Infrastructure Outlook: Bridging the Valuation Gap

2 December 2024

Key Takeaways

- Infrastructure's differentiated returns offer some diversification away from the risks of concentrated trades, and with Trump's policies potentially leading to a second round of inflation, infrastructure's inflation pass-through mechanism will likely be all the more valuable in 2025.
- Peaking interest rates are a good sign for infrastructure, as we have seen it outperform global equities following the last Fed rate hike prior to cutting cycles, while at the same time we believe we're still seeing a catch-up of a gap between infrastructure earnings and total returns since 2022, and valuations are attractive for this reason.
- Opportunities continue to be widespread across the infrastructure landscape, with utility fundamentals some of the best we have ever seen and the market still massively underestimating the growth in electricity demand driven by AI and data growth.

Defensive and Diversifying Returns Valuable in 2025

The concentrated market of 2024 and the return of inflationary pressures are a good reminder of what sets infrastructure apart from other asset classes and why this will be valuable in 2025. First, infrastructure offers a differentiated source of returns: unlike general equities and real estate, the key driver of long-term returns for infrastructure investors is growth in the underlying asset bases. Regulators generally provide an allowed return with reference to the underlying asset base of these essential companies, though how this occurs varies by region. If the regulator is providing steady allowed returns on a growing asset base, we would expect earnings to increase at broadly the same pace as the underlying asset growth.

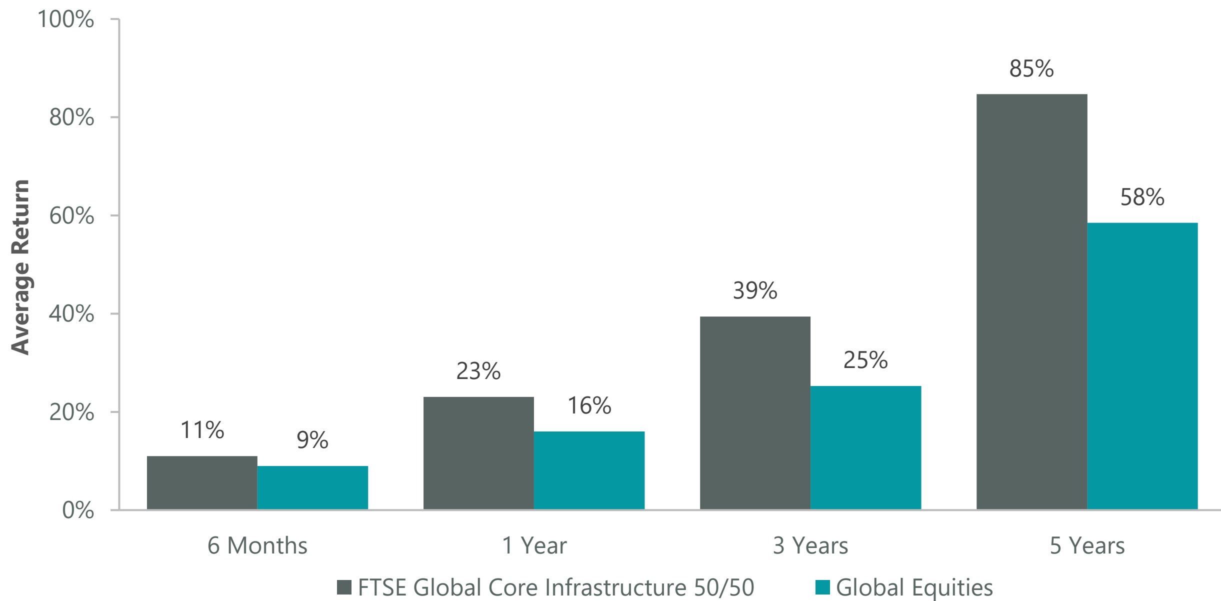
Second, infrastructure offers inflation protection. Infrastructure assets are designed to provide long-term benefit for their communities and stakeholders and, as a result, allowed returns are generally linked to inflation. This inflation "pass-through" mechanism allows prices paid by the users of the asset to adjust periodically and ensures that the returns to equity investors funding these assets are not eroded over time due to the effects of inflation. Importantly, this inflation pass-through can take anywhere from three months to three years to have an impact on reported earnings, depending on the type and location of the assets.

