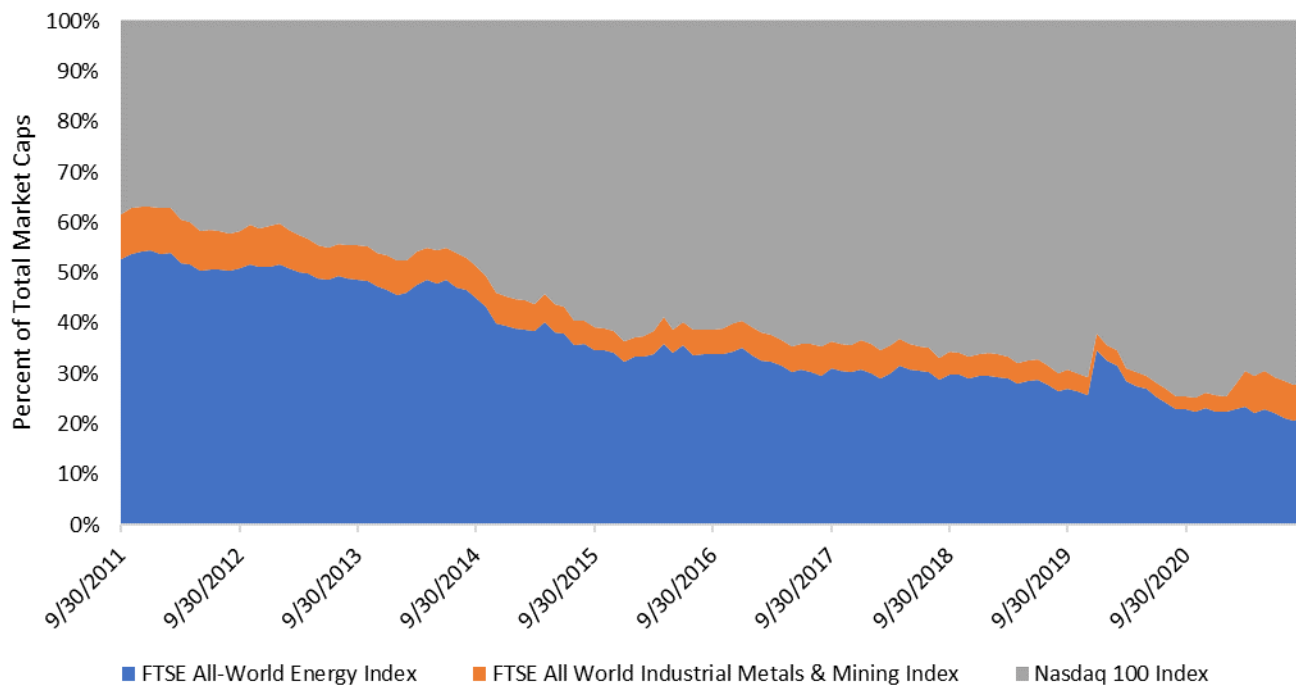


History 101

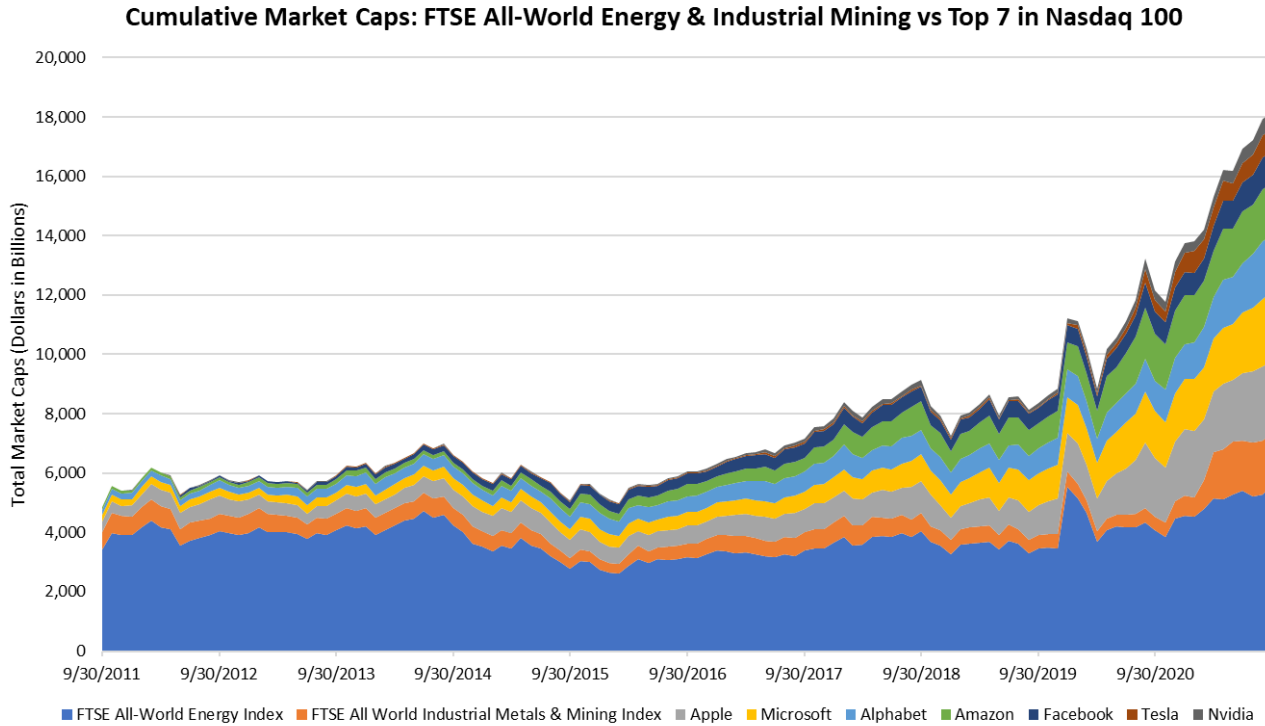
“The first lesson of history is that people need to eat,” so began my sophomore history seminar at Northwestern. That line has always stuck. Though spoken in the specific context of colonial American history, my professor’s broader point was that while we all like nice things, what we need are the basic ones: food, water, shelter, security and energy, to name a few. Historically, when people are lacking in nice things, they might feel bad relative to their better-off neighbors. And while jealousy can sap our psyches, it usually doesn’t lead to major unrest. It’s when people are lacking in the basics that we get some of history’s darkest moments: political instability, social chaos, war and even civilizational collapse. For those more interested in the subject, I highly recommend the 2011 book *Collapse* by Jared Diamond (best known for *Guns, Germs and Steel*).

Back to investing. For the last decade, we have been in a market environment that is putting a much higher value on things that are nice to have relative to the basic things people need to have. As covered below, this probably has much to do with the low growth, low inflationary macroeconomic regime that has persisted following the 2007/8 financial crisis. As a proxy for “nice” vs “need,” let’s compare the values of the technology, consumer discretionary and communications-dominated Nasdaq 100 Index (nice) to the FTSE All-World Energy and FTSE All-World Industrial Metals and Mining Indices (need).¹ Beginning about five years ago, the Nasdaq 100’s value eclipsed that of all global publicly traded energy and industrial metals/mining firms – and there’s been no looking back.

