CIO CONVERSATION SERIES

CARY STREET PARTNERS

Episode 9

CONSEQUENCES OF CONFLICT

Tom Herrick: Welcome to the CIO Conversation Series. I'm Tom Herrick, Cary Street Partners' Chief Investment Officer. On this episode, with the market trying to make sense of current events around the world, we'll focus on an asset class that's intertwined with those events more than any other. We're talking about commodities and resources such as oil and gas, of course, but also wheat and metals like copper and nickel, and lots more. In other words, stuff that's part of our daily routines as consumers and investors. With uncertainty in the air due to politics at home and crises abroad – most notably, of course, the ongoing Russian invasion of Ukraine – we'll seek strategic insights in historical context from a true voice of experience.

Brad Klein: Every single thing that we're talking about today will impact our daily lives going forward.

Tom Herrick: My guest is Bradford Klein, co-founder of Core Commodity Management, a Connecticut based firm that's a trusted partner of Cary Street's, with over $8 billion under management. This is Brad's second time on the show. Some of you may recall his first appearance last summer when he shared the wisdom of his four decades in the commodities business. Others may know him as one of the developers of the Bloomberg Commodity Index, the BCOM, the industry benchmark since the 1990s. But if you don't recognize Brad, well, simply know this – you're not going to find a more informed expert on the subject of commodities investing than him. Our conversation will take us deep into the commodities markets today as we see light at the end of the pandemic tunnel and where the markets may be heading. It's complex stuff, but Brad will help us with what we need to know about this highly visible topic that is literally crossing news wires as we speak. Brad Klein, welcome back to the show.

Brad Klein: Thank you, Tom, thank you for having me back.

Tom Herrick: We're recording this early the second week of March, about 10 days after the first shots were fired by the Russians and that situation is fluid every day. So before we talk business, we have to acknowledge that there's a significant human cost being paid by the Ukrainians here. One thing we're going to not talk about here is predictions on the war. No one has any, in my opinion, has any idea where this war goes from here. And we certainly don't know the mind of the Russian dictator, nor does anybody, in our opinion.

Brad Klein: I agree, regarding the tragedy of the loss of lives, which is occurring as we speak, and I certainly do agree that what Russia does and how they behave going forward is frankly just a calculated guess from here on anyone's behalf. So let's keep the conversation to commodities, and I'll do my best to answer your questions.

Tom Herrick: Let's start at the 30,000-foot level here and just talk about, you know, why commodities right now? Why is this such an important topic for the world to be aware of?

Brad Klein: Sure. You know, everything we're going to talk about today impacts our daily lives. It impacts the cost of the clothing we put on our bodies. It impacts the price of gasoline that we put into our cars. It impacts the cost of the food that we feed ourselves and our families with. It goes down to impacting the cost of the insurance that we're going to pay for our houses and for our cars going forward. So every single thing that we're talking about today will impact our daily lives going forward.

Tom Herrick: Let's get up to speed from the podcast we did last July, if I remember correctly. Commodities have moved significantly since then. Maybe you could contrast those returns to equities and bring us up to speed.

Brad Klein: So since we last spoke, the asset class, commodities, as an asset class have done very well, depending upon the benchmark that you follow returns since that time have been between 40 and 60% since July. This is in contrast to the S&P being essentially flat coming into today and the NASDAQ being down 8% over that period. Additionally, fixed income holders have seen the price of their bonds suffer significantly, with the 10-year benchmark moving 50 basis points off of a base rate of 1.2%. And I think if you go back to 1994, the worst year for bond returns was 2.9%, and as of the end of February, bondholders had already lost 3%. So it's certainly an interesting time to be talking about the asset class.

Tom Herrick: This is sort of a bit of the heart of where I want to go, and I'm going to be 63 this week and folks under 60 really don't recall inflation. They don't know an inflationary environment like we're in these days. Maybe it's an inflationary boom versus a stagflationary environment, but it's still obviously very, very hot inflation numbers. And this is outside the experience of not only a lot of investors, but a lot of advisors as well. One thing we run into quite a bit is this perception of commodities with a kind of a yo-yo like performance like we've had in the last 10 years where prices would go up, you know, substitution would occur in the marketplace or demand destruction would occur in the marketplace, and then prices would go back down again. That can lead to this sort of conclusion of, you know, it's over, it's too late that kind of thinking. Maybe we could revisit some supply demand factors that are different now than we've had in this last decade and address that entire dynamic.

