



By Patrick Fearon-Hernandez, Bill O’Grady, Mark Keller, and Joe Hanzlik

The Case for Hard Assets: An Update

First Quarter 2025

Background and Summary

Secular markets are defined as long-term trends in an asset. There are both secular bear and bull markets. In most markets, there are also *cyclical* bull and bear markets, often tied to the business cycle, and in some markets, there are *seasonal* bull and bear markets that are usually tied to annual production or consumption cycles. For example, a secular bull market in bonds is characterized by falling inflation expectations that trigger steady declines in interest rates. A secular bear market in bonds is caused by the opposite condition — rising inflation expectations that drive interest rates consistently higher. In comparison, a cyclical bull market in bonds is often related to the business cycle and monetary policy.

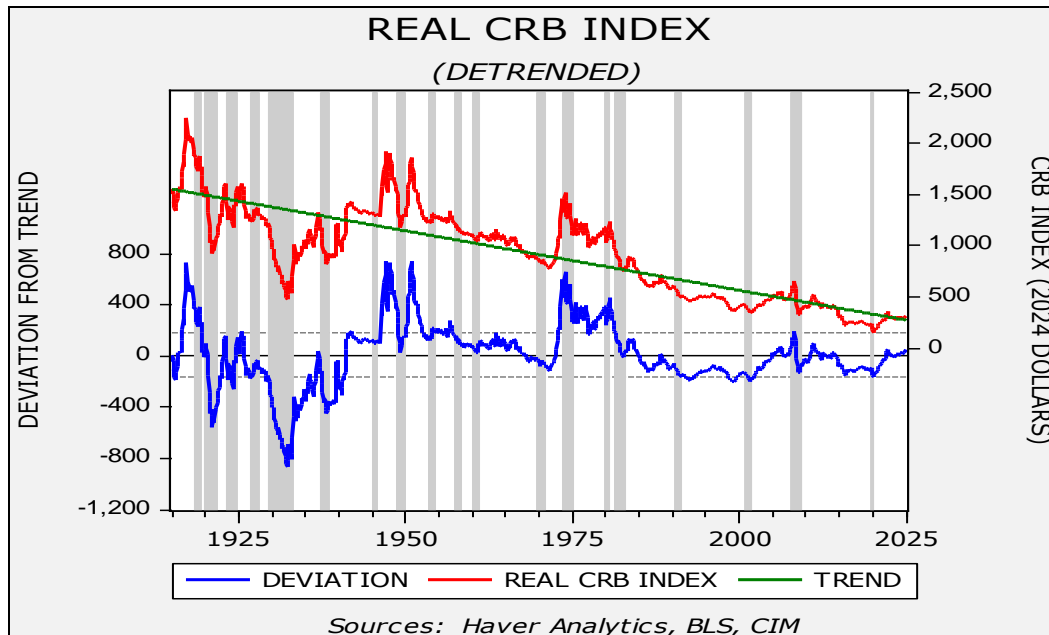
In general, secular cycles tend to last a long time. Using bonds as an example, we are likely concluding a four-decade secular bull market, which encompassed several cyclical markets as well. The length tends to be tied to specific characteristics of each market.

Commodity markets have secular cycles as well. Commodity demand is mostly a function of economic and population growth, whereas commodity supply comes from agriculture, ranching, mining, and drilling. As the chart on the next page shows, commodity producers are likely to face a serious secular headwind as capitalist economies tend to persistently improve their efficiency in producing finished goods from raw commodities. Commodity production is also subject to steady improvement in productivity.

In terms of commodity supply, sectors have varying levels of capacity to respond to changes in demand. For example, agriculture markets can react rather quickly. In the major grain markets, there are two main growing seasons: April through September in the Northern Hemisphere and October through March in the Southern Hemisphere. If a problem develops in one growing area, there is typically a chance to resolve it a few months later. Softs markets are similar to grain markets in this regard, although tree crops, such as coffee or cocoa, can take a few years. With livestock, the rate is a few weeks (poultry) to a couple of years (cattle). Energy markets usually take at least 18 months to respond and can even take years to develop large and complex oil fields. New mining supply can take up to a decade.

