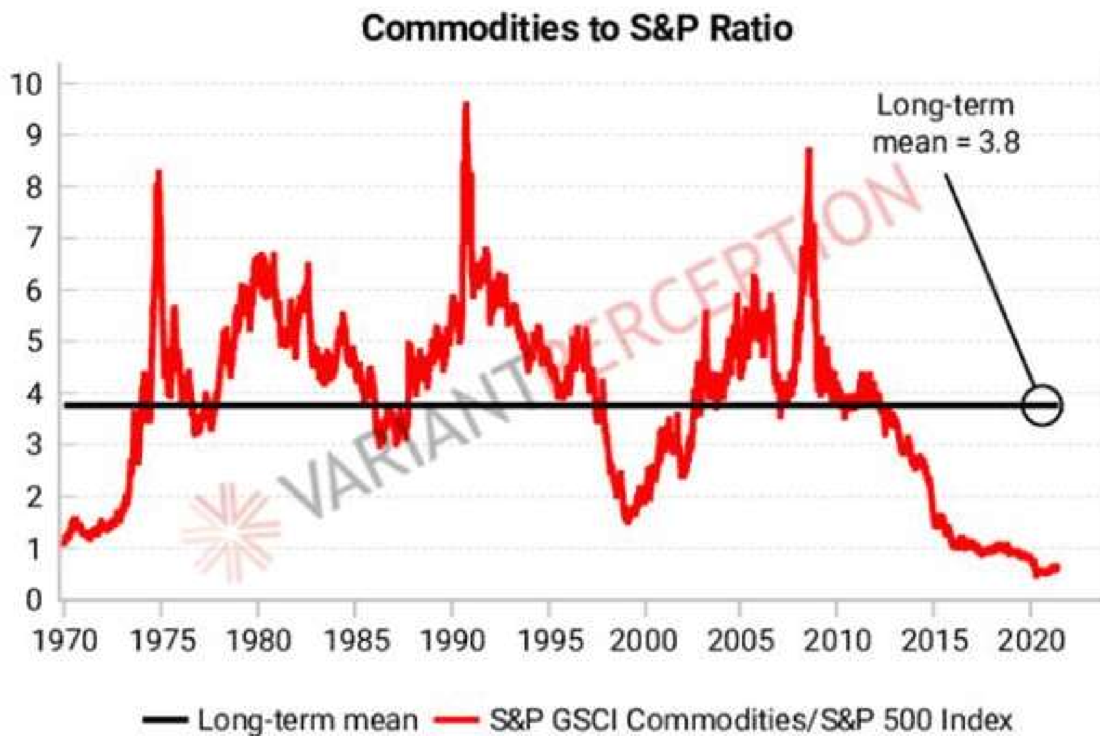
Hilberry Group
Wealth Management

June 25, 2021

Commodity Super-cycle?

From NBF's Daily Energy commentary June 21, 2021

Chart of the Day



Source: @VrntPerception

NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

This chart says the Goldman Sachs Commodities Index (GSCI) is at the lowest price level relative to the S&P500 since the inception of records in 1970. When we see stories about a 'Commodity Super Cycle' these kinds of charts are used to confirm it's a great time to buy commodities as they must be ultra- cheap. Screams 'bargain' right? Crude oil & natural gas comprise 54% of the GSCI Index. The Dow Jones Commodities Index hydrocarbon fuels weighting approaches 57%. Crude's slide explains this decline…right? Let's look at what most would imagine when we say 'commodities'. The following charts are all priced in $USD.

Gold Price in USD monthly - 20 years:

Gold isn't historically cheap vs. its own history.

