

4/2/2024

Summary: Global central bank rate tightening has likely ended even as inflation remains elevated with signs of the global economy reaccelerating. Global headwinds are turning into tailwinds for hard asset plays, such as commodities and infrastructure-focused themes, as global re-shoring and data center buildouts are producing a thirst for more materials and energy. Value investors nervous about the deteriorating landscape for financials, which comprise a large portion of value indices, can consider diversifying their value risk with an allocation to hard cyclicals.

1. Gold moving higher even in relation to U.S. Treasury yields

Rather than sliding into recession, U.S. economic growth is picking up in 2024 as is inflation risk. The U.S. Federal Reserve is now expected to delay cutting interest rates until the second half of 2024 even with headline and core inflation moving towards long-term policy goals, albeit at a slower pace. Elevated nominal GDP growth and global central banks on hold or on the verge of cutting rates have helped put a bid underneath commodities, especially oil and gold prices.

- Over the past five years, gold prices (white line below) and 10-Year U.S. Treasury yields (yellow line) have moved opposite each other, as the former anticipates an environment that would bring down inflation-adjusted (real) interest rates.
- However, this year has witnessed this inversion decouple as gold prices reach a post-pandemic high even as Treasury yields move higher. So, gold prices are moving higher even as real rates remain at post-pandemic highs.

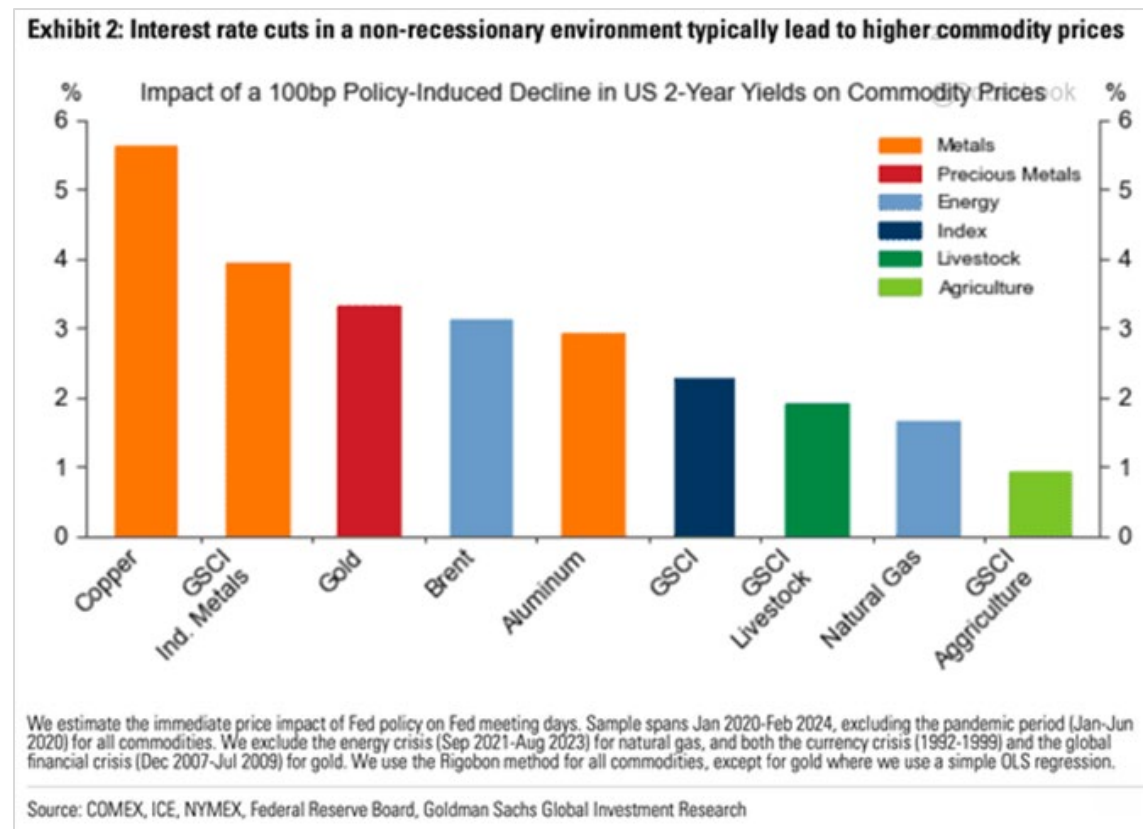


Source: Bloomberg

2. Commodity tail winds in a growth economy

Commodities are expected to perform well at the end of central bank policy tightening, barring a major deflationary-driven collapse in demand such as what happened during the 2020 pandemic lockdowns.

