As it stands, there were several events in the first five months of the year that unfolded contrary to our own expectations but that do not pose a threat to the integrity of the long-term trend. Namely, the first phase of the Chinese recovery proved far more uneven than anticipated. We were encouraged by the growth in mobility and services demand which continues to rebound aggressively. However, the more commodity-intensive corners of the economy (i.e., industry, manufacturing and property) remained weak, having a particularly acute impact on the industrial metals space.

Secondly, the energy sector witnessed a series of setbacks, each unexpected but temporary in nature. On the supply side, production was artificially lifted by a US government-mandated release of strategic petroleum reserves and a complete shutdown of one of the country’s largest liquefied natural gas (LNG) export terminals. Russian production was tremendously resilient in the face of price caps, divestment and a crippling sanctions program. Simultaneously, demand was severely impaired by the combination of mild weather (the second warmest winter on record) and European austerity measures. 1 In isolation, any one factor would have been modest; but, in aggregate, the effect was considerable for the sector.

Notwithstanding a major, global economic recession, we stand by the opinion that recent results are but a setback in a more substantial trend. As alluded to previously, our bullish thesis is first and foremost substantiated by our position within the capital cycle. Distinct from the economic cycle (expansion, peak, contraction, recovery), the capital cycle refers to the flow of investment into high-profit businesses during economic upswings and the subsequent drought of investment when competition increases and returns dissipate. The late 2000s and early 2010s comprised a period of high

1 “Global Climate Report”, National Oceanic and Atmospheric Administration (NOAA), March 2023
profit and high investment for commodity producers. Today, on the contrary, our position is one of distinct shortage. Adjusted for inflation, capital expenditures into the metals and mining industry and oil and gas industry are down more than 60% and 75% since the 2015 peak, respectively.2 Despite prices rising from the lows experienced in the spring of 2020, there is little evidence that suppliers are responding with additional capacity. Instead of growth-oriented business models, most suppliers have transitioned to maximizing shareholder returns via dividends, share buybacks and increased mergers and acquisitions activity.

We are also constructive on the supply situation given the many headwinds that producers face in achieving natural growth rates. If one were to consider the primary inputs to any large supply operation – capital, labor and materials – each lever has grown noticeably more expensive and more difficult to source. Higher interest rates and the recent banking episode imply lower access to credit for new projects. Record unemployment and elevated wages suggests costlier manpower. Higher inflation and lower resource quality equate to rising material costs. Further to the last point, new projects are not just limited because of the capital expenditures hurdle. They are increasingly limited by geography. If we were to use crude oil as an example, consider that nearly 75% of all unconventional supply growth of the last eight years has come from the Permian Basin.3 Ostensibly, three quarters of all incremental supply gains in the world’s most vital commodity are confined to just six counties in West Texas. If the Permian is to peak soon (which estimates suggest may occur by the end of 2024), who will fill the void?3 This is a structural issue that may demand years of exploration and investment to remedy.

We are lastly encouraged in our thesis by relative valuations. Most measures of intrinsic value indicate commodities and natural resource equities are undervalued relative to other asset classes (see Chart B). In one measure of sentiment, net speculative positioning for the BCOM Index (excluding London Metals Exchange (LME)) is now the most bearish it has been since June 2020.4 Incredibly, the index itself is trading 15% below the Ukrainian invasion date of February 24th last year. To us, this indicates many commodity markets are already pricing in expected demand destruction from a more aggressive economic contraction. The futures term structure, often a measure of immediate tightness, has indeed weakened on the year; however, many futures markets are still in significant backwardation and continue to draw visible inventories. Furthermore, we believe today’s lower prices may offer a cure of sorts as discounted levels entice greater consumption. As evidence, significant technical support is starting to develop under markets that have fallen towards the marginal cost of production.

There are a growing number of reasons to maintain confidence in the commodity asset class. Chinese economic activity is projected to accelerate into the second half of the year as the People’s Bank of China maintains an accommodative stance. Mounting infrastructure plans are scheduled to provide growing demand from the public sector in real time and so will the energy transition. The latter is a monumental trend that deserves little introduction and rightfully so. Decarbonization encompasses the most costly endeavor in modern history, and its success is heavily dependent on the mass-availability of critical resources. For these reasons and more, we are undeterred by the poor performance of commodities so far this year. We believe the fundamental data is relaying several important truths: production costs have risen alongside general inflation, suppliers are prevented or unwilling to invest the capital that is needed and price has retraced to attractive valuations.

Chart B: Commodities to Dow Jones Industrial Average Ratio

Source: Bloomberg, Goehring & Rozencwaig Models, Date Range: Jan 1900 – Apr 2023

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2 “Commodities: An underinvested supercycle”, Baker Hughes, Goldman Sachs, Apr 2023
3 “Hubbert’s Peak is Here”, Goehring & Rozencwaig, May 2023
4 Source: Bloomberg, Morgan Stanley, Date Range: Jun 2020 – Jun 2023
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The commodities markets and the prices of various commodities may fluctuate widely based on a variety of factors. Because the Fund's performance is linked to the performance of highly volatile commodities, investors should consider purchasing shares of the Fund only as part of an overall diversified portfolio and should be willing to assume the risks of potentially significant fluctuations in the value of the Fund. The Fund invests in commodity futures related investments, which are derivative instruments that allow access to a diversified portfolio of commodities without committing substantial amounts of capital. Additional risks of commodity futures related investments include liquidity risk and counterparty credit risk. Liquidity risk is the risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss. Counterparty risk is the risk that a party to a transaction will fail to fulfill its obligations. The term is often applied specifically to swap agreements in which no clearinghouse guarantees the performance of the contract.

Another principal risk of investing in the Fund is equity risk, which is the risk that the value of the securities held by the Fund will fall due to general market and economic conditions, perceptions regarding the industries in which the issuers of securities held by the Fund participate or factors relating to specific companies in which the Fund invests. The Fund’s investments in non-US issuers may be even more volatile and may present more risks than investments in US issuers. Equity investments in commodity related companies may not move in the same direction and to the same extent as the underlying commodities.

Bloomberg Commodity Index: an unmanaged index used as a measurement of change in commodity market conditions based on the performance of a basket of different commodities.

Dow Jones Industrial Average: a stock market index of 30 prominent companies listed on stock exchanges in the United States. The DJIA is one of the oldest and most commonly followed equity indexes.

NASDAQ 100 Index: one of the world’s preeminent large-cap growth indexes. It includes 100 of the largest domestic and international non-financial companies listed on the Nasdaq Stock Market based on market capitalization.

Refinitiv Equal Weight Commodity Total Return Index: a broad based commodity index that reflects the price movement of 17 exchange-traded futures contracts. The commodities are considered in equal-weights, which are maintained through daily arithmetic averaging.

S&P 500 Index: widely regarded as the best single gauge of large-cap US equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

One may not invest directly in an index.

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