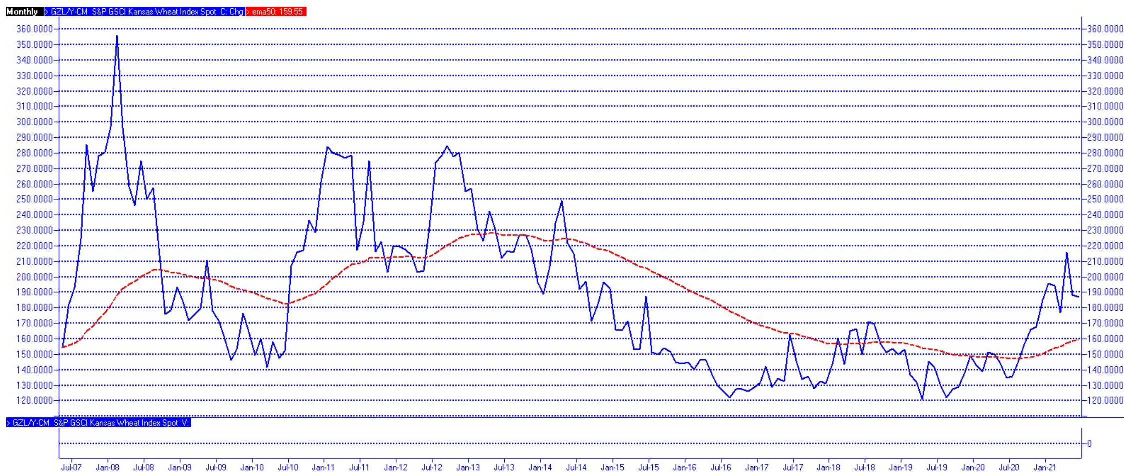
Silver in USD monthly– 20 years

Neither is silver.

Copper in USD monthly – 20 years

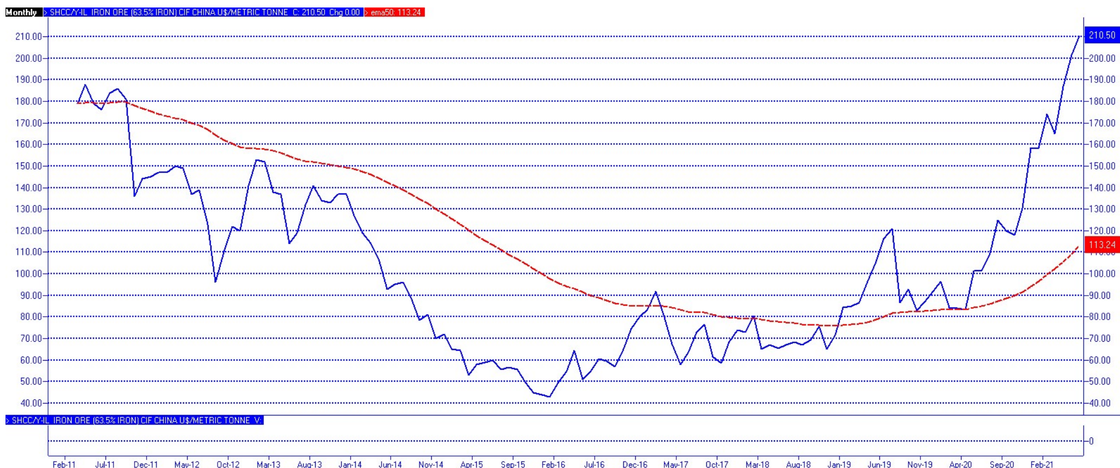
Copper cheap? Nope.

Wheat – Kansas Wheat Index - $USD monthly 20 years



Wheat is also trading above it’s 50-0month average and is roughly at mid-range over the past 20-year period. Not expensive but not cheap either.

Iron Ore (China) $USD monthly 10 years



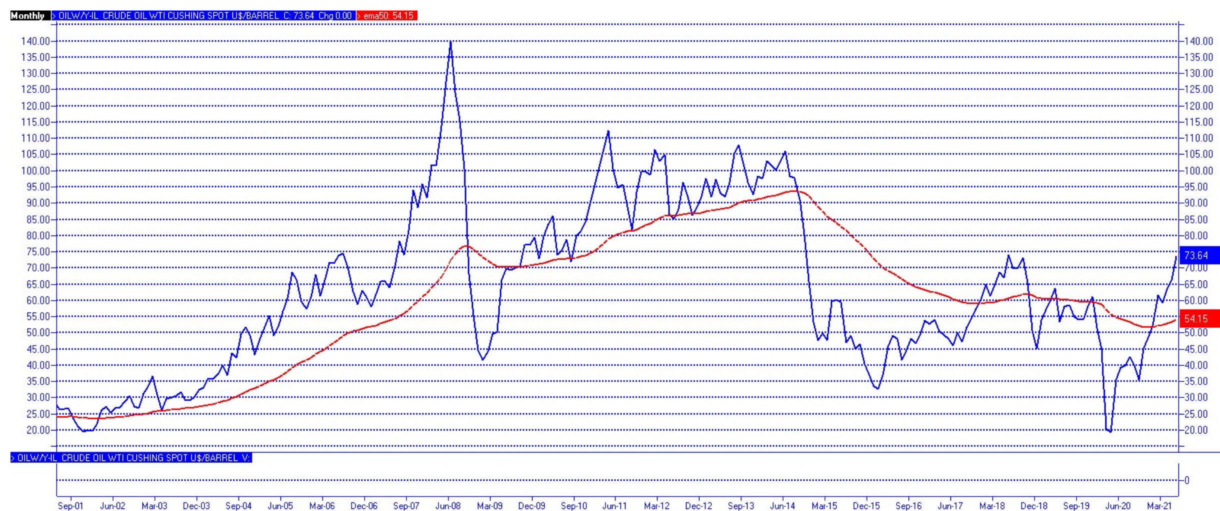
Iron ore prices certainly aren't cheap.

