Infrastructure remains resilient despite macro challenges

Will infrastructure remain resilient as monetary policy tightens, interest rates rise and the war in Ukraine stretches into its second year?

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Tightening monetary policy, rising interest rates, the Russian invasion of Ukraine and a limited banking crisis have shifted the macro landscape to the point where a global recession is increasingly likely in 2023. Whilst the infrastructure asset class is not immune to these challenges, we expect it to remain resilient given favourable links to inflation and steady underlying demand.

Macro challenges abound

After years of expansionary monetary policy, central banks are currently walking a tightrope, fighting inflation with rapid rate rises, whilst trying to deliver a soft landing for the global economy and preventing a full-blown banking crisis.

Mortgage interest rates have more than doubled in the past year in the US and UK, and European households are facing the further challenge of sharply higher utility bills as supplies of energy are curtailed.

These global challenges are problematic for investors as the combination of slowing growth, high inflation and tightening monetary policy has resulted in significant weakness across listed equities and fixed income markets in the latter part of 2022. The high correlation between listed equities and fixed income has severely reduced diversification benefits in mixed asset class portfolios. In this challenging macro environment, we think that there are good reasons to believe that unlisted infrastructure will continue to perform relatively well.

Inflation and infrastructure – the natural hedge

The return of inflation and the associated sharp rise in interest rates were dominant global themes in 2022 and have continued to be a key focus in 2023, along with the integrity of the banking system and continued geopolitical tensions.

To recap, higher interest rates have traditionally been viewed as a negative for the performance of long-duration investments like infrastructure, as they put downward pressure on asset valuations. This is directly due to the potential increase in the cost of borrowed capital, and indirectly because the discount rate used to value cash flows is likely to increase in response to changes in the risk-free rate (which is linked to long-term sovereign bond rates).

What we find in practice, however, is that the valuations within a well-constructed Infrastructure portfolio tend to be positively impacted by the root cause of higher rates – namely inflation. Infrastructure assets are often positively linked to inflation through contracted increases in prices for services that are linked to CPI. Such arrangements are common amongst regulated utilities, toll roads and ports, and they normally mean that the negative impacts from higher rates are at least partially offset by the positive influence of inflation on revenues.

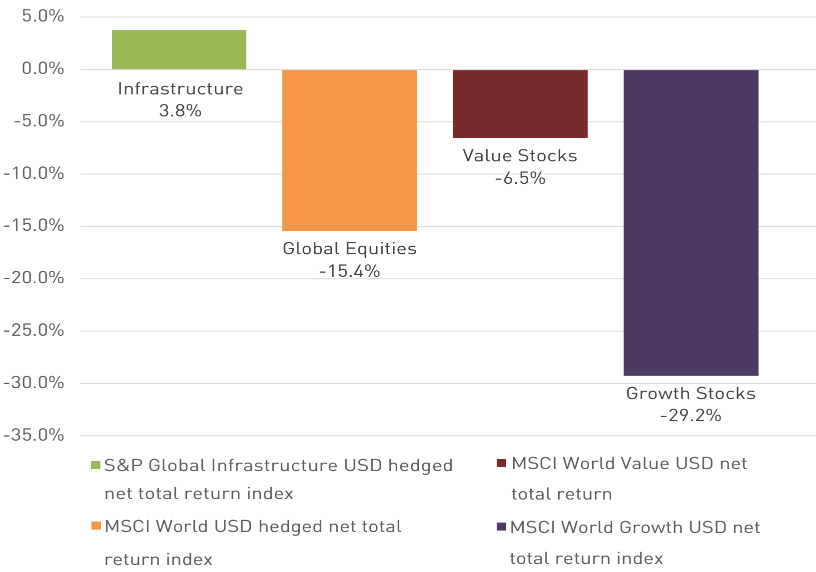
There are two important points to note regarding the pressures brought by rising rates. Firstly, infrastructure managers should have been capitalising on the recent long period of relatively low rates, so the impact of increased rates will be gradual as laddered long-term debt is refinanced.

Secondly, with respect to discount rates, independent valuation firms used by asset managers tend to take a long-term view when setting the risk-free rate, taking into account historical long-term sovereign bond rates and sustained changes in those rates. These factors are evident in both listed and unlisted markets, where infrastructure valuations tend to be less volatile than the broader equities market in response to negative macro events.

What if the global economy enters recession?

Revenue for most infrastructure assets is of course a combination of price times volume. As populations and economies grow, and the use of essential services increases, this can have positive flow-on impacts to revenues. Therefore, both price inflation and economic growth can provide infrastructure assets with a natural hedge that may offset any adverse impacts from rising rates.

Listed Market Returns, 2022 Calendar Year*



*Although markets remained volatile at the beginning of 2023 led by a recovery in growth stocks, the relative performance for the period 1 Jan 2022 - 21 March 2023 remains similar to that in Figure 1, with the S&P infrastructure index significantly outperforming the other listed indices.

The other side of this dynamic presents a key risk for 2023, namely the possibility that central bank monetary policy tightening proves too aggressive and global economic activity pushes into recession territory. But even in this scenario, we think that an investment in a mature well-diversified infrastructure portfolio would generally outperform broader equities investments, and potentially most other asset classes.

We have this conviction because infrastructure businesses generally operate real assets that provide essential services to the communities they serve. Underlying demand for these services tends not to be subject to the same level of competitive forces that exist in many other industries.

Although a period of weak economic growth, particularly accompanied by a rapid deceleration of inflation, could result in more subdued performance of assets within GDP-linked transportation sub-sectors, exposure to a balanced portfolio which includes diversified utilities and contracted services should mitigate the effect of cyclical performance.

Interestingly, this view seems to be well-supported by the recent performance of listed infrastructure assets. It is well known that listed investments can be more volatile as they are subject to broader swings in market sentiment than unlisted infrastructure, where best practice is to have investments valued quarterly by professional independent valuation firms, under various well-recognised accounting and valuation standards.

Nevertheless, despite the choppy market conditions in 2022, the S&P Global Listed Infrastructure Index (USD Hedged Net Total Return) was up 3.8% over the 12 months to 31 December 2022, while the broader MSCI World Equities Index (USD Hedged Net Total Return) performance was significantly weaker at -15.4%. Further, although Infrastructure is often classified as being a mix of "defensive" and "growth" investment styles, listed infrastructure significantly outperformed both Value and Growth stocks in 2022 as shown in Figure 1. We believe this demonstrates that even listed asset markets are recognising the resilience of the infrastructure asset class in the current volatile, rising rates and inflationary macro environment.

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