ClearBridge Investments

The Prudence of Infrastructure in a Recession

1 June 2023

Key Takeaways

- Infrastructure's focus on cash flows and underlying earnings make it a prudent investment as economic conditions deteriorate and a recession looms.
- With inflation elevated and its path uncertain, the dividends from infrastructure assets, unlike most fixed income, act as an inflation hedge due to the largely pre-programmed way infrastructure can adjust to inflationary environments.
- Longer-term investments like infrastructure assets offer essential service defensive exposure along with desirable exposure through the cycle to structural growth themes such as decarbonisation, onshoring/reshoring and the explosion of data demand.

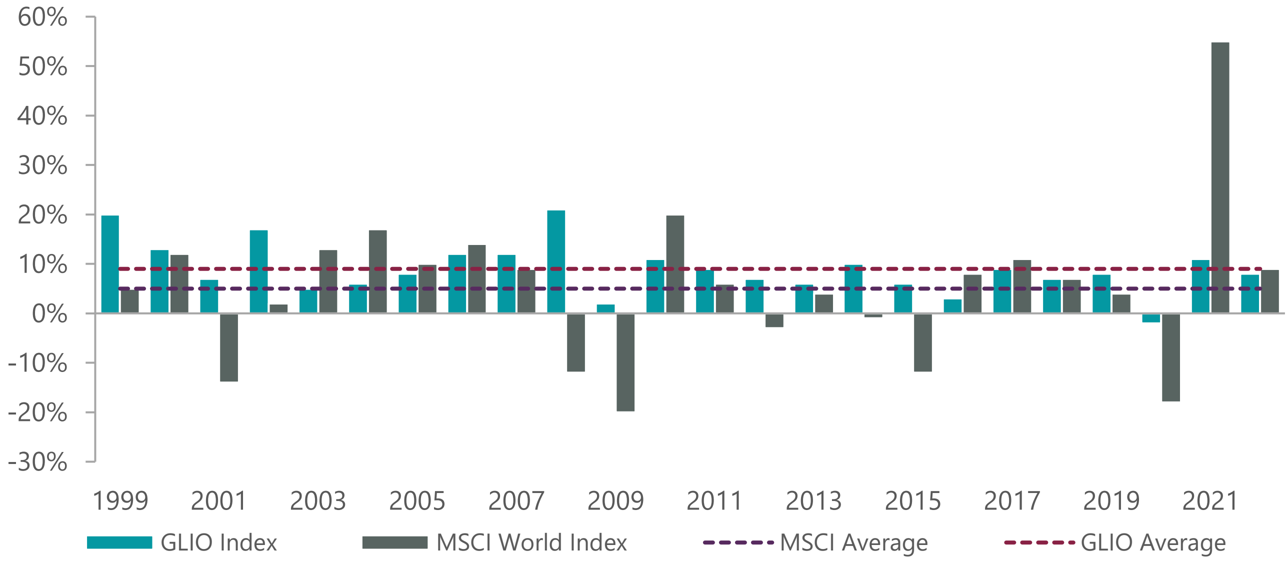
What's Behind Infrastructure's Defensiveness

Many signs suggesting a significant downshift in the economy have investors wondering how to position portfolios for a recession. The latest, rising jobless claims and deteriorating job sentiment, suggest a rising unemployment rate sometime in 2023 may weaken the consumer, whose ability to spend has been holding up market sentiment to this point. A retrenchment in consumption, as well as higher interest rates deterring business spending, should have investors thinking of defensive assets such as infrastructure.

We believe infrastructure's focus on cash flows and underlying earnings make it a prudent investment as economic conditions deteriorate and a recession looms, and it's worth a quick look into why now is a good time to allocate to infrastructure.