FTSE All-World Energy & Industrial Mining Relative to Nasdaq 100



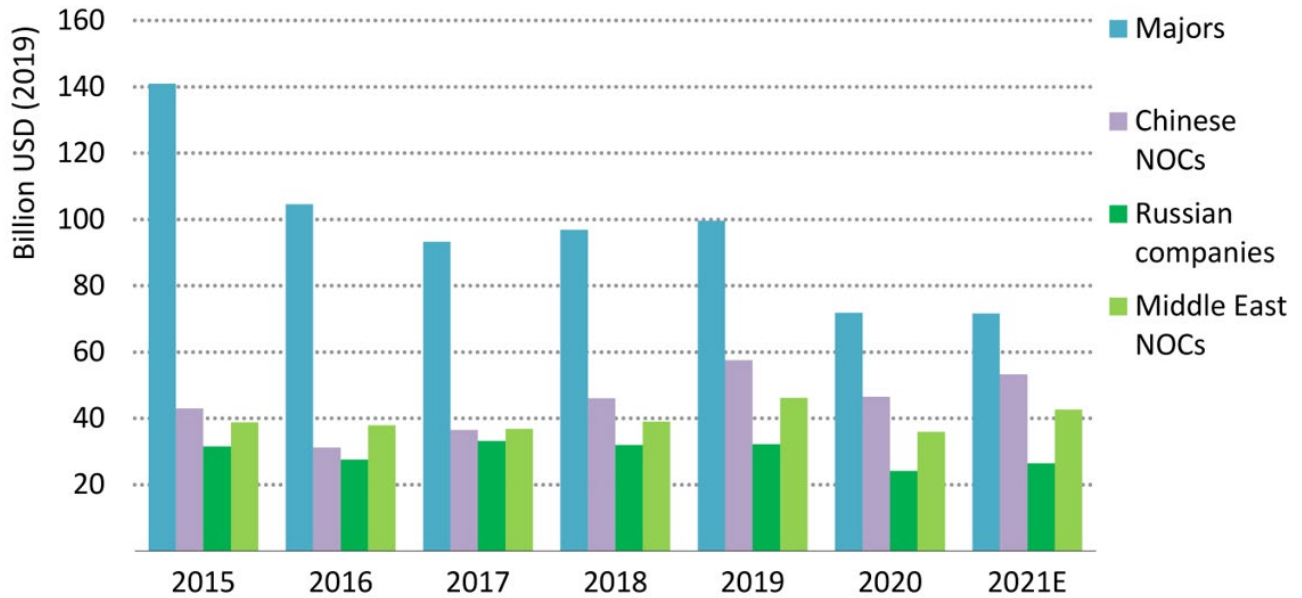
As highlighted in the below chart, the top seven holdings in the Nasdaq 100 – Apple, Microsoft, Alphabet (Google), Amazon, Facebook, Tesla and Nvidia – together are now worth approximately \$10.8 trillion, compared to the \$7.2 trillion for the global energy and metals/mining firms.² If we just focus on the U.S., Apple alone is worth more than twice the value of the components in the S&P 500 Energy and S&P Metals & Mining Indices.



From a valuation and financial sense, this outperformance is justified by the “nice” firms’ superior cash flows and far more consistent business models. Additionally, their sales growth over the last decade puts the “needs” firms to shame. But the last time we checked, no country has ever started a war over an iPhone embargo.

On the other hand, there have been numerous conflicts over energy supplies. It should cause some concern then that per two closely followed energy industry reports – the International Energy Agency’s 2021 World Energy Investment Report³ and BP’s 2020 Energy Outlook⁴ – upstream oil and gas investment (i.e., investment in new production) is falling below levels necessary to secure future conventional energy supplies even in a rapid clean energy transition scenario (see charts on following page).

