BRAMSHILL INVESTMENTS
June 2023

MONTHLY INSIGHTS

World Energy Markets and the Dollar: Entering a New Era

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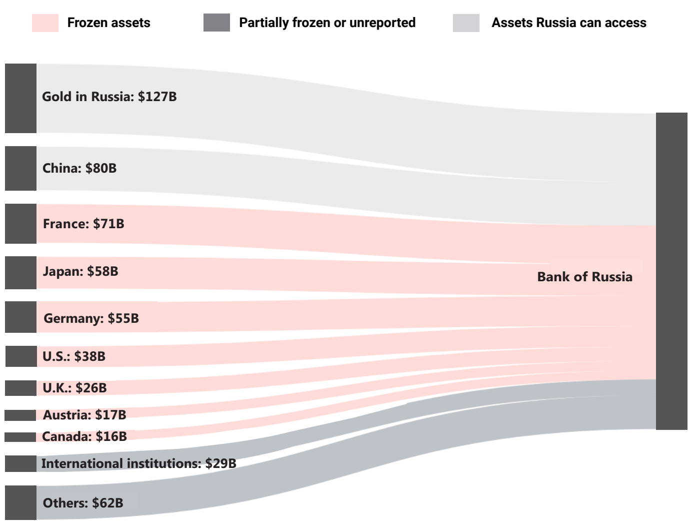
Introduction

The US economic sanctions on Russia following its invasion of Ukraine seem likely to have far reaching consequences in the energy and currency markets. Since World War II, the dollar has been the basis of international trade, backed by gold until 1971 (as well as US economic and military might) and later by oil when Henry Kissinger negotiated an agreement with Saudi Arabia in 1974 to accept only dollars in payment for their oil exports. With Saudi Arabia (and by extension OPEC) as the marginal supplier of world oil, any oil importing nation had an immediate need to acquire dollars to pay for oil (often for other imports as well). This had the further consequence that US Treasuries became a favored reserve asset for many nations as they could be readily converted into dollars. This stability came to a sudden halt (often little appreciated in this country) when the US confiscated most Russian reserve assets, largely dollar based, as detailed in the chart below. Heretofore, the dollar had not been used so directly as an instrument of foreign policy. Nations outside the Eurozone and eastern Asian US allies, already chafing in many ways at US economic dominance, accelerated their existing efforts to de-dollarize their trade and currency reserves. We believe this will have far reaching impacts on domestic investment risks and opportunities.

Russian Reserve Assets Confiscated

Seven countries have frozen assets barring Russia from a least $284 billion.



Source: Bank of Russia Foreign Exchange and Gold Management Report and NBC News

De-dollarization

There are two elements to "de-dollarization" which are often confused. As a reserve asset, governments hold US Treasury Bonds to settle trade imbalances and stabilize their currencies. It is this function which the seizure of Russian assets has probably foreclosed for many nations not closely aligned with US foreign policy. Separately from reserve assets, trade transactions between nations must take place in some currency, most commonly dollars, which are liquid, stable, and easily converted into US Treasuries as a reserve asset. If trade takes place in another currency, the creditor must be willing to hold that currency or convert it into something suitable for longer term holding. This was recently made possible for China by agreement between China and Saudi Arabia whereby the Saudis would accept Chinese yuan in payment for oil (the largest internationally traded commodity) with the ability to convert them into gold on the Shanghai exchange, thus beginning the dismantlement of the Petrodollar system.

The Saudi Pivot

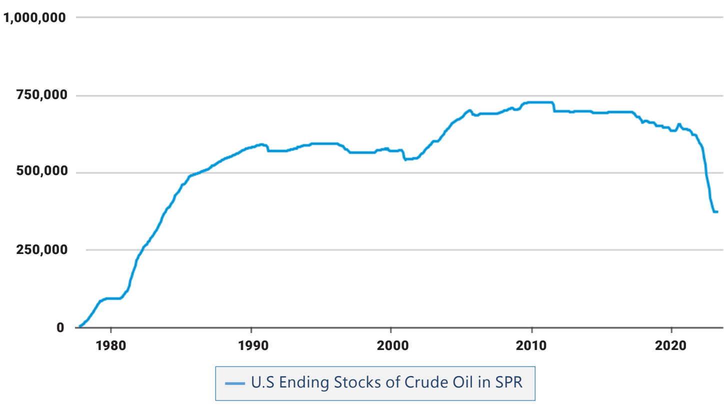
A palpable rift has begun to manifest between the current leadership in Saudi Arabia and the US, with the Saudis increasingly looking to China, Russia, and other Asian nations as their principal allies. China has replaced the US as the Kingdom's largest oil customer, and Russia has become a prime ally in managing oil price. China has mediated the resolution of the Saudis' longstanding feud with Iran, and Chinese President Xi's visit to the Kingdom to cement relations was a stark contrast to President Biden's frosty and unproductive 2022 visit in which he sought but did not receive a commitment to increase Saudi oil production.