With early 2024 returns for most investors dominated by momentum related to the Magnificent Seven stocks, or more recently cyclical stocks surrounding the U.S. presidential election, infrastructure's differentiated returns offer some diversification away from the risks of concentrated trades. And with Trump's policies potentially leading to a second round of inflation, infrastructure's inflation pass-through mechanism will likely be all the more valuable in 2025.

Total Returns Still Catching Up to Strong Earnings

Peaking interest rates are a good sign for infrastructure, as we have seen it outperform global equities following the last Fed rate hike prior to cutting cycles (Exhibit 1). Following global central banks kicking off easing in late 2023, market breadth has continued to improve. As this has occurred the market has begun to recognise the strong fundamentals and secular themes of the infrastructure asset class. These include decarbonisation, growing power demand from AI and data growth, and significant network investments to replace aging assets, improve resiliency and meet the needs of realigning supply chains and onshoring trends.

Exhibit 1: Infrastructure Performance Following Last Fed Rate Hikes



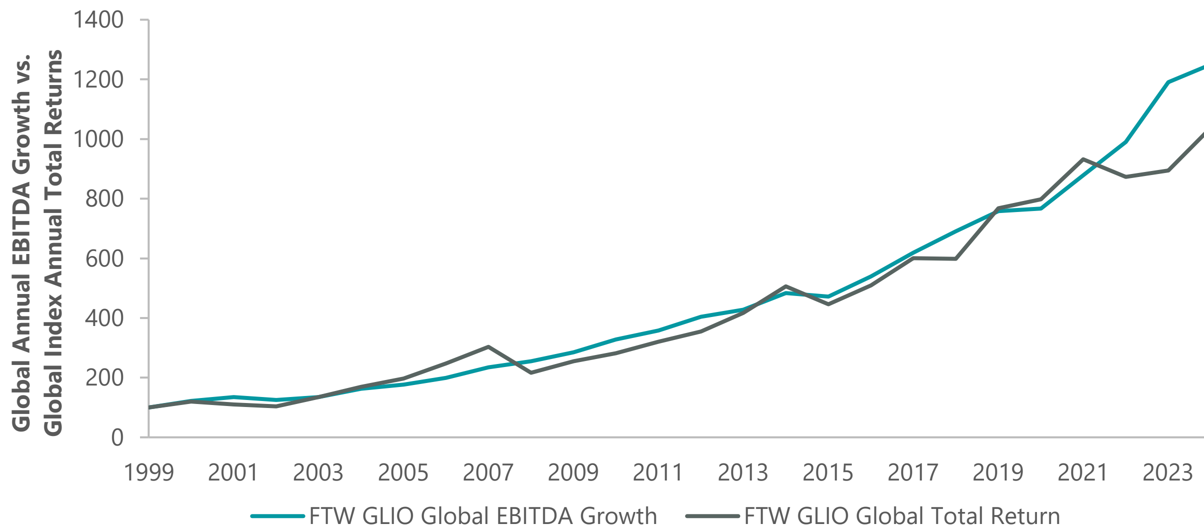
As of 30 September 2024. Source: ClearBridge Investments, FactSet. FTSE Global Core Infrastructure 50/50: average total return in local currency of the constituents for the past 5 years ending 30 September 2024. Hypothetical outcome, noting not all stocks in the FTSE Global Core Infrastructure 50/50 were available during each historical cutting cycle. Global Equities: MSCI AC World Index, gross returns in local currency. Performance reflective of the 6-month, 1-year, 3-year and 5-year period following the last Fed rate hike prior to cutting cycles in 1989, 1995, 2001, 2007, 2019 and 2023 (2023 cycle – 6-month & 1-year performance only).

For utilities, we think their earnings stability will be sought after in what looks to be a more unpredictable and volatile market going forward. Add to this the structural tailwinds we are seeing in AI, decarbonisation and network investment, and utility asset bases and earnings are set to grow at some of the fastest levels we have seen in many years.