Upstream spending by selected company types

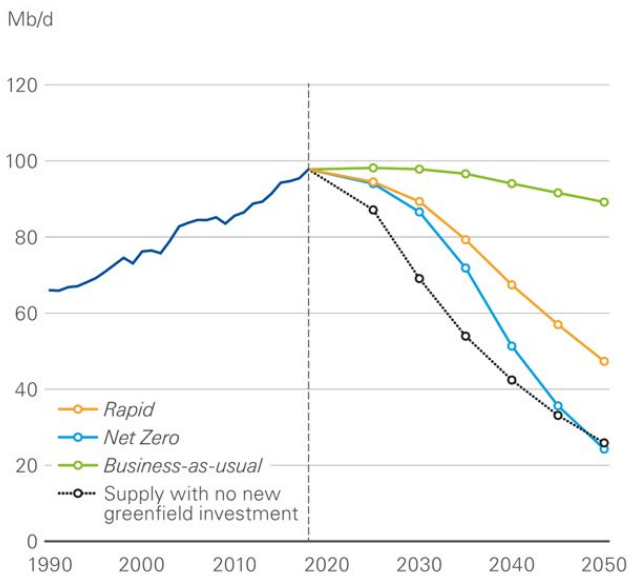


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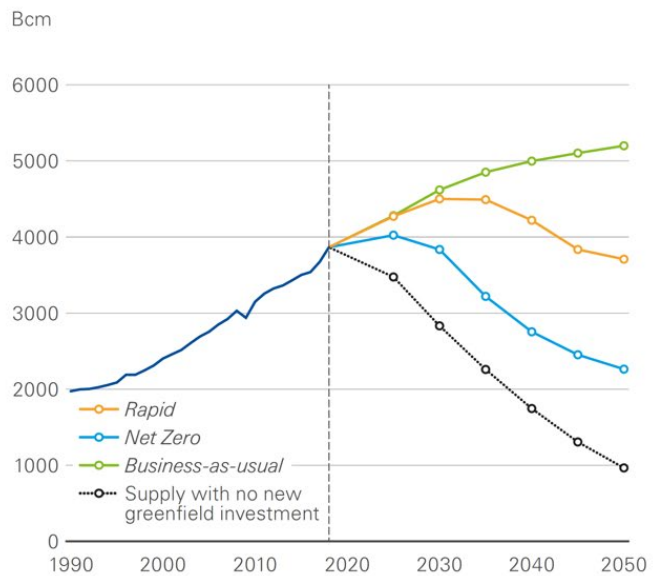
Source: IEA calculations based on company reporting.

Significant investment in new oil and natural gas production is still required

Consumption and production of oil



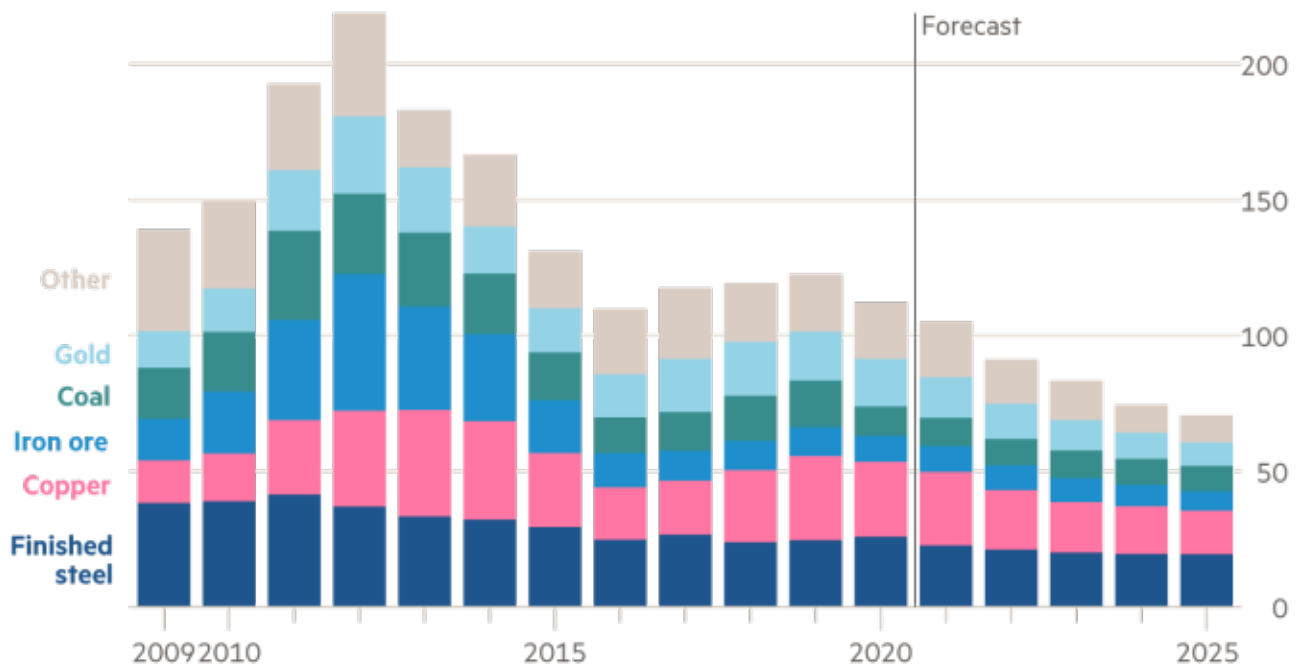
Consumption and production of natural gas



The same supply/demand imbalance may be true for industrial metals where spending on new production has declined despite rising demand – particularly that tied to clean energy development and the electrification of heavy industry.⁵ In fact, a Bloomberg index of industrial metals futures prices (for aluminum, copper, nickel and zinc) – the Bloomberg Industrial Metals Subindex – has nearly doubled since its April 2020 lows and, despite some recent China-related weakness, is close to its 10-year high.