Brad Klein: The short answer is no, it's not over by any means is my personal view. The supply demand dynamics are skewed right now and have been frankly, really since the middle of the pandemic to the upside. And if you go back to our previous chat, you know, I brought up a few key points which are still very much in play and I'll try to keep them short. But if you recall, Tom, the supply of money as we sit here today, it's hard to believe, but the Fed is actually still purchasing securities and growing its balance sheet.

Tom Herrick: Yeah, we haven't even started. We haven't got to neutral yet.

Brad Klein: We haven't gotten to neutral. It's going to stop over the next week or two, but it's going to take time to sort of wind that down. So we have this immense amount of money that's chasing goods. Interest rates are still very low and with M2, the United States M2, going from 8 trillion in 2010 to 22 trillion dollars now. And not to mention the rest of the world. You just haven't had too much liquidity, frankly, and that has spilled over. And as you correctly pointed out, you know, commodities have been a pretty terrible place to be over the decade, basically from 2010 through 2020. Inventories have been drawn down to what I would call dangerous levels. And you know, just remember if prices are not high enough to incentivize producers to produce stuff, if you will, gets consumed over time. And then we find ourselves in a position like where we are today where we have dangerously, dangerously low levels of inventories and quite a lot of demand. And then you had this little thing that we call the pandemic, and I don't mean to make light of it, but as we've come out of the pandemic, I think two things have gone on. One, people have more disposable income because frankly, they haven't really spent a lot of money over the last two years. And then there's this kind of revenge spending as people get out and travel and go to restaurants, and that's sort of being hit square in the face with bottlenecks in transportation and labor issues. And that further complicates the story. It sort of reminds me without the pandemic, of course, like us coming out of 9/11 back in 2001. And if you look at that period of time, commodities rally 300% off of their very similar bottom in that period of time. And I'm not suggesting that they are definitely going to rally 300%, but I get a lot of investors asking me, you know, darn Brad, I missed the move. And I just personally say, I don't think you have, because when these things start, it takes a long time for supply to come back on. Typically, years for supply to come back on. And I'm not even touching on the global inflation that's going on around the world and frankly, in the United States, which, as you know, Tom, commodities are the most highly correlated asset class to inflation. And if you recall, you know, the Fed was saying, we don't have inflation and they said, well, it's transitory and then they drop transitory, and now they're sort of scratching their heads and saying, how are we going to stop it? So that's kind of where we are.

Tom Herrick: You can almost sum that up by saying there's just not enough important stuff out there. There's not enough in inventory. There's short supplies to start with, which then leads to you throw the whole geopolitical situation in Ukraine on top of it, which clearly is throwing fuel on a fire. Not to be too casual or make a pun of it. We're talking about obviously Russian oil still on the market. We've already sanctioned Russia. Perhaps now we're going to literally ban, you know, Russian oil from world markets or from U.S. markets. When I hear this talked about by politicians in the press, you know, well, we'll ban oil, but we'll increase production here in the U.S.. How realistic is that? You know, that seems to be, you know, we talked about lack of production or the time it takes to ramp up production. What's your thoughts on that? Maybe you could give us some education around how realistic a comment that even is.

Brad Klein: I think it's interesting that the world has sort of on its own without the United States certainly coming out and saying, you know, we're going to ban oil imports from Russia, the world's sort of self-policing itself right there. Now, the U.S. has some choices.