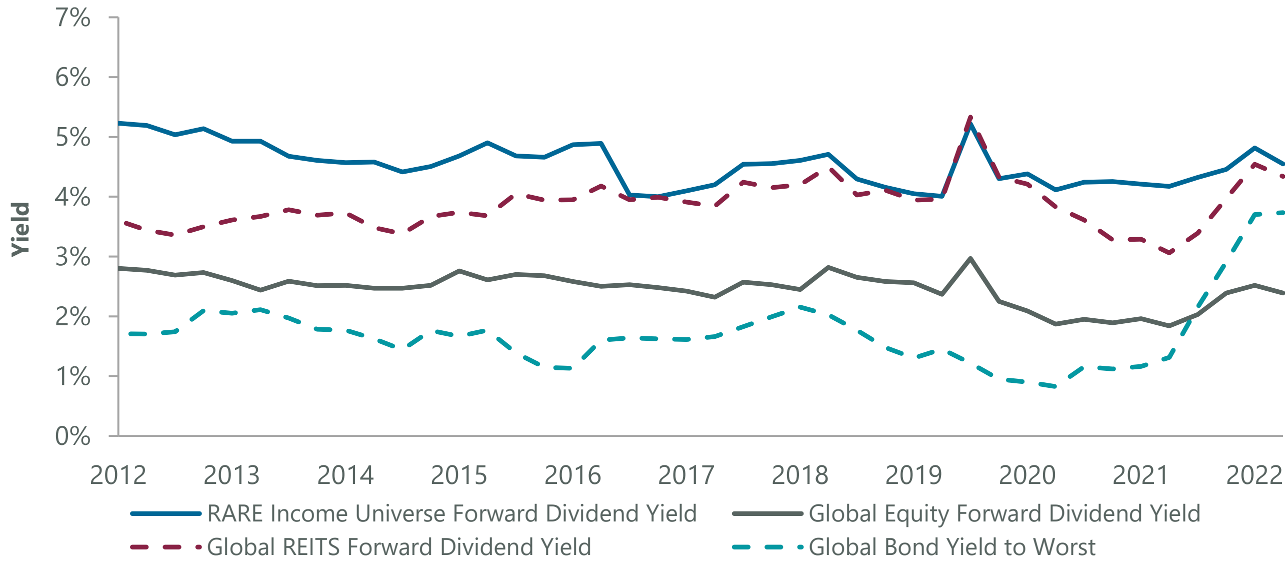
The first reason is infrastructure's fundamentally defensive nature. Infrastructure companies' cash flows tend to be durable: due to the essential nature of infrastructure assets, demand is relatively stable, providing lower volatility than traditional equities and resiliency of infrastructure revenue through the business cycle. Even in times of economic weakness, consumers continue to use water, electricity and gas, drive cars on toll roads and use other essential infrastructure services. The stability of infrastructure's cash flows compared to equities can reduce risk, making it an attractive allocation in a market downturn (Exhibit 1). Infrastructure's strong income also stands up well versus other asset classes (Exhibit 2).

Exhibit 1: Year-Over-Year EBITDA Growth for Infrastructure and Global Equities



As of 31 December 2022. Source: ClearBridge Investments, GLIO. GLIO Index constituents equally weighted, trimmed mean 5% tails. Global equities as measured by the MSCI World Index.

Exhibit 2: Infrastructure Yield Offers a Dependable Premium to Most Asset Classes

