ClearBridge
A Franklin Templeton Company

Global Infrastructure Value Strategy

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Key Takeaways

- Infrastructure rose in the second quarter but trailed global equities modestly as strength in defensive sectors faded late in the quarter.
- Growing power demand from data centres supporting AI was a positive for both utilities and energy infrastructure.
- With increased confidence that we are at the end of the rate hiking cycle and now looking toward the start of the rate-cutting cycle, we believe this could be the start of the turn for many of our long-duration assets such as towers and renewables.

Market Overview

Infrastructure and global equities rose in the second quarter, with infrastructure trailing global equities modestly as strength in defensive sectors faded late in the quarter, despite a moderation in bond yields. Overall, as investors began to appreciate the growing power demand from data centres supporting AI, this was positive for electric utilities. Energy infrastructure also benefited from an improving natural gas price outlook and growing acknowledgment that midstream infrastructure plays a key role to back up renewable power as AI demand grows.

Airports were weaker, by contrast, amid lower summer traffic expectations for some European airports, while a mix of coal haulage, fuel headwinds and a loose truck market placing pressure on tariff increases for the rails weighed on that sector.

By region the U.S. and Canada delivered the strongest performance, with returns cantered around the abovementioned drivers for electric utilities and energy infrastructure, while concerns over possible government intervention in Brazil weighed on performance in Latin America. Japan’s rail traffic recovery plateaued and looked to settle on a new normal, meanwhile, dragging down Asia Pacific Developed. We used the opportunity to crystallise some gains and exited our positions in Japanese rail operators Central Japan Railway and East Japan Railway.

In addition to airports weighing on Western Europe, U.K. water lagged largely due to political turmoil in the U.K., with a snap election and a water regulator ruling set for early July. Listed water companies there have also been unduly discounted due to trouble at an unlisted peer. Near-term political volatility could represent a buying opportunity for listed U.K. water utilities, however. Their spending on improving environmental impacts adds to the bottom line, and their investments can earn attractive allowed returns, which translates to better earnings and dividends. The listed water infrastructure companies we like are leaders in environmental responsibility with strong track records and targets for environmental performance that we believe the regulator and investors will reward over time.

Portfolio Highlights

Electric utilities were the top contributors for the quarter, with U.S. utilities NextEra Energy and Public Services Enterprise Group the lead performers. NextEra Energy is an integrated utility business with a regulated utility operating in Florida and is the largest wind business in the U.S. NextEra's regulated business, including Florida Power & Light, serves nine million people in Florida. Shares benefited from a positive readthrough to power and renewables demand as a result of data centre growth from AI.

Public Services Enterprise Group (**PEG**) operates the largest utility business (~90% of earnings) in New Jersey, along with a generation business (~10% of earnings) comprising nuclear assets. PEG's share price benefited from the company's potential to sign a data centre deal where nuclear will provide power at a premium price.

U.S. rail operators CSX and Norfolk Southern were the largest detractors. CSX operates the second-largest listed U.S.-centric railroad in terms of market cap operating in the East Coast. The company owns over 20,000 miles of track and operates across 23 states. Norfolk Southern is one of the five leading North American rail companies, engaged in the transportation of rail freight in the Southeast, East and Midwest U.S. and, via interchange with other rail carriers, to and from the rest of the U.S. and Canada.

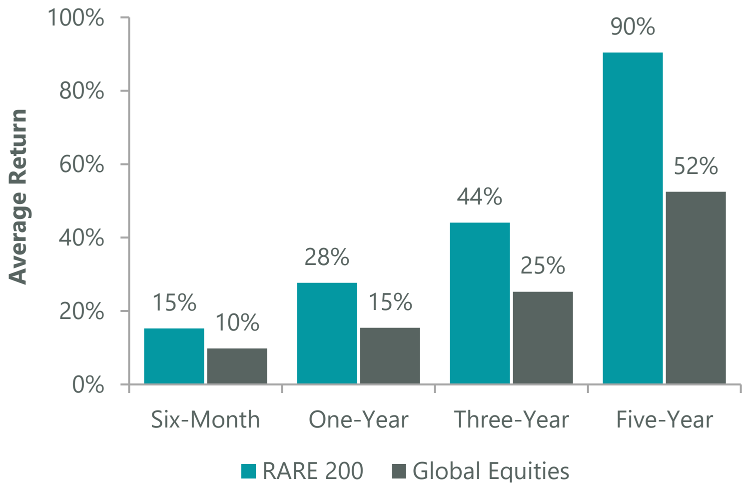
The U.S. railroad sector was weak in the quarter after rail companies talked down second-quarter results during conference season. This was on the back of a loose truck market, which has placed pressure on tariff increases for the railroads. While the pace of recovery in the U.S. freight market has been slower than our original expectations, we still expect an improvement in the operating environment in the back half of 2024 and early 2025, as excess trucking transportation capacity continues to rationalise in the softer pricing environment. We expect transportation supply and freight demand rebalancing to bode well for U.S. rails.

During the quarter, we used the opportunity to crystallise some gains and exited our positions in Japanese rail operators Central Japan Railway and East Japan Railway.

Outlook

Whilst the past 12–18 months have been challenging for infrastructure due to the sharp rise in bond yields and bond volatility, in addition to the narrow market breadth, we think the macro headwinds are starting to become tailwinds. Historically, we have seen infrastructure outperform global equities over several time periods as interest rates have peaked (Exhibit 1), something to keep in mind as inflation indicators slow and allow major central banks to move toward easing. We also believe bond yields need not roll over for investors to benefit from infrastructure returns, but that merely reduced volatility of bond yields could be supportive of valuations, something we have seen in the past.

Exhibit 1: Infrastructure Performance Following Last Fed Rate Hikes



As of 31 March 2024. Source: ClearBridge, FactSet, Bloomberg. The RARE 200 is the combination of the investment universes (updated on a quarterly basis) for ClearBridge Investments' infrastructure strategies. Constituents as of 31 March 2024, measuring total return in local currency. Global equities: MSCI AC World Index, gross returns in local currency. Performance reflective of the six-month, one-year, three-year and five-year period following the last Fed rate hike prior to cutting cycles in 1989, 1995, 2001, 2007 and 2019.

We remain generally balanced between more defensive regulated utilities and more GDP-sensitive infrastructure names. With increased confidence by market participants that we are at the end of the rate hiking cycle and now looking toward the start of the rate-cutting cycle, we believe this could be the start of the turn for many of our long-duration assets such as towers and renewables. Notwithstanding near-term supply-side constraints around labour and aircraft deliveries, we are positive on airports, where valuations are attractive. Utilities should continue to benefit from themes of electrification, renewables growth and more recently higher electricity demand from data centres, and we remain constructive on the sector, given reduced valuations.