They could have a significant release from the SPR, from the Strategic Petroleum Reserve. They have about 750 million barrels that they could put on the market. The Saudis could increase a few million barrels a day and even just any mention of the two of those or they, as you know, they're thinking about going and doing another deal with Iran, which could produce two million-ish barrels a day. This weekend, we met with Venezuela, apparently – not we, but the US government, which is an interesting development as well. So there are things that the world can do if it truly decides a hard ban on Russia. What they can't do, is all of a sudden, the United States can't start pumping more oil immediately. That just is not the way the world works. What I think is also important for the listeners to understand is oil is just one of the markets, right? And if you look at the asset class, which is, as I mentioned, got up 40 to 60%. I mean, Russia exports and produces 42% of the world's palladium. Most people don't even know what palladium is, but currently you need palladium to make a catalytic converter for cars. If you don't have a catalytic converter, you can't make a car. They are obviously the driving force there. You know, they produce 16% of the world's natural gas and you know, it's still cold in Europe, and people need natural gas to run their houses in Europe. They produce 12% of the world's platinum. And together, Russia and the Ukraine export 27% of the world's wheat and 15% of the world's corn. I don't mean to keep throwing statistics out, but people need to understand that as a producer of commodities and an exporter of commodities, you can't just shut down those businesses and expect the commodity markets to go on as they have for the last decade. And I think the last thing and this sort of speaks to something I was reading about over the weekend is that Russia's the major low-cost exporter of crop nutrients. That's a fancy word for saying fertilizer. Before this war, fertilizer prices already doubled due to the gas crunch, bottleneck issues, tariffs on Belarus shipping, etc. Last week, fertilizer prices went up 30%, 29% to be exact, which is a record in one week. So I personally believe that when it comes to food inflation, especially if they don't fix the fertilizer shortages and prices don't come down significantly before the growing season, both in the United States and frankly worldwide. The world is in for a rude awakening when it comes to food inflation. Since the pandemic, the U.N. Food Price Index has gone from 90 to 140, and no one is talking about it. And that will trickle down into the consumer. I'm pretty sure of that.

Tom Herrick: Just to put it in context, Russia's not a large economy and actually not even a large trading partner in general. I think their economy is something around the size of New York states'. But they have an outsized impact in commodities. They are resource based. What they do deliver to the world is not value added manufacturing and iPhones and things like that, it's the raw basics. It's all these metals and fossil fuels. And to your point, certain agricultural products as well, which creates added fuel on its supply demand dynamic that we're talking about, that has already changed for the better. If you're a commodity producer or a commodity owner for not necessarily the better or if you're a consumer. Is that a fair sort of summary characterization of the Russian situation and the impact?

Brad Klein: Yeah, I think you're spot on things like nickel, which is up about 50% as we sit here today. You need nickel for stainless steel to build buildings, and they're huge producer of nickel. And to put it in perspective, the high-end nickel prices was about $56,000 a metric ton back in 08. And it's trickled down to below 10,000. My guess is about $8,000 a metric ton. And today, as we sit here today, it's $14,000 a ton today to $43,400. I mean, that's a major move if you need nickel to build a building. You're going to be spending a lot more money now as a result of this.

Tom Herrick: It almost feeds into other things, you know, flipping back for a second to the oil situation. You mentioned some of these things in our conversation already. We've had labor shortages., you've got metal in tight supplies. If you want to increase the fracking capacity in the U.S., my understanding is we're a lot of guys short of what we need to do that in terms of bodies down in Texas. I've seen numbers like 20, 30,000. You need materials. Those businesses also consume materials much like a construction project would, I believe. Is that all sort of a fair summary?

Brad Klein: It is. It is. Labor, materials, et cetera. And frankly, you know, the fracking discussion is a much larger discussion. It could be an entire podcast, frankly.

Tom Herrick: Yeah.

Brad Klein: They can increase fracking to an extent. There is a political discussion about fracking and environmental issues. And as the world becomes greener, how much more fracking are they going to allow? And Democratic versus Republican views on fracking. But at the end of the day, fracking is pulling oil out of the ground faster. It's not necessarily just throwing more oil out because there is a huge loss of oil each year from every hole that they're drilling, so it could be a short-term fix, which again will take time. But that's, in my opinion, not the answer.

Tom Herrick: The environment for commodities, as we talked about them last July, is this very appealing as an investor long-term supply demand dynamic that's very much in favor of commodity prices going higher long term due to things like, you know, the electrification of cars and the grid and things like that, which will consume huge amounts of metals just on their own, forgetting this war that's come about and created this other problem. So you've got this baseline demand that's extremely strong, compounded by the war is really what's going on here. Is that fair?