Since the “hard” assets (e.g., energy and minerals) are more likely to experience multi-year price trends due to their slower supply responses, we favor these assets. However, the converse is also true: Once a supply response occurs, it can create excess supply for a number of years. In the past, we have seen situations where high prices not only led to an eventual supply response but a demand response as well. We note a casual comparison of [US automobiles from the 1960s to the](#)

1990s. The average miles-per-gallon (mpg) of a US vehicle in 1965 was 14.5 mpg. By 1990, this number was 20.2 mpg. Oil companies expanded production in the 1970s in response to high prices, only to see the expanded capacity continue to supply the market when demand waned. The outcome was generally weak prices into the early part of this century.



The above chart depicts the CRB commodity index deflated by US CPI starting in 1915. The green trendline on the chart is generated by regressing a time trend through the deflated CRB index. The downtrend is obvious. In fact, this may be one of the most important reasons why capitalism triumphed over communism — the Soviet Union’s economy was simply unable to improve its productive efficiency in this manner. So, while this is a benefit to capitalist economies broadly, it creates a challenging environment for commodity producers. Essentially, the real value of their output tends to fall over time, meaning that commodity producers must constantly improve their productivity in order to make a reasonable return on investment. Of course, another alternative is for producers to combine and create market power. Throughout history, there have been various cartels among commodity producers, the most famous being OPEC. Another factor that affects various commodity sectors is the ease of entry into and exit out of a market. If it’s relatively easy to expand or contract production, then firms in these commodity markets face relentless pressure. On the other hand, if expanding production is hard, making it difficult to enter or leave a market, then firms have some degree of market power.

The lower line on the above chart shows the deviation from that trend. Although the downtrend is dominant, there are four clear examples of when real commodity prices moved sharply above trend. There are two factors that lead to periods of high real commodity prices — war (especially mass industrial conflicts) and monetary debasement. All four periods of above-trend commodity prices are tied to wars: WWI, WWII, Korea, and Vietnam. Wars affect commodity markets in numerous ways. First, they disrupt global trade. During peacetime, potential adversaries often trade with each other, but the outbreak of hostilities disrupts these trade flows and can lead to

localized shortages of commodities. Nations, firms, and households facing shortages usually react by hoarding, which boosts demand for commodities and raises their prices. Second, disruptions in trade flows can also interfere with the flow of goods necessary to produce the commodities in the first place, which can reduce the supply of the affected commodity. Third, nations at war tend to expand fiscal policies to make war material. This fiscal expansion typically boosts demand for everything, which in turn lifts prices. In addition, war often leads nations to abandon hard-money monetary policies, forcing central banks to support the war effort. Stimulative fiscal and monetary policies tend to support commodities. As government spending for war increases, inflation often results.

Monetary debasement is the second factor that tends to lead to periods of high commodity prices. President Nixon's decision to move the US off the gold standard in 1971 not only led to price instability and an inflation crisis, but it also moved the world from a dollar/gold standard to a dollar/Treasury standard, with Treasuries replacing gold as the reserve asset. After nearly a decade of high inflation and unstable prices, Federal Reserve Chair Paul Volcker restored order by showing the world that the US would implement monetary austerity. The combination of Volcker's tight monetary policy, globalization, and deregulation tamed inflation. In the aftermath, a global fiat currency standard was established. Industrialized nations adopted central bank independence and a clear inflation target to build confidence that policymakers would implement austerity to stabilize prices. The Volcker consensus created conditions that gave credibility to fiat currencies.

As the above chart shows, commodity prices fell below trend by the mid-1980s and remained below trend until the early 2000s, when China's remarkable economic development triggered a commodity demand shock that lifted the real CRB index above trend. However, this commodity bull market paled in comparison to the war/debasement-driven commodity bull markets of the past. As China's growth has slowed, commodity prices have fallen back to their long-term downtrend.