GSCI Nickel Index - $USD monthly

Nickel prices are well off the early 2,000's highs and may have a lot more room to run. Past 10-year range doesn't look that depressed at these prices.

And finally…maybe the 50%+ representation of oil & gas in the commodities indices is the culprit. After all, oil prices are waaaay down right?

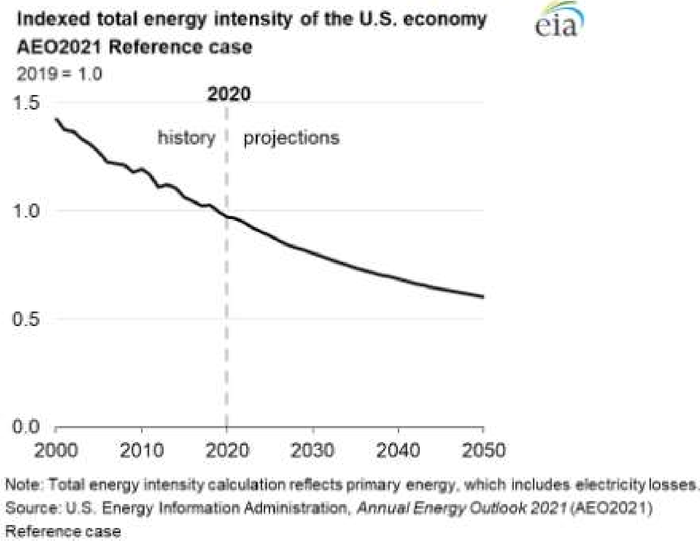
West Texas Intermediate Crude Oil (WTI) - $USD monthly 20 years



Oil is also above its 50-month moving average and is at the mid+ range in prices. What gives?

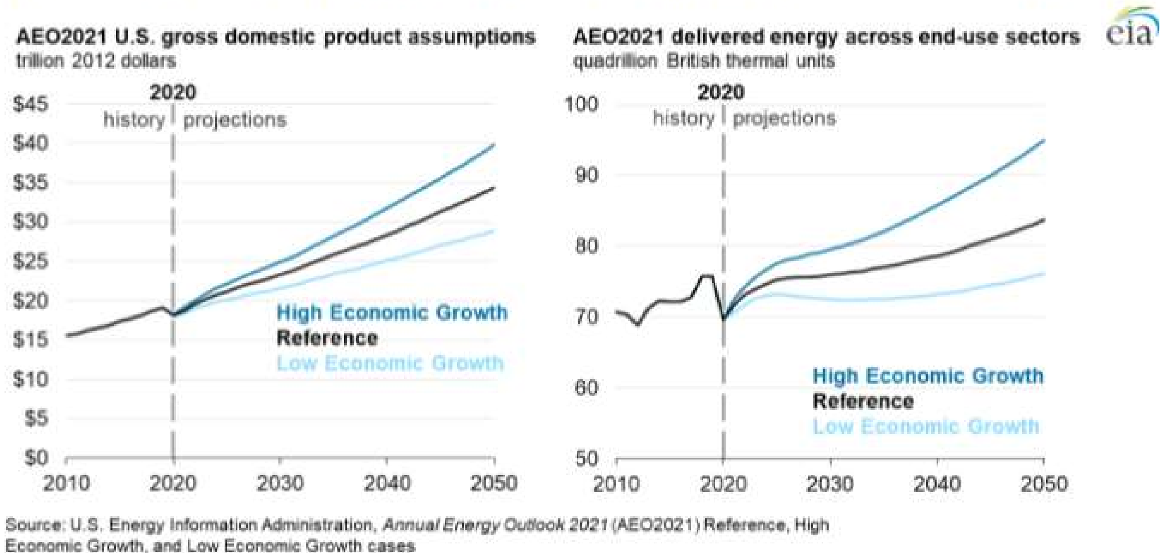
Pundits have pointed to the low commodity price ratio to S&P500 as a sign the S&P500 has been pushed up by excess investment in certain sectors (FAANGS anyone?) leaving commodities behind. Its a head-line friendly idea. Or…maybe the low ratio of commodities vs. the S&P500 has more to do

with US industry being more efficient and productive in it's use of commodities. In the USA, energy intensity per unit of GDP has dropped sharply over the past two decades.



https://www.eia.gov/outlooks/aeo/consumption/sub-topic-03.php

Note this doesn't mean total energy consumption in the USA has declined, nor is it expected to decline in the future including oil.