The two nations have been consistently at odds in oil markets recently. The Saudis need relatively high oil prices to fund their massive budget and social programs. The Biden administration targeted high gasoline prices as a major driver of sky-high inflation and released barrels from the US Strategic Petroleum Reserve SPR to drive prices down (conveniently before midterm elections). More recently, on the demand side fears of a recession and a slower China reopening have been the driving narratives keeping a lid on prices. Much to the consternation of the Saudis, the administration has failed to add to demand by aggressively refilling the SPR at lower prices. This is widely believed to have prompted OPEC+ (led by the Saudis) to recently announce two major production cuts.

The Strategic Petroleum Reserve now stands at low levels not seen since the early 1980's as shown in the chart below.

U.S. Ending Stock of Crude Oil in SPR

Thousand Barrels



Source: US Energy Information Administration

Broader De-dollarization Trends

In March of this year, it was reported that India was buying Russian oil using the UAE's Dirham and Russian Rubles. Brazil and China recently agreed to transact all future trades in their own currencies. Saudi Arabia agreed to become a "dialogue partner" in the Shanghai Cooperation which allowed China to broker a deal to establish diplomatic relations between the Kingdom and Iran. Also, French oil company, Total, agreed to buy LNG from the Chinese in Yuan.

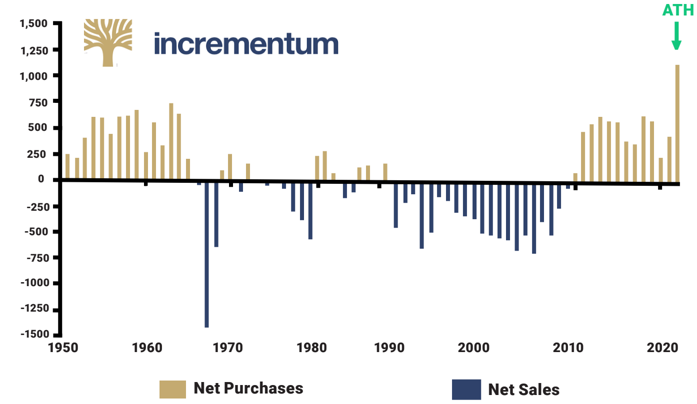
With the BRICS (Brazil, Russia, India, China, and South Africa.) countries attempting to reduce their reliance on the US dollar as the dominant global reserve currency, they have been engaging in bilateral currency swap agreements, which allow for direct trade between their respective currencies without the need for US dollars for cross-border transactions. It is important to note that these efforts have been relatively limited thus far and have not yet significantly destabilized the US dollar's status. For context, in the 20 years up until 2019, the Federal Reserve estimates that the dollar accounted for 79% of global trade transactions.

In addition to these bilateral agreements, ongoing efforts by multilateral organizations such as the Eurasian Economic Union, the Shanghai Co-operation Organization, and BRICS have accelerated since last year's Russian sanctions. While these organizations are less well developed than their Western counterparts, a common theme in all of their de-dollarization discussions have been greater use of members' currencies combined with various forms of commodity backing, with the most obvious of these being gold as a recognized national reserve asset, and oil as the most traded global commodity by far.

The tenor of these discussions is underscored by the action of global central banks in the gold market. The Global Financial Crisis of 2007-8 was a watershed event for overseas perceptions about the dollar as a reserve currency. Leading up to that event, US monetary policy did not maintain the dollar's value relative to gold and oil, leading to various interest rate hedging strategies which failed in the crisis.

Consequently, global central banks which had been net sellers of gold prior to this event became net buyers, with purchases reaching an all-time high last year, as illustrated in the chart below. Given the current geopolitical climate, we see every likelihood that this will continue.