The Impact of the End of the Cold War

In 1989, Eastern Europe freed itself from Soviet domination, and the removal of the Berlin Wall symbolized the unwinding of the Soviet bloc. By 1991, the Soviet Union had dissolved, ending the Cold War. During the 1980s, the Free World had been steadily globalizing, leading to increasingly unified markets, including commodity markets. The end of communism accelerated that process by extending globalization to the former communist bloc. Increasingly, commodity prices became globalized; price differences were arbitrated away, with the differences mostly reflecting transportation costs.

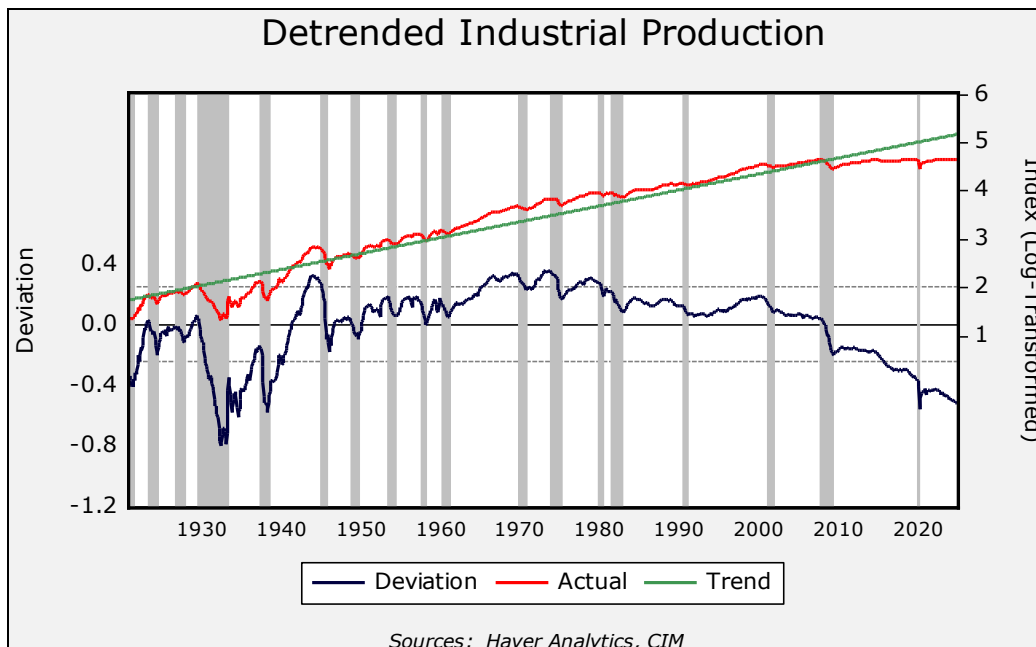
From an economic perspective, expanding globalization led to a trading system envisioned by Adam Smith and David Ricardo. Essentially, nations traded with a focus on efficiency, giving little consideration to geopolitical risk because that risk was thought to have ended with the fall of the USSR. Supply chains were optimized to reflect efficiency over security. This pattern included commodity markets as production generally gravitated to the lowest-cost producers. Although this led to lower overall inflation and generally depressed commodity prices (excluding the China bull market), vulnerabilities were created.

The Return of Geopolitics

After 1991, the US was the undisputed global hegemon. The US developed the Washington Consensus, which argued that the end of communism as an alternative economic system meant it was undisputed that policies of open capital markets, floating exchange rates, and open trade were the only reasonable way to organize economic activity. That didn't mean that every nation followed those policies completely, but much of that policy mix was adopted.