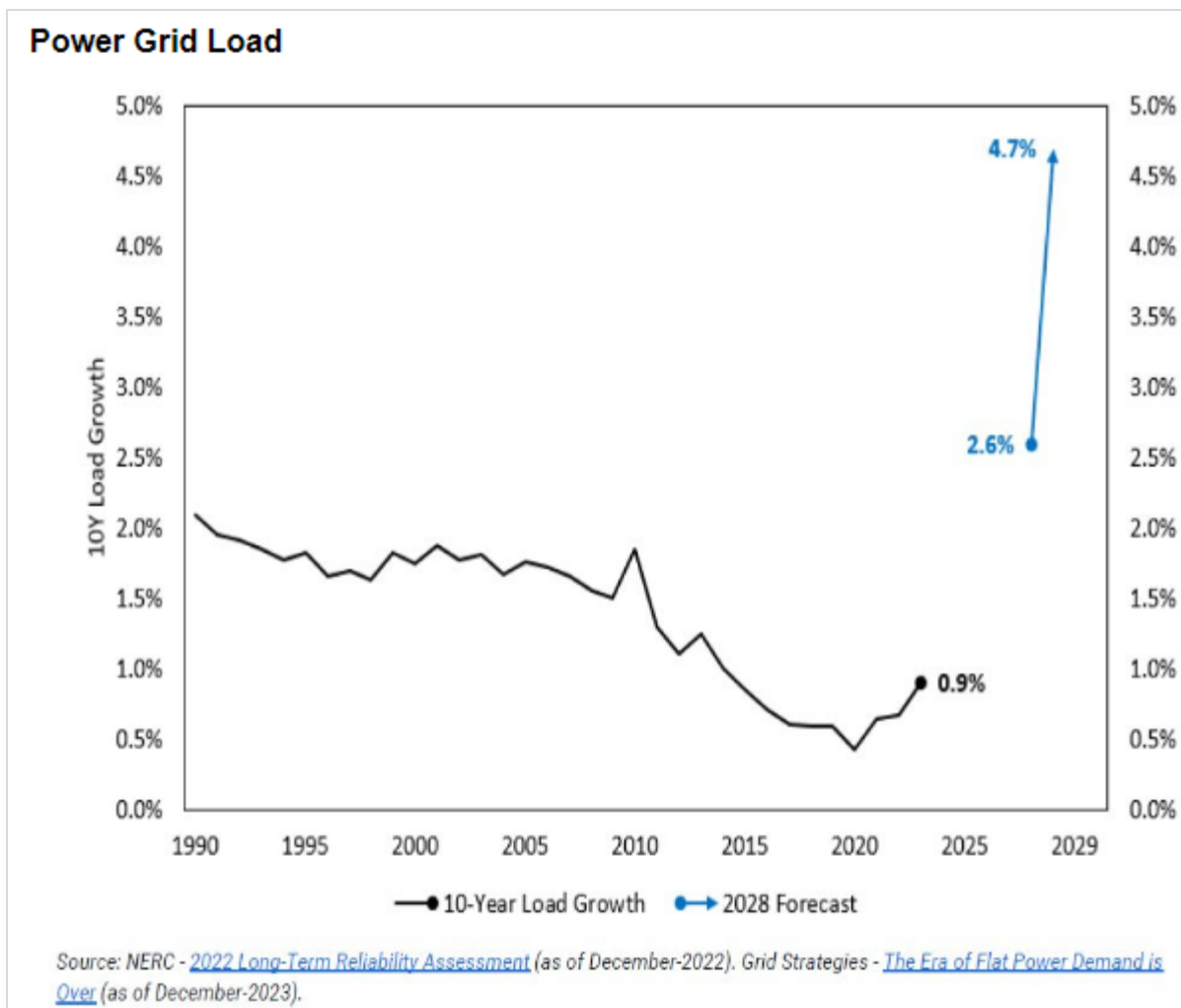
- Even as the Federal Reserve delays embarking on rate cuts until later this year, commodity prices are expected to respond positively to eventual lower rates if the U.S. economy does not fall into recession. As of 3/31/2024, Fed Funds Futures still anticipate three rate cuts by the end of 2024.



3. AI and expanded data center buildouts

In addition, the massive buildout of data centers to handle intensive artificial intelligence applications is expected to create a secular increase in demand for energy and materials. As investor capital is funneled into the hardware needed for this massive data center buildout, where will the capital needed to build out the necessary infrastructure to supply the materials and energy come from?