Global Central Gold Purchases, in Tonnes, 1950-2022



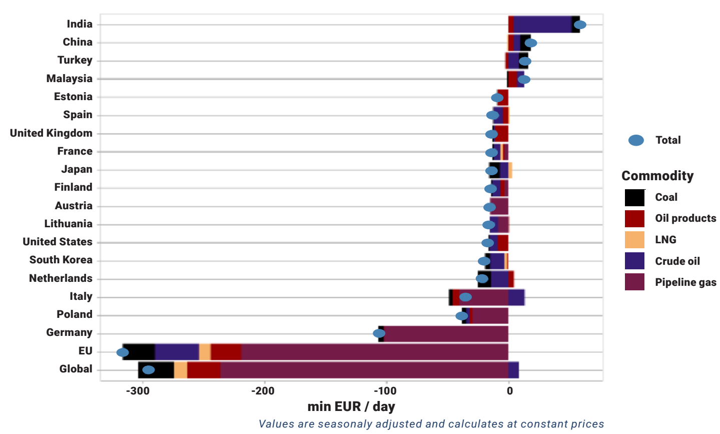
Source: World Gold Council and Incrementum AG

Russia/Ukraine Conflict

Quite apart from the sanctions and asset confiscation issue, the conflict in Ukraine has deeply impacted the global supplies of key commodities. Russia is a top 3 global crude producer and Europe had been dependent on Russia for much of its crude and natural gas supplies. As noted in the chart below, the impact of the conflict and associated sanctions lead to a reduction in energy exports from Russia, though some were shifted to India and China from Europe. Both Russia and Ukraine are major exporters of agricultural products and inputs such as fertilizer as well as energy. The conflict has disrupted commodity production throughout Eastern Europe and hampered global commodity trade, particularly through the Black Sea. With the sanctions imposed on Russian exports, Europe had to look elsewhere for sources of energy and agricultural commodities which raised global prices and impacted food and energy availability in less wealthy regions. A warmer than normal winter saved Europe from potential catastrophe, but assuming weather trends revert to historical norms, these shortages and price pressures could easily extend into next year and even beyond.

Changes in monthly import volumes from Russia

September 2022 compared to February-March 2022, seasonally adjusted



Source: Centre for Research on Energy and Clean Air

Conclusion

Although it is very difficult to predict the timing of developments, we believe that more and more countries outside the direct US sphere of influence will seek to peg their currencies to some form of commodity, fiat currency other than US dollars, or gold. Demand for dollars, either for international transactions or reserves, will gradually decline. Commodity producing countries, led by major energy exporters, will be less accommodating to US political objectives if not directly hostile, as Saudi Arabia has been recently in its unwillingness to moderate oil prices. Consequently, we expect prices of globally traded commodities to increase over the longer term in dollar terms, though short-term volatility will, of course, come from economic cycles. With new investment often restricted by the US government, we believe that existing domestic producers, transporters, and processers of most commodities with costs in dollar terms could be on the verge of an extended period of high profitability.

What investments benefit from these trends? We believe domestically based hard asset producers and transportation systems will be in the sweet spot, benefiting from a weaker dollar cost base and higher prices for their production. This will include most forms of domestic energy production, including both fossil fuels and renewables which can serve both domestic and export markets as well as transportation systems such as pipelines and tankers. LNG may experience strong growth given the arbitrage between domestic and overseas gas prices. Agricultural products should do well also, yielding opportunities in equipment manufacturing and fertilizer producers. Gold will be a special case due to demand for it as a reserve asset. Industrial metal prices are likely to be more volatile than gold, but the trend toward electrification for climate reasons will bolster long term demand for copper, nickel, rare earths, lithium, and many other metals. Increasingly, we are witnessing attempts by national governments to control resources for which they are primary suppliers, such as China in rare earths, Chile in lithium, and Indonesia in nickel. This trend will tend to bolster these commodity prices in dollar terms. Obviously, attention must always be paid to the investment characteristics of each prospective holding, with an emphasis on sustainable high free cash flow and distributions.

About Bramshill Investments

Bramshill Investments is an alternative fixed income asset manager with over $4.4 billion in assets under management as of May 31, 2023.

Founded in 2012 and headquartered in Florida, with offices in California and New York, the firm offers alternatives to traditional fixed income investment management featuring a variety of strategies across various debt and fixed income markets and specializing in preferred securities.

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