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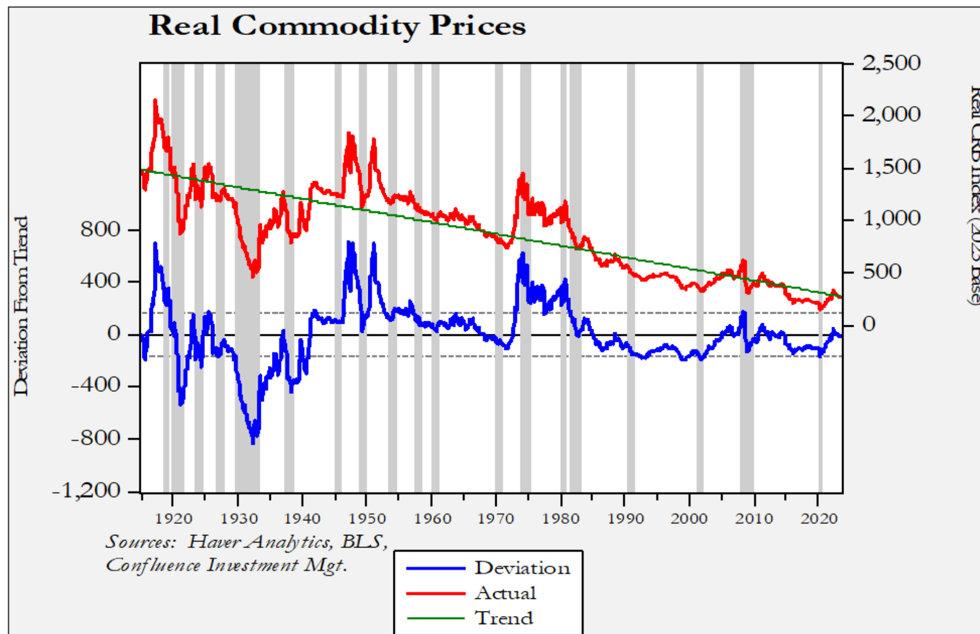
The Case for Hard Assets: An Update

Background and Summary

Secular markets are defined as long-term trends in 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 which lead to consistently rising interest rates. 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 are likely concluding 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 agriculture, ranching, mining, and drilling. As this chart 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.



The previous chart depicts the CRB commodity index deflated by U.S. CPI starting in 1915. The green trendline on the chart is generated by regressing a time trend through the deflated CRB index. The downtrend is obvious. In fact, this fact may be one of the most important reasons why capitalism triumphed over communism. The Soviet Union's economy was simply unable to improve its productive efficiency in this manner. So, while this fact is a benefit to capitalist economies broadly, it creates a challenging environment for commodity producers. Essentially, the real value of their output tends to fall over time, meaning that commodity producers must constantly improve their productivity in order to make a reasonable return on investment. Of course, another alternative is for producers to combine and create market power. Throughout history there have been various cartels among commodity producers, the most famous being OPEC. Another factor that affects various commodity sectors is the ease of entry and exit in a market; if it's relatively easy to expand or contract production, then firms in these commodity markets face relentless pressure. On the other hand, if expanding production is hard, making it difficult to enter or leave a market, then firms have some degree of market power.

The lower line on the above chart shows the deviation from that trend. Although the downtrend is dominant, there are four clear examples of how real commodity prices moved sharply above trend. All four periods are tied to wars—WWI, WWII, Korea, and Vietnam. Wars affect commodity markets in numerous ways. First, they disrupt global trade. During peacetime, potential adversaries often trade with each other. The outbreak of hostilities disrupts these trade flows and can lead to localized shortages of commodities. Nations, firms, and households facing shortages usually react by hoarding, which boosts demand for commodities and raises their prices. Second, the disruption of trade flows can also disrupt the flow of goods necessary to produce the commodities in the first place. This disruption can reduce supply of the affected commodity. Third, nations at war tend to expand fiscal policy to make war material. This fiscal expansion typically boosts demand for everything which lifts prices. In addition, war often leads nations to abandon hard money monetary policies, forcing central banks to support the war effort. Stimulative fiscal and monetary policies tend to support commodities. As government spending for war increases, inflation often results.

Inflation can make commodities attractive as a store of value. The most expansive commodity rally ran from 1970 to 1980; not only were prices boosted by war demand, but the debasement of the dollar triggered by the end of the Bretton Woods agreement also led the OPEC cartel to radically boost oil prices to protect their purchasing power. The rally of the 1970s ended because the Volcker Federal Reserve dramatically lifted interest rates. In addition, the U.S. and eventually the West aggressively deregulated markets, leading to more efficient consumption of raw materials.

