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Weekly Commentary

Issue **No. 7** | **FEBRUARY 14, 2022**

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Is a Commodities Supercycle in the Cards?

As discussed in last week's edition, inflation has become a hot topic given its correlation to central bank interest rates policy. Renowned investor Jeremy Grantham recently made headlines by commenting that the world is in the "early stages of running out of raw materials" and that we'd better get used to "bottlenecks, shortages and price spikes". Grantham further remarked that rising interest rates and inflation would leave "growth" equities vulnerable to correction while "value" stocks should be more attractive. According to Grantham, value "is about as cheap as it gets".

Also making headlines last week were comments from Jeff Currie, head of commodities research at Goldman Sachs. Currie believes that we are potentially entering a commodities "supercycle". Currie bases this on his belief that a "structural decline in supply" is being accompanied by a "structural rise in demand" as the global economy emerges from the pandemic. Currie added that a supercycle could fuel a "multi-year" bull market across all sectors of the commodities universe. In an interview on Bloomberg TV, Currie went on to say that he'd never seen anything like the current "tightness" in his 30-year-long career.

We find these comments interesting. The Bloomberg Commodity Index (Bloomberg: BCOM) is a useful economic indicator that tracks a 'basket' of physical commodities that trade on global futures markets. The index is diversified across multiple sectors and includes weightings in 23 different commodities. In January, the largest weightings were 30% energy (e.g., oil, natural gas), 23% agricultural (e.g, wheat, corn, soybeans), 20% precious metals (e.g., gold, silver) and 20% industrial metals (e.g., copper, aluminum); the balance being comprised of 'soft commodities' like cotton and coffee.

There have been four periods over the last fifty years where inflation, as measured by prices, saw significant gains. In the 1972-74 and 1977-80 periods, economic growth and the "oil shock" were major contributors to rising prices. The 2003-2008 period saw oil prices roughly triple between January 2007 and July 2008, which culminated with the onset of the financial crisis of 2008-09. From the cyclical peak in July 2008 and the 'covid-related' trough in April 2020, commodities encountered a twelve-year period of decline during which the index fell by roughly 70%. However, since the April 2020 low, the index has risen by over 80% as prices for virtually all commodities are on the rise.

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Of particular interest to us are energy prices. Crude oil, as measured by benchmark West Texas Intermediate (WTI), has risen dramatically from well below USD$20/barrel in the spring of 2020 to trade above USD$94/barrel on this past Friday. This is the highest price since August 2014 and followed headlines speculating that Russia was imminently planning to invade Ukraine. Such an event would have serious implications for the global economy. Europe relies heavily on Russia for supplying its natural gas needs and conversely, energy exports are critical to the well-being of the Russian economy.

Of course, energy is not the only hot commodity. Natural Gas traded above USD$6 in January, well above the USD$1.50 level in June 2020. Using Friday's closing prices (Feb. 11), on the London Metals Exchange (LME), and April 2020 prices as our base, aluminium is +115%, copper is +104% and Nickel is +93%. On the New York Mercantile Exchange (NYMEX), also using April 2020 as our base, Unleaded Gasoline is +259%, Heating Oil is +268%, and Natural Gas is +108%. In the agricultural space we see a similar trend with Corn +70%, Wheat +53%, Coffee +114%, Sugar +45% and Cotton is up a whopping 123%. The trend is clear. Prices are on the rise.

As we know, the Fed is committed to managing inflation. Should inflation continue to rise, the Fed will act accordingly and try to cool the economy by raising rates. While higher rates are clearly a headwind for growth stocks, the opposite can be said for companies that profit from rising prices on the 'hard assets' they produce and sell. Further, commodities are widely viewed as an excellent hedge against inflation. Logically, stock prices for companies in the energy, mining, and materials sectors should benefit and outperform given these sectors are more sensitive to rising global demand, inadequate availability or diminishing supply, and a robust economy.

The good news for Canada is that our economy, which in a previous era was often referred to as being built on "oil, rocks and trees", is well positioned to capitalize on a commodities boom. While our economy has evolved to be much more diversified today, a sustained commodity "supercycle" would be good for Canada. Our energy sector has sprung to life after a seven-year period of challenges tied to low prices, a shortage of pipeline capacity and pressure to decarbonize. Canadian oil and gas companies are among the best - if not THE best, at incorporating decarbonization technologies and growing their 'green energy' agendas. Recent pipeline expansions and massive new projects for the export of liquified natural gas (LNG) from B.C. have our energy sector in a great place.

Canadian lumber producers, many of whom have faced prolonged challenges related to U.S. tariffs, deforestation, and poor pricing, are generating record cash flows and have improved the health of their balance sheets. Lumber was trading at all-time highs last summer. Similar tailwinds are being felt by miners of industrial metals, including the materials that are critical to the evolution of electric vehicles (EVs) and the metals required to build EV batteries. Canadian miners of copper, zinc, cobalt, nickel and lithium are also looking at a brighter future.

As of Friday's close, Canada's S&P/TSX Composite Index is up 1.5% for this year while peer indices south of the border are lower. The Dow Jones Industrials is -4.4%, the S&P500 index is down 7.3%, and the technology

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heavy NASDAQ is lower by 11.9%. A commodities bull market will benefit companies that operate in transportation (rails, trucking), mining (industrial metals), energy (oil, natural gas, infrastructure), materials (lumber, iron ore, copper) and even Canadian banks. We are bullish on Canadian equities.

In coming editions we'll be taking a closer look at some of the companies we currently hold in our Palos funds.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$9.99	1.53%
Palos Equity Income Fund - RRSP	PAL101	$7.33	1.25%
Palos Merchant Fund L.P. (Dec 31, 2021) [2]	PAL500	$1.16	24.67%
Palos WP Growth Fund - RRSP	PAL213	$17.96	-5.22%
Palos-Mitchell Alpha Fund [3]	PAL300	$10.28	0.01%
S&P TSX Composite (Total Return with dividends reinvested)			1.73%
S&P 500 (Total Return with dividends reinvested)			-7.16%
S&P TSX Venture (Total Return with dividends reinvested)			-7.49%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			1.94%
Canadian Government 10-Year			1.85%
Crude Oil Spot			US $93.10
Gold Spot			US $1,810.80
US Gov't10-Year/Moody BAA Corp. Spread			191 bps
USD/CAD Exchange Rate Spot			US $0.7851

[1] *Period ending February 11th, 2022. Data extracted from Bloomberg*
[2] *Fund is priced annually*
[3] *Fund is priced weekly on Tuesdays*

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