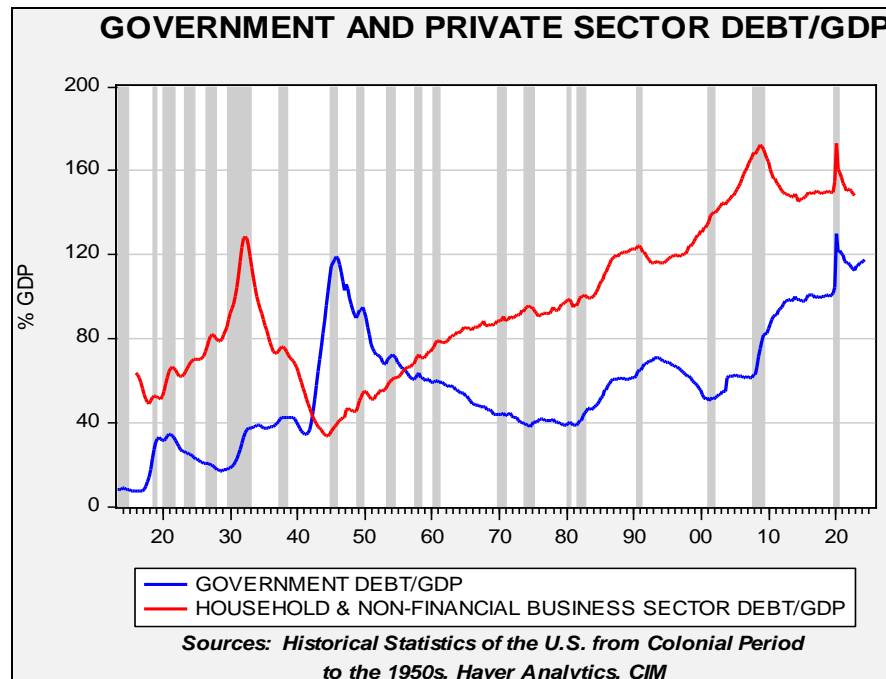
In fact, several important nations engaged in neo-mercantilist economic policies. China, Germany, and South Korea deliberately suppressed consumption and promoted exports, which undermined the US industrial base and was a contributing factor to US debt growth.

First, we examine the impact on the industrial base in the US.



The lower line in the above chart shows the deviation of US industrial production from its long-term trend. This deviation peaked against trend in 1973 and slowly declined thereafter. However, since the Great Financial Crisis, the trend has turned decidedly negative. This low level of production is inconsistent with hegemony; it's hard to be the "arsenal of democracy" if you can't produce at scale.

Next, let's discuss the debt problem.



When most people talk about a “debt problem,” they focus on government debt. And although government debt is a concern, it is not problematic in the same way that private sector debt is. The latter can cause debt liquidations, which were the primary cause of the Great Depression and the Great Financial Crisis. Note that after 1980, private sector debt began to rise at an increasing rate. This debt is being driven by global imbalances, which are facilitated by the dollar/Treasury reserve currency/reserve asset system.¹ During the Great Depression, the private sector debt overhang was resolved by debt/deflation. This led to a banking crisis and excessive unemployment. By the time the US entered WWII, private sector debt was quite low, providing the economy with ample borrowing capacity to fund the war effort. Government debt/GDP peaked at 120% by the end of the war. To resolve this excessive debt, financial repression was implemented. Essentially, long-term government borrowing rates remained persistently below the growth rate of nominal GDP. The Federal Reserve supported this effort by fixing rates along the entire Treasury yield curve. Although the US central bank gained its independence from the Treasury in 1951 and ended yield curve control, by then, the debt level had declined to 75% of GDP. Less obvious forms of financial repression remained in place into the 1980s through the implementation of deposit caps ([Regulation Q](#)) and capital controls.

