dollar is likely to begin an extended period of weakness, in our view.
3. We believe a *cyclical* upturn in hard asset prices is also likely as the world economy recovers from a global recession induced by the pandemic. Although we consider hard asset price performance will primarily respond to secular factors such as those above, investors should be aware that such assets are sensitive to the business cycle.

Recessions and falling demand can adversely affect prices. Holders of such assets should note that performance can be volatile. As the last 12 months have shown, recessions can show up with great speed and quickly affect hard asset prices negatively.

Bill O'Grady, *Chief Market Strategist*
Mark Keller, CFA, *CEO/Chief Investment Officer*

September 2020

This report was prepared by Bill O'Grady and Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.