Productivity and falling energy intensity explain why commodity prices have gone nowhere for 20 years, while GDP has grown sharply. That's a good thing. To be clear I'm not saying commodity prices can't/won't rise and I'm not saying owning commodity producers won't be very profitable. It seems

likely the recent collapse in global oil exploration and development may lead to a spike in oil prices. In the past, owning oil producers during such times has been profitable. Oil price spikes have also led to inflation. More on that below.

While the decline in energy intensity is a very good thing, it's not enough to hit climate change targets. NBF's Geopolitical team has a look this week.

'The monumental challenge of trying to hit climate targets'

NBF's Geopolitical Desk reviewed the climate target challenges this week. Doesn't mean it can't be done. **IF** new technologies oriented towards climate change mitigation also result in productivity we'll all benefit. From the 16th to 19th century's whale oil was principally used for lamps and soap. Only the very wealthy could afford anything other than a tallow candle for lighting. Now we don't give a thought to flicking a light switch. Someday we may view fossil fuel burning cars the way we now think of steam engines.

https://nbf.bluematrix.com/sellside/EmailDocViewer?encrypt=721786fd-2d8a-47f6-b856-b6a4105e609b&mime=pdf&co=nbf&id=Institutional-SalesAll-Branches@bnc.ca&source=mail

Dallas Fed Energy Survey Q2/2021

The US oil industry has been the largest marginal adder to oil supplies. What does the US industry think of the future? The Dallas Fed was out with their 2nd quarter survey of the Energy Industry this week.

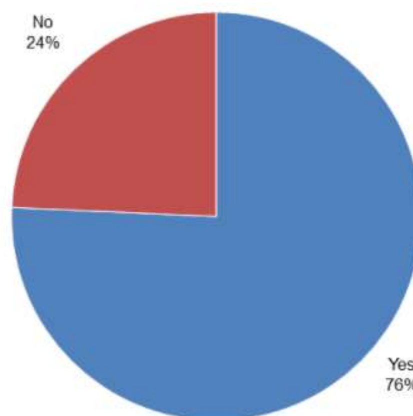
https://www.dallasfed.org/research/surveys/des/2021/2102.aspx

Some highlights from the 'Special Questions' section of the report

https://www.dallasfed.org/research/surveys/des/2021/2102.aspx#tab-questions

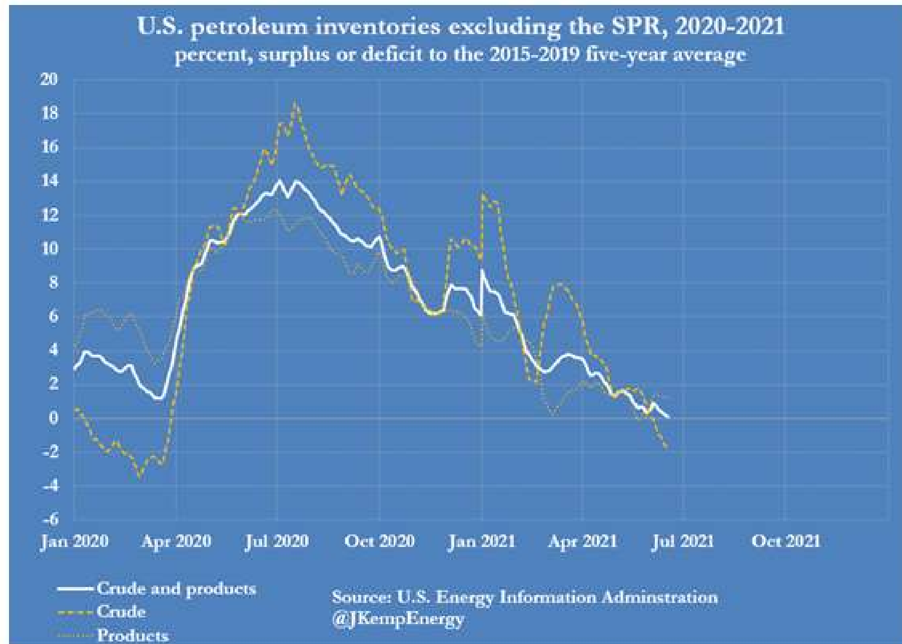
Do you believe there will be a global crude oil supply gap in the next two to four years?

Seventy-six percent of executives said they believe there will be a global crude oil supply gap in the next two to four years.