It should be noted that there is no exact level of debt/GDP that automatically suggests there is an issue. In general, it only becomes obvious there is a problem in the economy when borrowers struggle to service their debt. History would suggest, though, that a private sector debt ratio around 80% is sustainable. Since debt/deflations are probably not possible under democracy, such private sector debt problems are usually resolved with a public-private debt swap. Essentially,

¹ For an in depth analysis of this process see: Pettis, Michael, and Klein, Matthew. (2020). *Trade Wars are Class Wars: How Rising Inequality Distorts the Global Economy and Threatens International Peace*. New Haven, MA: Yale University Press.

private sector debt is moved to the public balance sheet and then governments deploy [financial repression](#) to reduce public debt ratios. How does financial repression work? The usual playbook includes caps on interest rates for depositors and government debt, regulation to force various entities to buy government debt, central bank subsidization of government debt, issuance of non-marketable government securities, and tolerance of higher inflation.

What makes the current situation concerning is that, at least in its initial stages, the public-private debt swap causes the public sector's debt ratio to rise. Unfortunately, US public sector debt is already at a historically elevated level. This doesn't mean that more debt can't be issued, but the combination of higher price levels and Treasury debt, which is likely to remain an attractive asset, suggests that investors will probably be searching for ways to protect their purchasing power. *We expect commodities to become an increasingly attractive way to protect purchasing power.*

The Impact of COVID

The 2020 COVID pandemic revealed the fragility of global supply chains as it created widespread supply shortages and showed just how supply chain management had evolved into a system with little resiliency. Just-in-time inventory management systems rely on uninterrupted trade flows, and the pandemic caused a myriad of problems that led to shortages in some markets and excess goods in others. As the pandemic waned, supply chains did eventually recover. However, the vulnerabilities revealed by the pandemic raised concerns about the way nations had become overly dependent on foreign sources.

In addition to the pandemic, both China and Russia have rebelled against the US-led global order. For the first time since 1991, the world is facing great power competition, which, in our opinion, is leading to the formation of blocs of allied nations. This situation is not only increasing the odds of conflict, but it is also breaking down the post-Cold War globalization that stabilized inflation after 1980.

We believe the next major bull market in commodities will likely be driven by the steady erosion of US hegemony. Charles Kindleberger postulated that the world economy functions best when there is a global hegemon. This idea, known as "hegemonic stability theory," was expressed in Kindleberger's [book about the Great Depression](#). The hegemon provides two global public goods. First, it has the ability to project power globally, which tends to keep regional wars from expanding. This power projection leads to geopolitical stability. Second, the hegemon provides various financial functions, including the reserve currency and the reserve asset, and acts as global financier and importer of last resort. When a hegemon is functioning properly, large wars are less likely and global trade expands via the use of the reserve currency and asset. Kindleberger's theory was that the Great Depression occurred because the British were no longer able to provide global financial stability and the US was unwilling to accept the role. World War II followed, in part, due to the breakdown of British hegemony. When the US accepted the mantle of hegemon after the war (which was shared with the Soviets until the early 1990s), the world economy generally stabilized, although it was not without its challenges as the 1970s showed.

As we noted above, since the end of the Cold War, the US has struggled to formulate a foreign policy that allows the US to simultaneously provide the global public goods of security, reserve

currency, and reserve asset in a manner compatible with domestic stability. The wars in Afghanistan and Iraq taxed the volunteer military, and the persistent trade deficits, which are necessary to supply dollars to the world, have led to the loss of jobs and deindustrialization. The rise of populism and deep societal divisions are due, in part, to the divergent policies required to address the domestic political situation and maintain global hegemony. As the political class attempts to improve the domestic situation, it will become increasingly difficult to maintain US hegemony as it was practiced from 1945 to 1991.

Political developments since 2008 suggest that internal political stability in the US has become a higher priority than global stability. We expect the breakdown in global order to bring higher commodity prices.

