RMH Thoughts: Energy (Commodity Metals) & Inflation

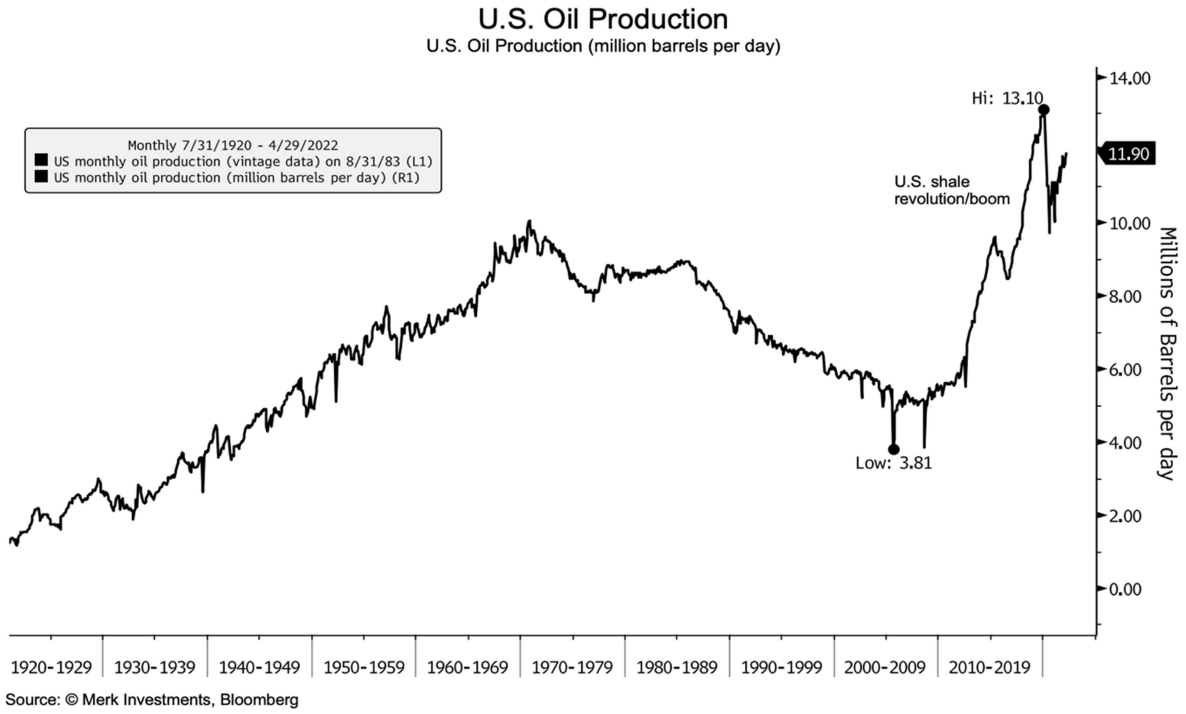
Part 1

Part 1: Energy and Commodity Metals

Energy, Food and Inflation all are intertwined. As this is a complicated topic, this is the first part of two articles.

I am always amused when I see the following: Inflation is 2.5% **ex** Food and Energy (Latin for without). The reason these two factors are left out has to do with volatility. Food and Energy prices can be very volatile and if you leave them out, the inflation readings are a lot smoother. After all we need to eat, and utilize Energy. Does this help IMO, no, it just confuses the issue. This will be one of the most covered topics all summer as the price of gas/diesel to fill a car or truck will continually hit the headlines.

Why are we in this pickle, here in the U.S. and around the world? **First** the U.S., where the energy troubles are much easier to explain. As you can see from the chart below, as recent as several years ago, we were the swing producer for the world and our domestic production was allowed for the first time to be shipped around the globe. The U.S. shale revolution drove the cost to produce a barrel of oil equivalent to under $40.00 **from land**, i.e., the various shale basins around the country, and the U.S. is blessed with the technology **and the water to extract**.



Analysis: US oil production has bounced back somewhat from its Covid-related decline. But even with oil in the $100s, shale producers (and investors) have been reluctant to ramp back to pre-pandemic production levels—supply chain issues may be playing a role as well.

Tel: 520-314-2300 Email: richard@rmhinvestment.com 5151 E. Broadway Blvd. Suite 1600
Tucson AZ, 85711

Rightly or wrongly a political decision was made to source our energy needs from offshore, from countries that may or may not be our allies.

Second, a decision was made in Europe (mainly) to source their energy needs of oil and natural gas from Russia. You all know what is happening there, no need for me to add anything. ***If there is please call me*.** All of Europe and the U.K. have shale fields, and are choosing to not utilize them. China has a massive supply of shale; however they don't have the water to help with the extraction.