NOTE: Executives from 140 oil and gas firms answered this question during the survey collection period, June 9–17, 2021.
SOURCE: Federal Reserve Bank of Dallas.

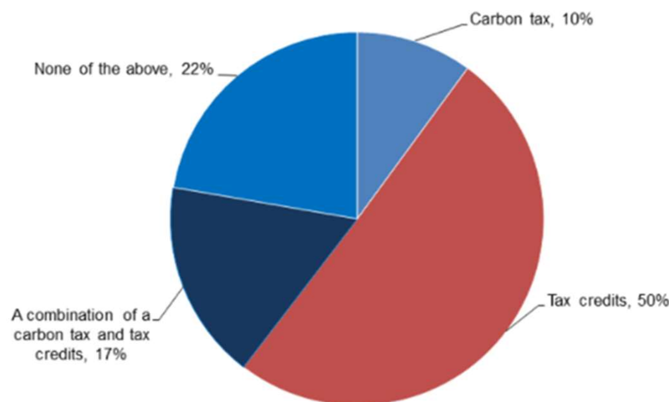
The bulk of US oil industry insiders believe there will be a supply gap (IE not enough supply to meet demand = rising oil prices). Over the past 5 years, thanks to US Shale oil / Saudi market share battles, the world has been awash in crude. Where is the current US supply?



Currently there is a negative supply of crude, balance of crude and refined product s and a small surplus of refined products. The latter is a lagging indicator. Rising fuel pump prices appear likely. That may be good news for Canadian suppliers…if they can sell into that gap.

Which do you believe will be more effective in reducing carbon emissions: a carbon tax or tax credits to fund investments in carbon capture?

Fifty percent of executives believe tax credits to fund investments in carbon capture will be more effective in reducing carbon emissions than a carbon tax. Ten percent believe a carbon tax will be more effective. Those who did not choose between the options were allowed to answer "None of the above" (22 percent) or "A combination of a carbon tax and tax credits" (17 percent). (Percentages don't sum to 100 due to rounding.)



To no surprise the Oil industry doesn't like the idea of carbon taxes, much preferring carbon sequestering. They'd make money pulling oil out of the ground and then make more stuffing carbon back in. Climate activists generally dismiss carbon sequestering. They argue higher oil prices are needed making alternative energy more attractive. That's what carbon taxes are for. Unless alternative energy drops a lot in cost, this hope implies an increase in the cost of all forms of energy. Increased cost is ultimately borne by the consumer. If consumers have a viable alternative to conventional energy at a lower cost, productivity increases, no inflation and better outcomes for all. That's the dream. If there are no less expensive alternatives to current energy supplies, there are two choices, neither of them good. Either use less (falling demand) or pay more (inflation). The 1970's 'Stagflation' demonstrated both at the same time. It's been a long time since inflation was much of a thing. Consumers have gotten used to negative real borrowing costs, increasing the prices of leveraged assets like real estate. Be careful what you wish for.

'Eric Nuttall: The fog of energy ignorance is clouding a generational investment opportunity' – Financial Post June 23,2021

Mr. Nuttal, portfolio manager for Canadian based Nine Point partners, is a regular contributor to the Financial Post. He's been pounding the table on energy stocks generally and Canadian energy in particular for a couple of years. His was a lonely voice in the wilderness in 2019. He's been bullish and right.

https://financialpost.com/commodities/energy/oil-gas/eric-nuttall-the-fog-of-energy-ignorance-is-clouding-a-generational-investment-opportunity

What to avoid, how to profit from rising interest rates?

I assume interest rates are heading higher. What I don't know is when, how fast and how high. It would be handy to get paid a reasonable rate while waiting for that higher rate, while avoiding instruments that would suffer should rates rise.

An example of the latter is a high yield/highly leveraged Real Estate Investment Trusts (REITs). At first glance a REIT paying 9% looks appealing compared to a 1.4% Government of Canada 10-year bond yield. Be careful. REITs are leveraged to various degrees. They also tend to have low growth rates as it's hard to hike rents much above the inflation rate). Flat-to-falling interest rates tend to enable higher property prices. Banks then see the gains in property prices as an improvement in 'net equity', and are more willing to lend, further enabling more buying. It's a virtuous circle…until it isn't.

Increasing borrowing costs limit the amount buyers can pay, depressing property prices. Prices can go flat for long periods. Highly leveraged property buyers go 'underwater' quickly. Banks get nervous and either call in loans or refuse to lend more. Prices sag further. Rental buildings are harder to convert into strata-condos. Refinancing older mortgages from a higher rate to a new lower rate to 'capitalize' the increased equity ceases. REIT distributions often get squeezed. Prices of the REITs drop. Not all REITs are highly leveraged. A properly

structured one can weather the rising storm but they still won't have much fun. At it's core it's the low growth that's the problem.