Capital expenditure on copper sector set to fall

\$bn, mined commodities

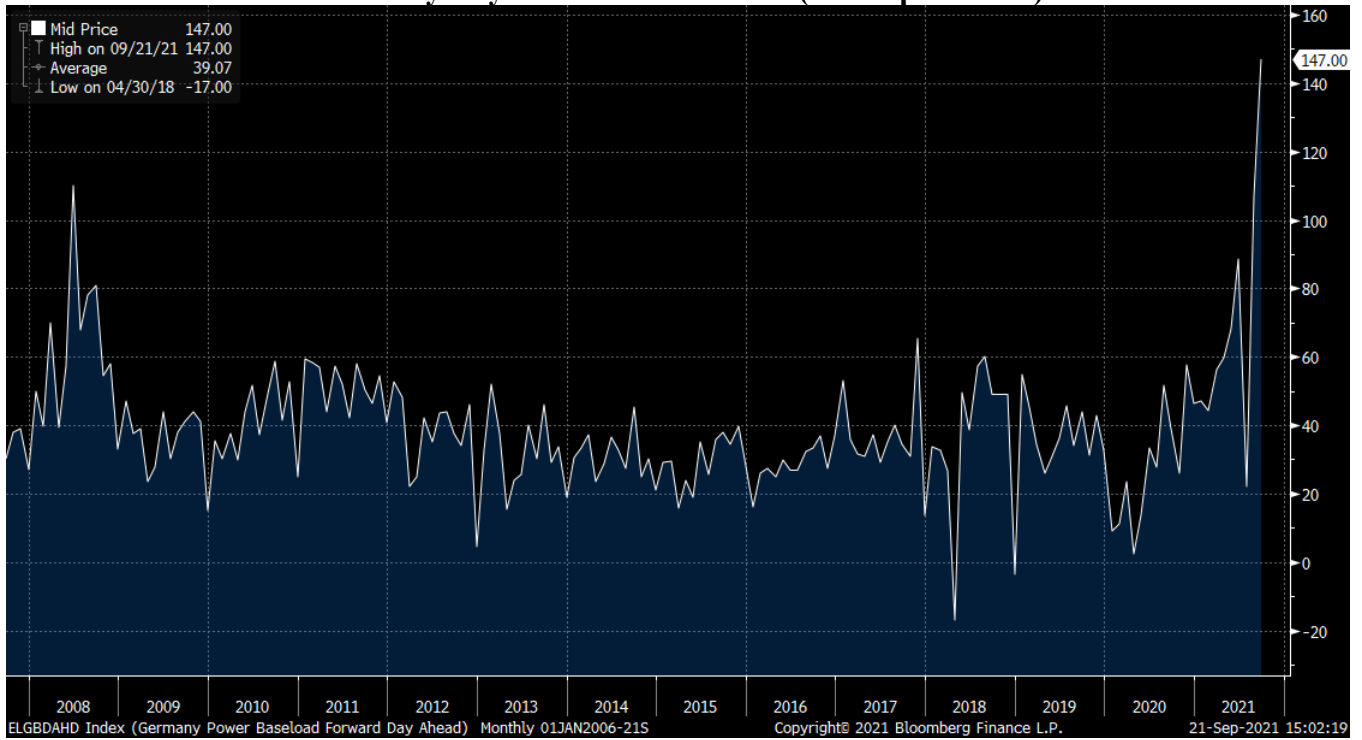


Source: Wood Mackenzie
© FT

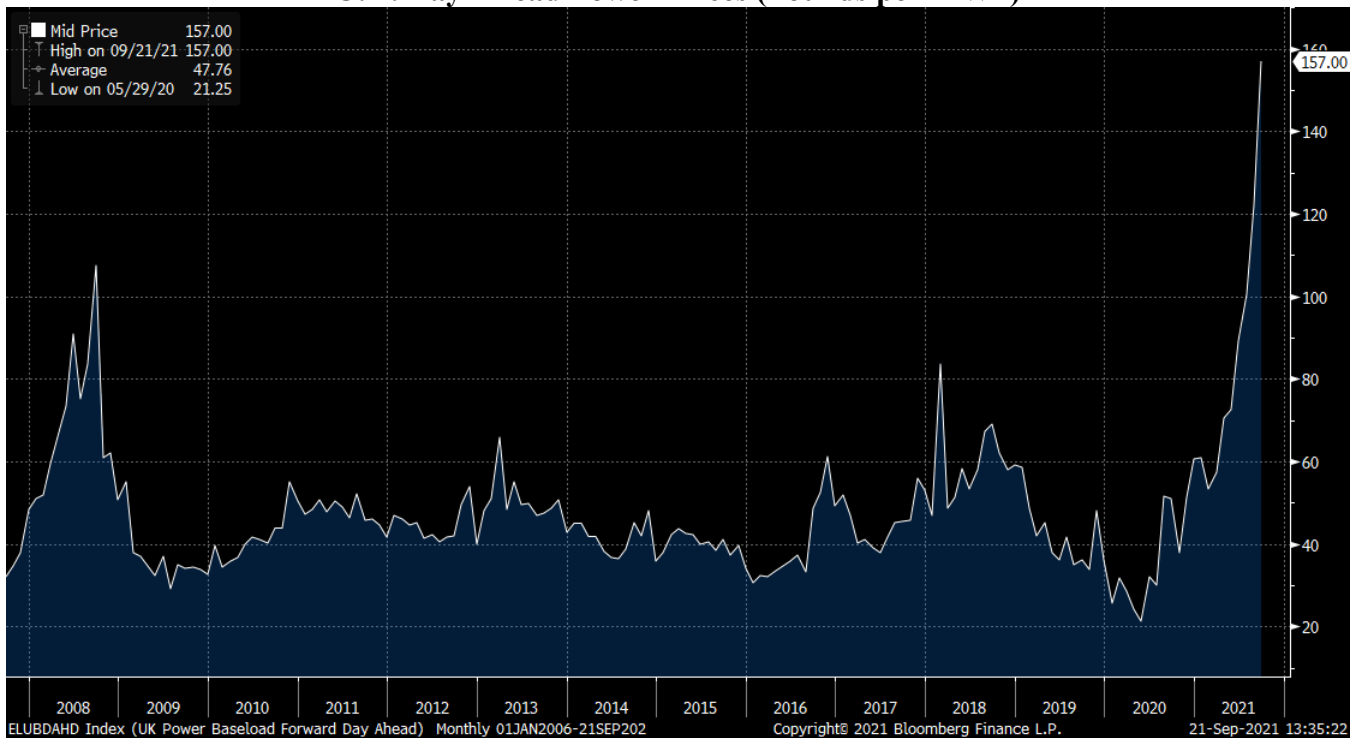
As we have written many times, we are proponents of smart clean energy development (particularly nuclear) and have invested in many opportunities in renewable infrastructure. While many of those investments have proven lucrative, there is a real risk that we will face a shortage of things we need in the coming years.