Below is an article excerpt from *Bloomberg News.*

> Chevron (NYSE:CVX) CEO Mike Wirth said Friday that he does not expect another oil refinery will be built in the U.S. ever again, due to decades of federal government policies.
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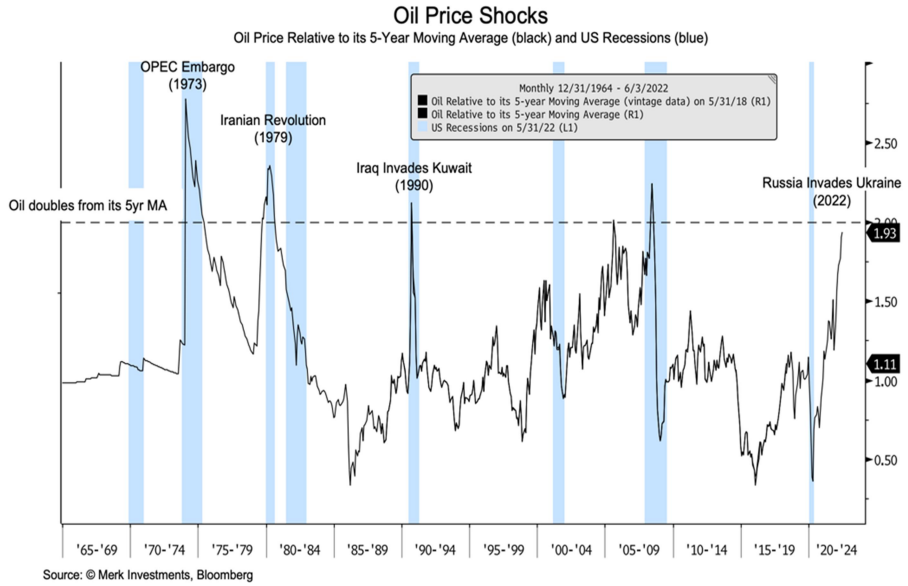
> "*We haven't had a refinery built in the United States since the 1970s. My personal view is there will never be another new refinery built in the United States," Wirth said in an interview with Bloomberg.*
>
> *"You're looking at committing capital 10 years out, that will need decades to offer a return for shareholders, in a policy environment where governments around the world are saying we don't want these products," Wirth said.*
>
> *"At every level of the system, the policy of our government is to reduce demand, and so it's very hard in a business where investments have a payout period of a decade or more," according to Wirth. "And the stated policy of the government for a long time has been to reduce demand for your products."*



Analysis: Supply shocks driven oil price spikes tend to increase recession risk. The extent of the current oil price spike is approaching the warning level, which is 2x the 5-year moving average.

We are in the midst of an oil price shock to the upside. If oil prices just stay at this level, this will be a huge boost to their margins, and as a result to their earnings. **With the last several energy price collapses still in mind**, the energy companies with regards to upstream, downstream, and energy services, are all showing capital expenditure discipline. With earnings increasing, and share buybacks continuing, **we see the share prices of the Energy Complex rising.**

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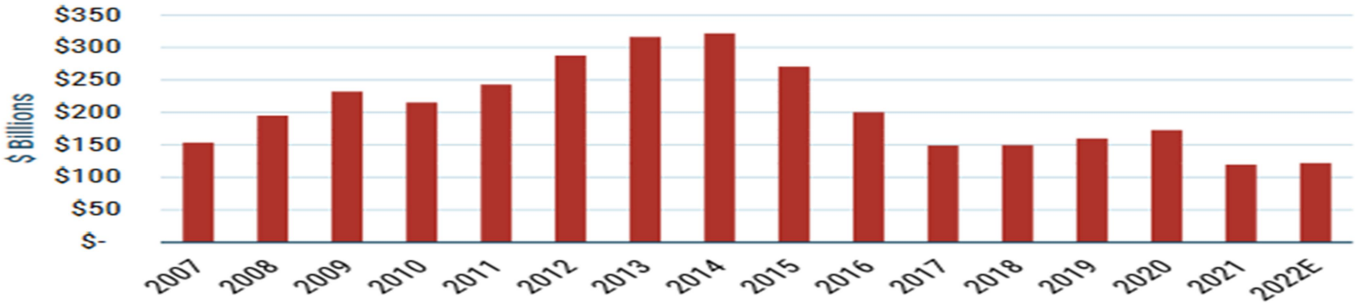
The following is from the GMO Quarterly Letter 1Q/2022 describing the challenges ahead and the resulting investment opportunity for the Commodity Metals complex:

"Unfortunately, resource scarcity isn't the only supply challenge we face. Underinvestment in supply in recent years will impact production for at least the next decade. Over most of the last decade, commodity prices have been falling or low. Commodity producers, reacting to low prices and criticism that they had overinvested during the China-driven commodity supercycle, slashed capex significantly (see Exhibit 3). Pressure from ESG/sustainability circles and divestment campaigns also sought to starve fossil fuel companies of capital. Then, Covid hit, and resource companies cut capex again. Given that the world consumes around 40% more of many major commodities (e.g., natural gas, iron ore, copper) than it did 15 years ago, it's somewhat stunning that capex levels would be at 15-year lows. Furthermore, the capital intensity of commodity production has also risen substantially in recent decades as we've moved from higher- to lower-quality assets. In short, current capex levels are totally insufficient if we are to meet growing global demand."

EXHIBIT 3: CAPEX IN THE RESOURCES SECTOR HAS BEEN SLASHED TO 15-YEAR LOWS

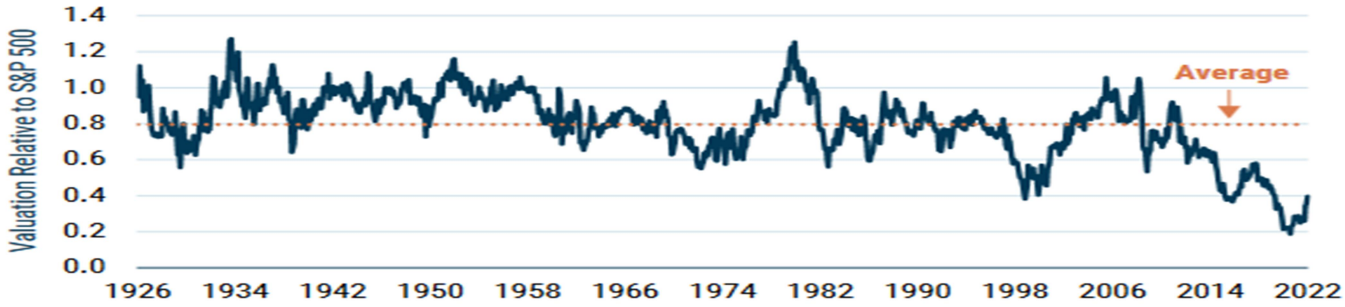
Energy/Metals Capex



As of 3/31/2022 | Source: WorldScope, MSCI, GMO
Energy/Metals capex represents the aggregate capex of 30 of the largest publicly traded fossil fuel and mining companies globally.

EXHIBIT 4: RESOURCE EQUITIES CONTINUE TO TRADE AT DEEPLY DISCOUNTED LEVELS

Valuation of Energy/Metals Companies Relative to the S&P 500



As of 3/31/2022 | Sources: S&P, MSCI, Moody's, GMO
Valuation metric is a combination of P/E (Normalized Historical Earnings), Price to Book Value, and Dividend Yield.

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The other sector that goes hand in hand with the Energy complex is the Commodity Metals complex. All of the following metals (Copper, Iron Ore, Rare Earth metals, Lithium, Cobalt, just to name a few) have seen tremendous underinvestment, and we the Western world have outsourced a lot of this production in similar fashion as we did with Energy. Now we are paying the price.

In conclusion even with the rise in share prices of the Energy Complex and Commodity Metals, we see further room for the share prices to move to the upside as their earnings continue to increase.

If there are ever any topics you wish for us to explore, please let us know. ***We are here to help and guide you through these times.***

We thank you all for taking the time and reading "Market Watch." It is meant as an educational piece on the always evolving markets. It is something we plan on providing every month, and your feedback is very important to us.

On a personal note, RMH is now in the position to bring on new clients so please be sure to share this informational letter with whomever you wish. RMH's focus is on the customizable investment needs of individuals, families, and foundations. We enjoy working with our clients to better understand their goals, values, and passions for what is important in their lives. In expanding our client base, we look forward to working with people who share these same desires

Richard Mundinger, CFA
Ashlyn Brooke Tucker

Sources:
Merk Research June 2022 Business Cycle Report, Nick Reece CFA
Merk Research May 2022 Business Cycle Report, Nick Reece CFA
GMO Quarterly Letter: 1Q/2022
The Lead Lag Report The Lead Lag Report May 27: A Global Diesel Shortage Could Keep Fuel And Food Inflation High Indefinitely
Lead Lag Report: Leaders and Laggards: June 7, 2022
Seeking Alpha: June 30, 2022 No new refineries likely ever built again in the U.S., Chevron CEO warns

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