User-pays infrastructure assets are more tied to GDP growth, which is projected to stay at 3.1% globally in 2024 and rise to 3.2% in 2025, per the IMF. This bodes well for economically sensitive assets such as toll roads, airports and ports. Freight rail in the U.S. should also see increasing momentum, as the U.S. economy continues to be a standout grower among its peers. The risk remains, meanwhile, that reflation could hinder some of the consumer-driven services such as travel at the margin.

Zooming out, we believe we're still seeing a catch-up of a gap between infrastructure earnings and total returns which has been in place since 2022, and valuations are attractive for this reason. Even though there is a strong positive correlation between infrastructure earnings growth and infrastructure total returns, increasing earnings and strong fundamentals have yet to fully offset the dislocation in valuations due to the rise in real bond yields in 2023 (Exhibit 2). We expect this gap to close over time as the market recognises the strong long-term themes of infrastructure.

Exhibit 2: Infrastructure Total Returns Typically Track Earnings



Data as of 30 September 2024. Source: Global Listed Infrastructure Organisation (GLIO). FTW GLIO Global Index is the FT Wilshire GLIO Global Listed Infrastructure Index.

Infrastructure Opportunities Across the Globe

Opportunities continue to be widespread across the infrastructure landscape, with utility fundamentals some of the best we have ever seen. The market is still massively underestimating the growth in electricity demand driven by AI and data growth, as well as any pro-growth fiscal policy that would boost manufacturing. Utilities with exposures to these strong themes, and a high likelihood of earnings upside surprises, look well positioned. For example, Entergy, a pure regulated electric utility in the U.S. Gulf region — today's industrial heartland of the U.S. — is seeing significant tailwinds from decarbonising the industrial footprint there. Entergy is building 312 MW of solar power to support U.S. Steel's decarbonisation efforts and will also be delivering power to and connecting Amazon's US$10 billion data centre investment in Mississippi. Growth in the region is structural, driven by onshoring trends and electrification, and as Entergy's industrial base grows, it should lead to accelerating sales and earnings growth. The company recently upgraded its annual earnings growth guidance from 6%-8% to 8%-9% in the medium term.

North American energy infrastructure assets also have an outstanding growth trajectory, driven by consolidation in the sector, rising AI-related demand for gas infrastructure and the essential role gas fuel plays in stabilising the grid as coal plants get retired. Canadian Energy infrastructure company TC Energy is a clear example of this, with 90% of its assets now natural gas pipelines where tailwinds persist for LNG exports (especially post Trump's election), coal-to-gas conversions, utility reliability and high power demand, all of which could accelerate growth.

North American rail is expected to be a dynamic place, with pricing pressure from the trucking market a counterbalance to improving volumes and company network and operating efficiencies.

In Europe in 2024, outside of select countries like Spain and Italy, long-duration assets in general underperformed. Anemic economic growth, slow-to-respond central banks and a weak currency have pressured the region. But there is a clear disconnect between valuations and where infrastructure assets are trading. European utilities continue to benefit from drivers very similar to those in the U.S., where utilities have seen greater share price gains. E.on, a German regulated utility, is investing heavily in its regulated network and is expecting 10% annual growth in its asset base and over 6% annual adjusted earnings out to 2028. In Spain, Redeia Energia, primarily an owner of electricity transmission grids, expects much improved regulated returns and a strong grid development plan out to 2030 to support increased electricity demand and the continued rollout of renewable energy.

European transport infrastructure, in particular airports, may see some economic headwinds in 2025, but with idiosyncratic drivers and the removal of overhangs we see these assets remaining attractive. German airport group Fraport is one such example, with a new tariff agreement, the ramping up of Boeing's deliveries to Lufthansa and a cash flow breakout in 2026 all positive catalysts for the company.

Elsewhere, utilities and infrastructure assets continue to suffer in Brazil as monetary policy tightens, Mexico will likely suffer from Trump policies and a weakening currency, and Australia, while yet to kick off its rate-easing cycle, will likely see this occur in the first half of 2025, creating a positive environment across infrastructure sectors. New political leadership in the U.K., France and the U.S. will lead to some volatility, as governments wrestle with high deficits and differing global economic conditions and political priorities.

Overall, we believe the opportunity set for global infrastructure remains highly attractive in 2025 as an expanding and more demanding population, as well as multidecade mega trends such as decarbonisation, reindustrialisation and digitalisation, drive growth.

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