This phenomenon is currently manifesting itself in European energy and electricity markets, where a lack of wind power production and gas shortages have caused skyrocketing prices (see day-ahead power price charts for Germany and the U.K. on the following page). This is not only causing pain for consumers in the form of exorbitant electricity bills but has also caused industrial manufacturers and fertilizer producers to curtail production, in some cases threatening the food supply.⁶

Germany Day-Ahead Power Prices (Euros per MWh)



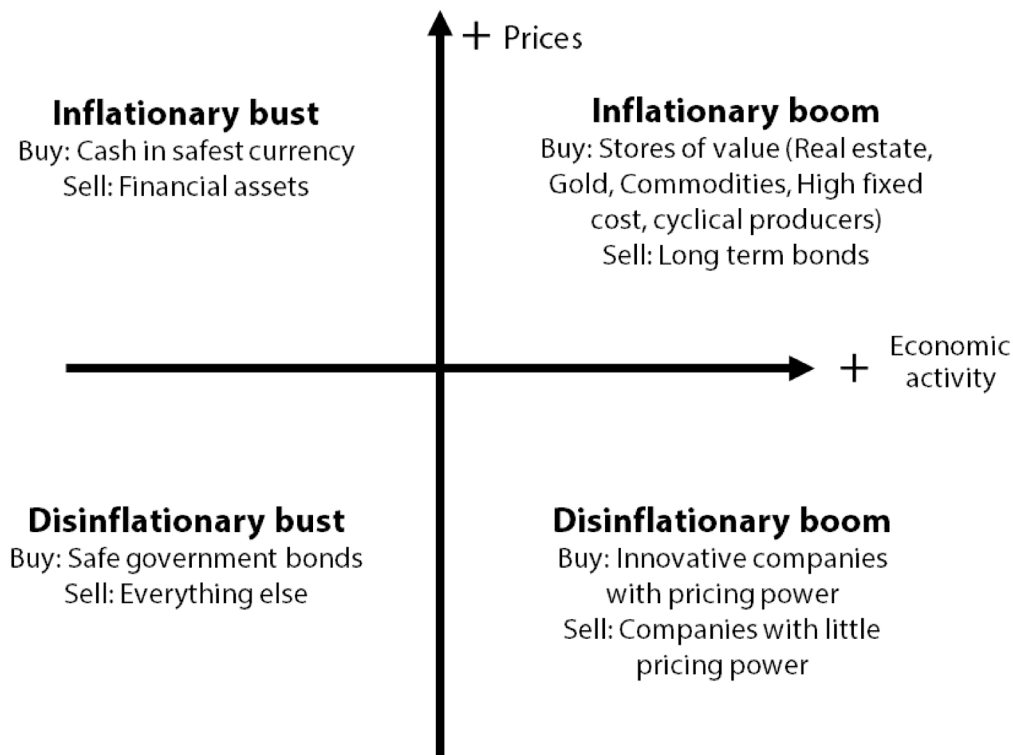
U.K. Day-Ahead Power Prices (Pounds per MWh)