1. As the US attempts to maintain global order, it is increasingly relying on financial sanctions rather than military intervention. The use of financial sanctions was arguably most aggressively used against Russia following its invasion of Ukraine, rendering the majority of Russia's foreign reserves untradeable. Thus, sanctions have raised concerns among other nations that the accumulation of dollar reserves is risky; however, given that there are few attractive alternatives to the dollar and Treasuries, we expect less global trade over time (which is inflationary) and the diversification of foreign reserves into gold and other commodities. Although inferior to the dollar/Treasury system, gold and other commodities are also less sensitive to sanctions.
2. The rebuilding of the US industrial base will lead to industrial policies that will be at least partly protectionist. Trade impediments tend to reduce efficiency and increase inflation. At the same time, a recovery in US industry will also likely boost commodity demand.
3. The Biden administration attempted to prioritize national security over efficiency, and the stated policies of the Trump administration would suggest the new government intends to expand this goal. This focus has the potential to be inflationary.
4. As the world evolves into blocs, [resource nationalism is returning](#). Several nations have restricted commodity exports for various reasons. In some cases, commodity producers want to process these goods themselves to boost margins. In other cases, a nation may try to constrain supply to extract favors from a more powerful country. Conflicts can destabilize markets; for example, Russia's invasion of Ukraine disrupted the global wheat market for nearly a year. The European natural gas market has also been volatile as Europe steadily lost access to inexpensive Russian gas. The US has been a major supplier to that market in the form of LNG, but it would not be a complete surprise to see the US government cap exports to keep US natural gas prices low. Thus, we may be in a world where price differences become difficult to arbitrage and will likely lead to persistently high prices in some markets. Resource nationalism could return the world to a Cold War environment and might also trigger hoarding, further lifting demand and prices.
5. The continued war in Ukraine and the rising tensions in the Far East are leading to heightened international tensions. Fears of war are boosting defense spending and commodity accumulation.

From the end of the Cold War until 2020, the world was in a “unipolar moment” where the US was the undisputed global hegemon. The US shaped a world that favored capital as American

security coupled with the power of the dollar allowed firms around the world to source labor at its cheapest location and use the power of technology to create nearly seamless supply chains. This world of “just-in-time” logistics was generally disinflationary. Although the first eight years of this century were bullish for commodity prices, it was only due to the historic growth in China. We are now seeing something different evolve. The world order is fracturing; several developing nations are turning away from the US-led world, which is escalating geopolitical risk and disrupting supply lines. There is growing uncertainty surrounding the dollar’s role as the reserve currency and the Treasury as the reserve asset. Overall, we expect this backdrop to increase demand for natural resources to ensure supply availability. Put another way, the world we are anticipating will be much different and riskier than the one that existed from 1990 to 2021. The Confluence Global Hard Assets strategy is our response to that world.

The Global Hard Assets strategy focuses on commodities that require multiple years to generate a supply response. Thus, we are currently focusing on markets that have costly and difficult barriers to entry. We invest in companies responsible for the extraction of these hard assets, excluding those firms involved in ancillary or support functions. In practical terms, this means mining companies rather than mining equipment providers. The portfolio may also hold exchange-traded funds that invest directly in commodities.

Concluding Thoughts

1. We consider this portfolio to be a strategic alternative asset. In other words, its function is to protect against the breakdown of US hegemony. Investors should remember that commodity prices are cyclical, and that even in secular bull markets, commodity prices will tend to decline during recessions.
2. Although current US monetary policy is attempting to return to orthodoxy, elevated debt levels in both the public and private sectors will likely lead to a return to unorthodox policies. Such unorthodox policies will tend to undermine the Volcker solution that gave confidence to holders of fiat currencies. If the Volcker consensus breaks down, a return to the inflation and commodity volatility of the 1970s is possible.
3. This portfolio isn’t specifically an inflation hedge as we think that natural resource prices should be supported without reflation. However, if inflation does develop, and signs suggest it likely will, we would expect this portfolio to benefit.

Patrick Fearon-Hernandez, CFA, *Chief Market Strategist*

Bill O’Grady, *Advisory Director — Market Strategy*

Mark Keller, CFA, *CEO/Chief Investment Officer*

Joe Hanzlik, *Equity Analyst*

This report was prepared by the Global Hard Assets Investment Committee of Confluence Investment Management LLC and reflects the current opinions of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. Information does not constitute a solicitation or an offer to buy or sell any security.



Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics, and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.