The other area to avoid is long-dated maturity bonds. The longer the maturity the more price risk for a given interest rate move. The lower the starting interest rate (coupon) the greater the subsequent price moves. The 10-year Govt Canada bond yield has been below 3% since late 2011. The economy has gotten used to ridiculously low yields. What happens if rates rise? The following table projects price changes at various future interest rates.

Price sensitivity of generic bond paying 1.4% in a rising interest rate environment

Issue Date	Maturing Price	Coupon	Maturity Date	Currrent Yield	Years to Maturity	Bond Price*
30-Jun-21	$100	1.40%	30-Jun-31	1.40%	10	$100.00
Mkt Value Date	Maturing Price	Currrent Yield	Years to Maturity	Bond Price		
30-Jun-22	$100	2.50%	8	$91.00		
30-Jun-22	$100	3.00%	8	$87.50		
30-Jun-22	$100	4.00%	8	$80.50		
30-Jun-22	$100	5.00%	8	$74.20		
Mkt Value Date	Maturing Price	Currrent Yield	Years to Maturity	Bond Price		
30-Jun-23	$100	3.00%	7	$88.70		
30-Jun-23	$100	4.00%	7	$82.30		
30-Jun-23	$100	5.00%	7	$76.50		
30-Jun-23	$100	6.00%	7	$71.00		
30-Jun-23	$100	7.00%	7	$66.10		
Mkt Value Date	Maturing Price	Currrent Yield	Years to Maturity	Bond Price		
30-Jun-25	$100	3.00%	5	$91.30		
30-Jun-25	$100	4.00%	5	$86.25		
30-Jun-25	$100	5.00%	5	$81.60		
30-Jun-25	$100	6.00%	5	$77.10		
30-Jun-25	$100	7.00%	5	$72.90		

* Bond price based on semi-annual yield to maturity, rounded to nearest dime.

A move up in rates from the present 1.4% to 3% by Jun/2022 equates to a -12.5% price drop in this bond.. If a government bond price drops 12.5% guess what happens to a less secure investment?

How to profit from rising rates.

We thought bond yields would rise coming out of the 2020 Great Recession. It wasn't rocket science. Bond yields have a 100% accuracy of rising post-recession. For client mandates with a defined allocation to fixed income (bonds) we divided that allocation between bonds maturing 1-3 years and floating-rate preferred shares. Here is an example

BCE Inc Preferred floating-rate Series S (BCE.PR.S-$18.25) daily ranges 12 months

This BCE floating-rate preferred pays a monthly dividend that adjusts (floats) each month to the prevailing 90-day Govt Canada Treasury Bill rate. If 90-day T-bill yields rise, the dividend quickly follows higher. Investors will often price floaters in advance of the actual move in 90-day rates.

The starting left-hand price is $11.00. At this writing the price is $18.25. The combination of a higher dividend and improved investor confidence has floating rate preferreds rising. The 65% price gain helps offset flat-to-down bond prices in our fixed income portfolios. Floaters often have small numbers of shares outstanding, meaning small trading volumes (illiquid) Building a holding takes time and effort. One must read the prospectus.

Finance companies have created Floating Rate Preferred Share ETFs for DIY retail investors. The ETF buys up the preferreds as a bundle then trades on a stock exchange. Simple right? Be careful. The constituent floaters inside the ETF can vary widely meaning you're not sure what you're getting. Banks tend to dominate the markets, rarely offering floaters (banks don't like paying higher rates). Preferred share securities are often traded by Pros. ETFs tend to be traded by Joes. When Joe loses his cool and hits the sell button the ETF drops in price even though the underlying instruments should be rising in price. The ETF pushes down the preferred prices. Generally, we've stayed with individual preferred selections.