For those familiar with economist Robert Gordon – author of the 2016 book *The Rise and Fall of American Growth* – energy and materials price spikes and shortages are the types of setbacks that can sap economic productivity growth. A lack of things we need has a much more detrimental societal impact than a lack of nice things we simply want – even if we want them badly.

So the key question is why are markets valuing things that are nice to have so much higher than things we need? A lot has to do with the slow growth and stable price environment post-2008. To rehash part of our July letter, this period has been what the strategists at Gavekal Research would call a “disinflationary boom.” Per the below chart from Gavekal, this is one of the four main sets of economic conditions investors confront, each of which has a unique optimal portfolio construct.⁷ During disinflationary booms, innovative companies with pricing power (e.g., large cap tech firms) tend to outperform, as growth assets are rare and get rewarded with premium valuations. However, it’s possible we are shifting into a new regime marked by higher prices (due to commodities underinvestment, supply chain localization and tighter labor markets). If global fiscal spending remains elevated, we may soon find ourselves in an inflationary boom, where both prices and economic activity rise. In this type of environment, it’s the cyclical and commodity-type firms that become dominant relative to long duration growth assets (like many tech firms).

The Four Quadrants framework



The risk investors are running is that most portfolios are underweight the things people actually need and overweight the things people think are nice to have. If global consumers begin feeling pricing pressures in their everyday lives, where do you think they will start to cut back on spending? iPhones or electricity?

Whether as a hedge to higher prices, or as an outright wager on continued strong commodities performance due to supply underinvestment, we think investors should consider a higher allocation to the still very out of favor energy, metals and materials sectors. This does not mean to sell out of our large cap technology holdings – they remain great companies. Rather, the message is to consider diversifying into a different set of assets that may benefit more from a changing set of economic circumstances.

Remember the first lesson of history: people need to eat. And during times when the food supply is short and more costly, it's good to own the farm.

We hope you and your families are doing well as we head into the fall. As always, please feel free to reach out to discuss any of the ideas covered in this letter or your portfolio strategy.

Sincerely,



Peter Karmin
Managing Member



Stuart Loren
Director

Citations and Disclosures

¹ Bloomberg (as of Sept 16, 2021). All data cited herein is from Bloomberg as of the date of this letter unless otherwise noted.

² Bloomberg (as of Sept 16, 2021).

³ International Energy Agency, *World Energy Investment 2021* (June 2021), available at: <https://www.iea.org/reports/world-energy-investment-2021>.

⁴ BP, *Energy Outlook 2020 Edition* (Sept 2020), available at: <https://www.bp.com/en/global/corporate/energy-economics/energy-outlook.html>.

⁵ Financial Times, *Copper boom: how clean energy is driving a commodities supercycle* (June 7, 2021); The Economist, *Big miners' capital discipline is good news for investors* (June 26, 2021).

⁶ The Wall Street Journal, *Surging Energy Prices Close U.K. Factories, Another Bottleneck in a World Full of Them* (Sept 16, 2021); Financial Times, *UK scrambles to contain gas price crisis* (Sept 17, 2021).

⁷ Charles Gave, Gavekal Research, *The Boom Of 2021* (Dec. 18, 2021).

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