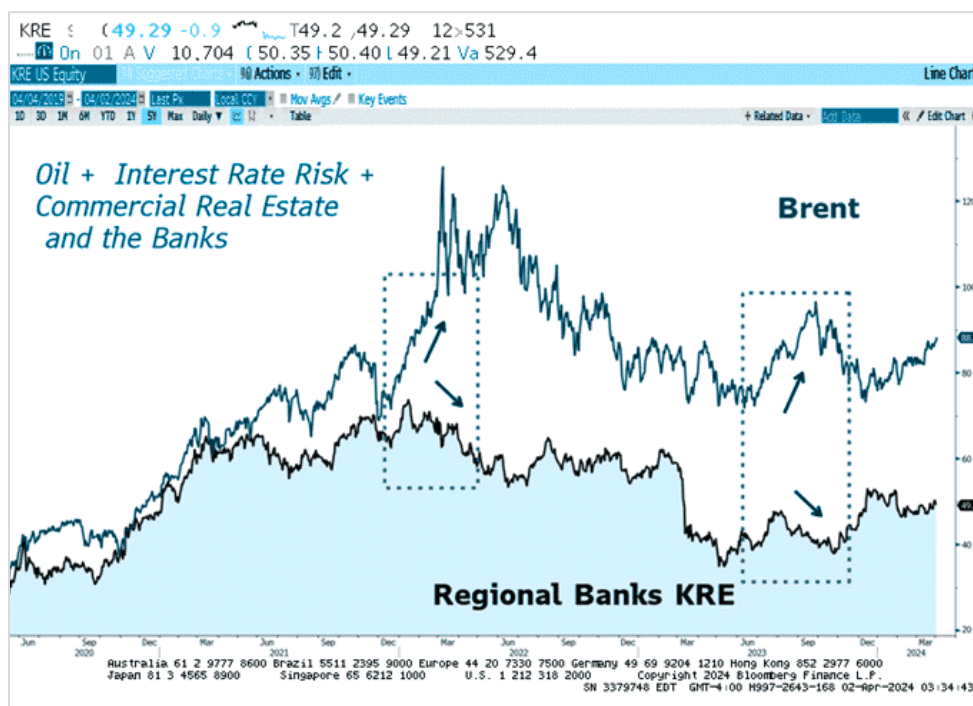
- According to the Verge, the energy needed to power expected data center usage could increase to between 620 and 1,050 terawatt hours (TWh) by 2026, up from 460 TWh in 2022 – equivalent to the energy demands of Sweden or Germany.
- The stress on the power grid will also increase as the overall growth in power load is expected to quintuple by 2028 resulting from the expected data center buildout.



4. Avoid the potential pain in financials and value trap with hard assets

Value-focused investors should consider ways to diversify their value-style exposure. Since the regional banking crisis in March 2023 that saw the collapse of Silicon Valley Bancorp, regional banks have come under pressure as high interest rates weigh on balance sheets and profitability, compounding stress from commercial real estate weakness. Higher commodity prices may force central banks to delay rate cuts due to the poor optics of cutting rates in the face of higher headline inflation.

- Regional bank stocks, represented by the KRE Index, have decoupled from oil prices, suggesting that higher oil prices put even more pressure on financials as relief from lower interest rates gets delayed further.
- The financial sector comprises nearly a quarter of the overall weighting of common value indices, such as the Russell 1000 Value and 2000 Value. Value indices are highly sensitive to the fortunes of the financial sector.
- More targeted hard asset themes offer similar overall value exposure to the broad market value indices but without the financial sector risk. The MSCI Global Metals and Mining Producers Index trades at 11.4x Price/Earnings (NTM) and 1.54x Price/Book, while the Morningstar Global Upstream Natural Resources Index trades at 12.3x Price/Earnings (NTM) and 1.66x Price/Book (source: Bloomberg). The latter holds a broader basket of infrastructure-focused companies across energy, materials, and industrials while the former primarily holds materials.



Source: The Bear Traps Report 4/1/2024

5. Ways to participate

Freedom Advisors offers several solutions on its platform that invest in hard assets.

- Consider pure beta options such as EQIS Energy ETF, EQIS Precious Metals ETF, EQIS Materials ETF, and EQIS Commodities ETF.
- Consider actively managed commodities strategies such as American Beacon AHL Managed Futures Fund and Parametric Commodity Strategy Fund.

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