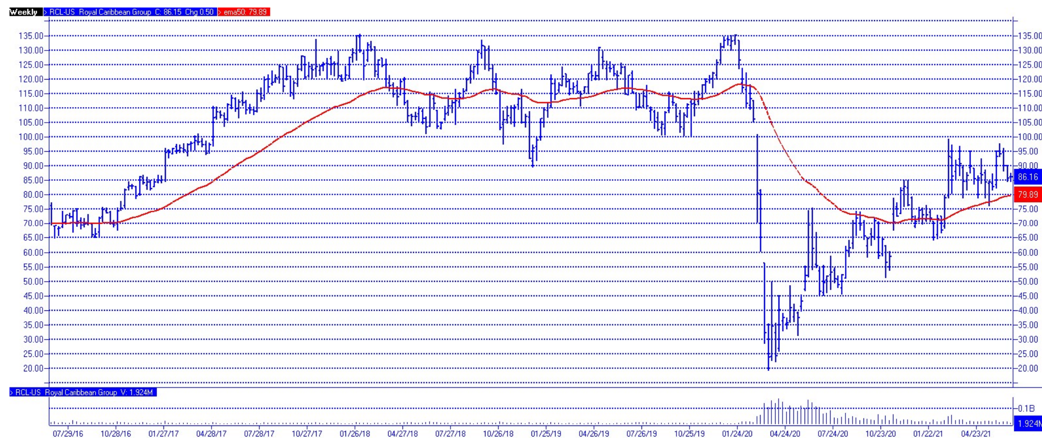
"I Need A Vacation…Gotta' Get Away…"

We've been asking clients "What are your plans for the coming Fall / Winter?" Invariably they answer, "I want to go somewhere" many hoping for a warm destination. When asked about going on a cruise ship holiday, some have mentioned the COVID-19 lockdown of the 'Diamond Princess' passengers held in quarantine at Yokohama Bay for over a month.

https://en.wikipedia.org/wiki/COVID-19_pandemic_on_cruise_ships

Some contrarians have asked if it's time to buy the cruise-lines? COVID-19 was a disaster for the cruise industry. Damage has been severe; some cruise lines may seek bankruptcy protection wiping out the common shareholders. Care must be taken with balance sheets. Time heals many wounds. My bet is the customers will come back. As clients have asked, we'll take look at Royal Caribbean this week.

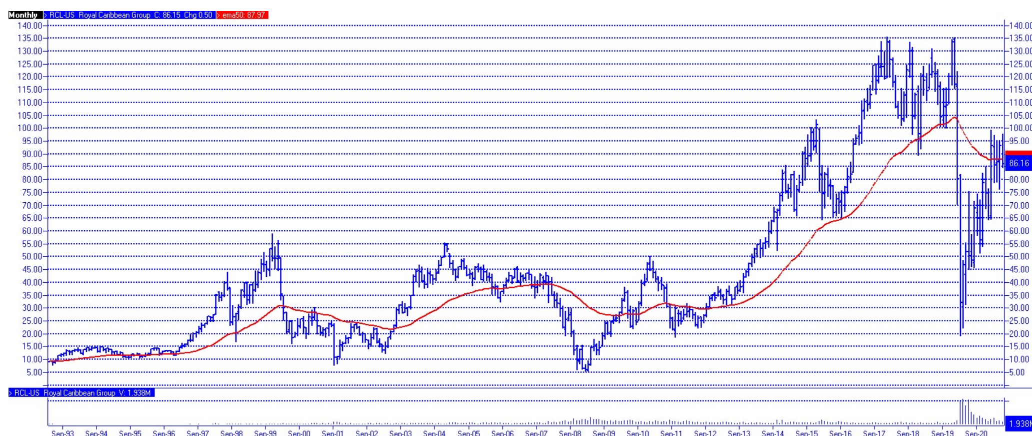
Royal Caribbean Group (RCL-NYSE-$86.15) – weekly 5 years.



Insiders in the company have been sellers of late. Given the deep declines last year and a muted rebound, insiders having a chance to sell isn't a surprise and may not necessarily be a bad sign. On the other hand, it's not a sign of confidence. If RCL stock is cheap and about to rebound next quarter or so insiders would be holding if that was likely. It could take awhile.

Our research data says in better times RCL's shares have traded around 8X Cash Flow Per Share (CFPS). With the collapse in revenues, cash flow is currently negative. A return to normal in 2-3 years could see RCL's CFPS back at 2019+ levels . Assuming CFPS comes in at $16 sometime 2024 to 2026 X 8 = $128 target. We've seen 2024-26 target ranges $110 to $210. 28%-44% potential upside for patient investors willing to take the risk.

Royal Caribbean Group – monthly ranges - Sep/1993 to date.