We believe that the next major bull market in commodities will likely be driven by the steady erosion of U.S. hegemony. Charles Kindleberger postulated that the world economy functions best when there is a global hegemon. This idea, known as "hegemonic stability theory," was expressed in Kindleberger's book about the Great Depression. The hegemon provides two global public goods. First, it has the ability to project power globally, which tends to keep local wars from expanding. This power projection leads to geopolitical stability. Second, the hegemon provides various financial functions, including the reserve currency and the reserve asset, and acts as global financier and importer of last resort. When a hegemon is functioning properly,

large wars are less likely and global trade expands via the use of the reserve currency and asset. Kindleberger's theory was that the Great Depression occurred because the British no longer were able to provide global financial stability and the U.S. was unwilling to accept the role. World War II followed, in part, due to the breakdown of British hegemony. When the U.S. accepted the mantle of hegemon after the war (which was shared with the Soviets until the early 1990s), the world economy generally stabilized, although it was not without its challenges as the 1970s showed.

Since the end of the Cold War, the U.S. has struggled to formulate a foreign policy that allows the U.S. to simultaneously provide the global public goods of security, reserve currency, and reserve asset in a manner compatible with domestic stability. The wars in Afghanistan and Iraq taxed the volunteer military, and the persistent trade deficits, which are necessary to supply dollars to the world, have led to the loss of jobs and deindustrialization. The rise of populism and deep societal divisions are due, in part, to the divergent policies required to address the domestic political situation and maintain global hegemony. As the political class attempts to improve the domestic situation, it will become increasingly difficult to maintain U.S. hegemony.

It is our assumption that internal political stability in the U.S. will be a higher priority than global stability. We expect the breakdown in global order to bring higher commodity prices. In the following section, we discuss evidence for this position.

1. As the U.S. attempts to maintain global order, it is increasingly relying on financial sanctions rather than military intervention. The use of financial sanctions, arguably most aggressively used against Russia following its invasion of Ukraine, has rendered the majority of Russia's foreign reserves untradeable. Sanctions have raised concerns among other nations that the accumulation of dollar reserves is risky; however, given that there are few attractive alternatives to the dollar and Treasuries, we expect less global trade over time (which is inflationary) and the diversification of foreign reserves into gold and other commodities. Although inferior to the dollar/Treasury system, gold and other commodities are also less prone to sanctions.
2. The rebuilding of the U.S. industrial base will lead to industrial policies that will be at least partly protectionist. Trade impediments tend to reduce efficiency and increase inflation.
3. Recent speeches by National Security Director Sullivan and Treasury Secretary Yellen highlighted that national security is now considered a higher priority than free trade and economic efficiency. This focus, though understandable, will also be inflationary.
4. As the world attempts to transition away from fossil fuels, resource nationalism is returning. Mexico and Chile are considering restrictions on lithium and copper foreign investment, which will likely lead to less supply. Meanwhile, fossil fuel producers are getting a clear signal that the twilight of demand is on the horizon (although probably more distant than the media would suggest). Thus, we are seeing a decline in oil and gas investment, which will tend to also boost prices.
5. The continued war in Ukraine and the rising tensions in the Far East are leading to heightened international tensions. Fears of war tend to boost defense spending and commodity accumulation.

From the end of the Cold War until 2020, the world was in a "unipolar moment" where the U.S. was the undisputed global hegemon. The U.S. shaped a world that favored capital as American security coupled with the power of the dollar allowed firms around the world to source labor at its cheapest location and use the power of technology to create nearly seamless supply chains. This world of "just-in-time" logistics was generally disinflationary. Although the first eight years of this century were bullish for commodity prices, it was only due to the historic growth in China. We are now seeing something different evolve. The world order is fracturing; several developing nations are turning away from the U.S.-led world, which is escalating geopolitical risk and disrupting supply lines. There is growing uncertainty surrounding the dollar's role as the reserve currency. Overall, we expect this backdrop to increase demand for natural resources to ensure supply availability. Put another way, the world we are anticipating will be much different and riskier than the one that existed from 1990 to 2021. The Confluence Global Hard Assets strategy is our response to that world.

The Global Hard Assets strategy focuses on commodities that require multiple years to generate a supply response. Thus, we are currently focusing on markets that have costly and difficult barriers to entry. 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 this portfolio to be a strategic alternative asset. In other words, its function is to protect against the breakdown of U.S. 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. Although current U.S. monetary policy is attempting to return to orthodoxy, elevated debt levels in both the public and private sectors will likely lead to a return to unorthodox policies.
3. This portfolio isn't specifically an inflation hedge; we think that natural resources prices should be supported without reflation. However, if inflation does develop, and signs suggest it likely will, we would expect this portfolio to benefit.

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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. Information does not constitute a solicitation or an offer to buy or sell any security.

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