Brad Klein: That's exactly what's going on. And electrification is here to stay, it's growing every day. Obviously, we need to build our grids to support it. But that's a challenge that's out there. But yeah, it's certainly an interesting time for the asset class, Tom.

Tom Herrick: And how long does it take? If I was a commodities producer, if I was actually in this business and I saw this and I said, ok, I'm going to go out there and develop a new source of copper. Or maybe I found it, I found a new source. How long does that take to flip the switch to bring that production online?

Brad Klein: Well, I think there's two things. The first is you need to get financing, and the banks have been badly burned multiple times in financing projects. You know, capex projects. I imagine VC money will step in, the private equity money will step in eventually. But if you can get financing, it takes eight years to develop a greenfield mine. And if you had a brownfield mine, it will take four years. So again, there are no short-term fixes for what's going on in the copper world right now.

Tom Herrick: As we have surveyed the whole landscape here. Going back to this phrase, I have, you know, the new yet old diversifier of commodities within portfolios. I see this as a true alternative as opposed to the magic genie of just picking stocks better. Prior to 2010, we had a long run in commodities with return and risk profiles that looked somewhat similar to equities, and I'm going to let you comment as to what that looks like. What we're leading to I believe here as we're returning to that profile, or maybe even a better one. What would be your take on that?

Brad Klein: You're spot on. So I would say that between 1970 and the financial crisis in 08, commodities and equities each annualized at 10% per year over that 38 year period and then post financial crisis, obviously, equities far outpaced commodities. But I would submit to you that over the medium term, let's call it a catch up, commodities will outpace or should outpace, in my opinion, the equity markets. You know, some of our investors we've had discussions with believe commodities are more volatile than equities. I think that's more of a media issue, frankly and it's simply not true. If you go back all the way to 1990, when essentially the asset class became recognized through February of 2022, the S&P had an annualized volatility, using daily returns of 18.1% and commodities were 14.7%, so actually less volatile. And if you have a longer-term perspective and you take 90 day annualized vol, you'll see that still commodities were 16.7% and the S&P was 17.6%. So there's this common misconception that adding commodities increases volatility where in fact, that's just not true. And now we are starting to see, certainly in my business clients turning around and saying, hey, I need protection for my fixed income market, which is clearly going to be challenged. I mean, fixed income owners are getting a little bit of a reprieve in a flight to safety with the war. But I think we can all agree that rates are going higher, not lower. And if they go lower than the world is really in

Tom Herrick: Yeah, we don't want to see that.

Brad Klein: We don't want to see that. And the equity world, I think, is it's getting a little bit of a rerating, you know, and there's this common saying Call Tina, there's no alternative, but in fact, we think there is an alternative.

Tom Herrick: Yeah and I would argue this is the real alternative as opposed to over the last couple of years, you've had this sort of excess liquidity induced interest in other things, you know, the speculative excesses that you always get in a really strong, highly liquid environment. You know, recent IPOs, SPACs, crypto could probably fall into that category. I'm not saying these things aren't here to stay, but rather they've been driven by that excess liquidity, in my opinion, in any event. And you make a great point that adding commodities to a portfolio does not actually, you know, while nothing is linear, nothing goes straight up. The volatility characteristics here are very similar in many cases, a little bit lower than stocks. So having that within an allocation within a portfolio is the alternative for those investors desperately looking for that right now. So Brad, thanks for sharing all your experience and insights. As always, it was great speaking with you today.

Brad Klein: Thank you for having me, Tom.

Tom Herrick: That was Brad Klein on the commodities markets at a time when events are developing quickly and dramatically. We're grateful for his experience and insights and for the work done by all our friends over at Core Commodity Management. Thanks for helping to make this show happen and thank you for tuning in.

We'll be back next month with more thought leadership as we strive to maintain Cary Street Partners higher standard on the airwaves. We'll continue to cover important questions and issues that are front of mind for investors. So stay tuned for more next month here in the Conversation Series. In the meantime, for more information, please visit our website at CaryStreetPartners.com. Subscribe, share the show, send us your feedback, too. We'd love to know your thoughts. Thanks again for listening. I'm Tom Herrick, talk to you next time.