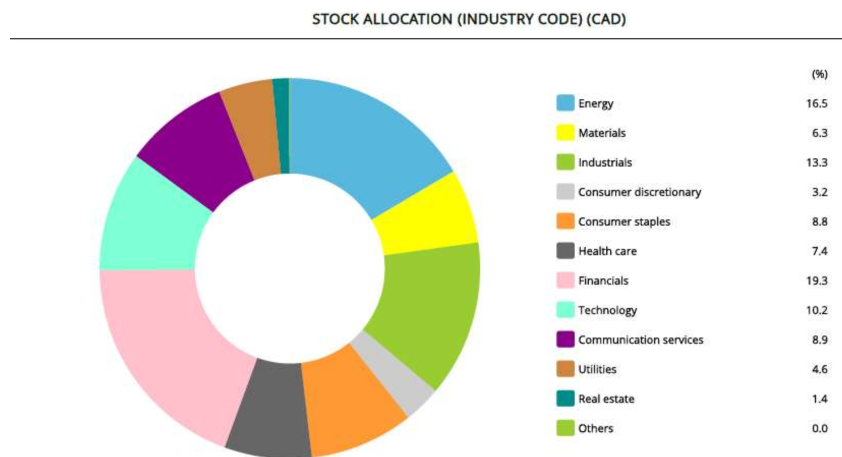


Patience may indeed be required. The 2nd chart says the stock has gone through long periods of doldrums in the past. 1997 to 2013 saw little total return with lots of volatility followed by explosive growth. Will it take 7 years again this time? Chinese tourists love cruises. Will they turn the industry around quickly?

On balance, while the idea is intriguing the likely lack of a dividend, questions around the timing of a rebound (this coming winter 2021 or winter 2022-23?) has us looking elsewhere.

So….what do we like?

We own a diversified basket of large cap, blue-chip dividend payers. Blending our Canadian and US equity portfolios, here is our industry allocation.



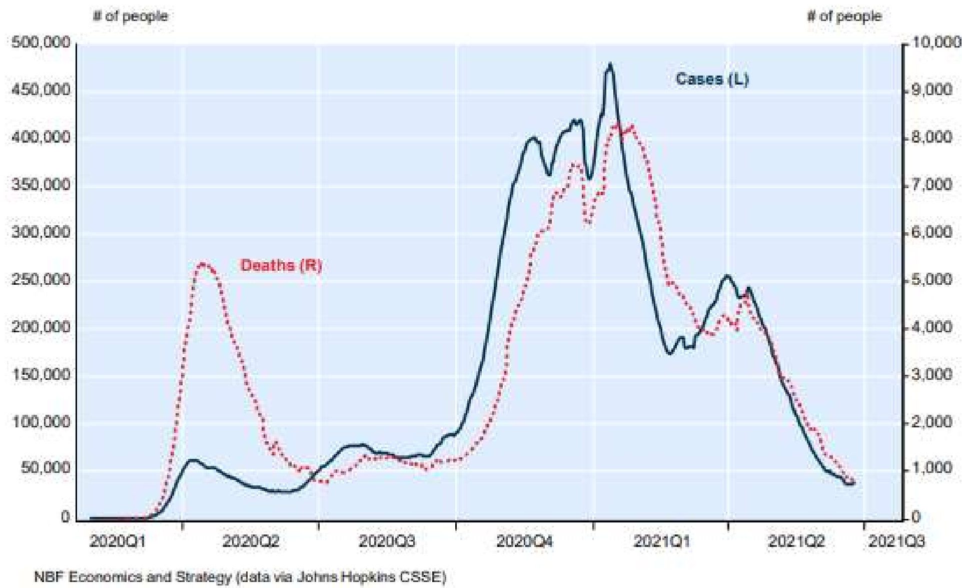
We've been lite on technology, tilted towards **Financials** (Banks and Life Insurance) and **Energy** (Oil & Gas, Pipelines, Alternative Energy).

What of the markets?

Last week saw a slide in prices. This week prices are back up. I haven't found the attempting to predict short-term market price moves rewarding. We don't buy 'markets' we buy stocks. One group I have found entertaining to watch is the non-bank owned Securities Broker/Dealers. Think Goldman Sachs, Morgan-Stanley, Raymond James, etc. If anyone has a sense of investor enthusiasm or distress it's this group. Currently the broker dealers think things are just fine.

COVID-19 Daily Monitor for Friday June 15, 2021

Cases continue to fall in the developed world.



See the link for the full report.

https://nbf.bluematrix.com/sellside/EmailDocViewer?encrypt=173688c5-2e3c-4483-a826-9a705945d468&mime=pdf&co=nbf&id=steven.hilberry@nbc.ca&source=mail

You Can't Predict Outperformance | How Should You Invest

Watch Anna's latest video here

https://www.youtube.com/watch?v=LVRtcZJAOH8

It's supposed to be a hot weekend. Hit the beach and keep the sunscreen handy. I'll be mending farm gates and keeping the new fruit trees watered.

Steve & Anna Hilberry

Have a Great Weekend!

FOR THE RECORD June 25, 2021

DOW INDUSTRIALS:	34,178
S&P 500:	4,182
S&P/TSX COMP:	19,336
WTI:	$63.26
LOONIE IN $USD:	$0.7994 $US

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