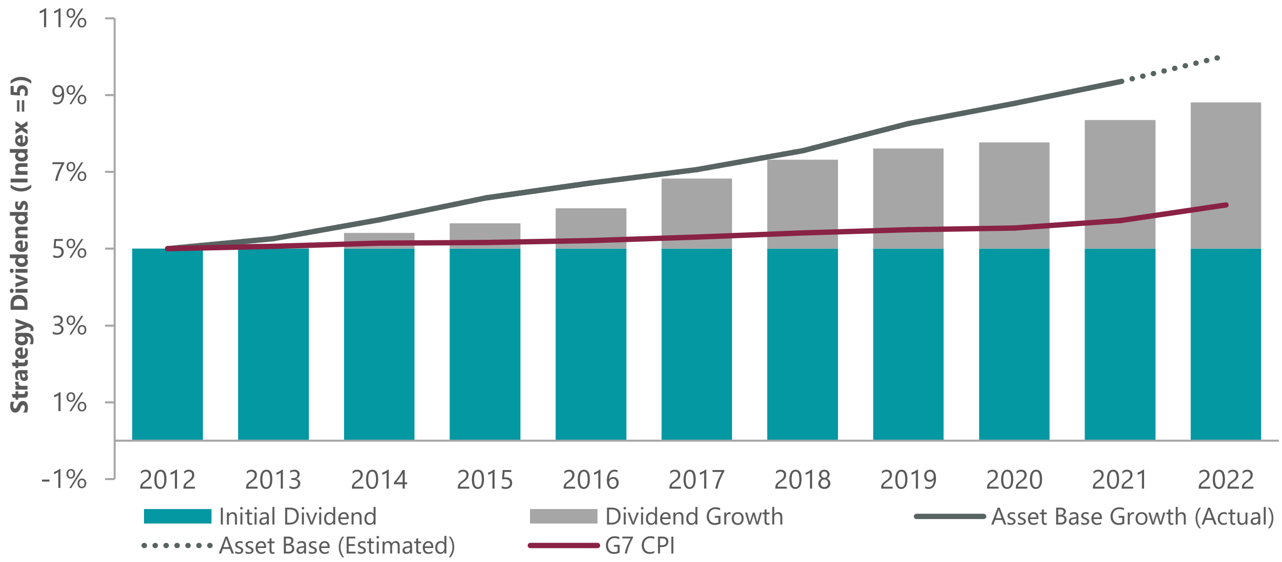


As of 31 December 2022. Source: ClearBridge Investments, FactSet, Bloomberg Finance. Global Equities represents MSCI World Forward Dividend Yield; Global REITs represents FTSE EPRA/NAREIT Forward Dividend Yield; Global Bond represents the Bloomberg Global Aggregate Bond Index.

Second, infrastructure plays strong defense against inflation. While a recession seems a little more certain today, the path of inflation does not. Even if a recession takes some of the heat off inflation, a likely lag in this happening would mean infrastructure's strength as an inflation hedge will still be valuable through a potential downturn.

Macroeconomic headwinds for equities are often infrastructure tailwinds due to the way infrastructure treats inflation largely as a pass-through. Unlike most fixed income, the dividends from infrastructure assets act as an inflation hedge due to the largely pre-programmed way — through regulation and contracts — that infrastructure can adjust to inflationary environments (Exhibit 3). This applies to both utilities and user-pays assets such as toll roads or rail, as both generate inflation-linked revenues. Infrastructure's pricing power gives it true inflation protection, in our view.

Exhibit 3: Infrastructure Dividends, Above Inflation, Are Linked to a Growing Asset Base



As of 31 December 2022. Source: ClearBridge Investments. ClearBridge Global Infrastructure Income Strategy.

Third, recent regulatory and policy tailwinds also point to steady spending in infrastructure to increase asset bases, which should offer further support. The U.S. Inflation Reduction Act, for one, is just getting off the ground as utilities and renewables invest in electrification, increasing their growth profile. We've seen this already in capex plans for infrastructure companies. Meanwhile, Europe's Green Deal Industrial Plan, announced in early 2023, looks to extend and accelerate funding for the net-zero industry in Europe; major goals of the plan include the rollout of renewables and the transformation of energy and transport infrastructure such as grids. It calls out infrastructure as key to the net-zero business environment it seeks to establish, and the push for charging and refueling infrastructure, hydrogen, and smart electricity grids it calls for will benefit regulated utilities.

It's difficult to know the timing and depth of a recession, and at what point the market may turn more risk-friendly. But we believe longer-term investments like infrastructure assets are especially prudent. They may include both regulated utilities and more GDP-sensitive assets, offering essential service defensive exposure and structural growth that many other asset classes would not offer. Longer-term themes infrastructure investors can benefit from include decarbonisation, onshoring/reshoring and the explosion of data demand. Infrastructure regulatory regimes and concession agreements are designed to produce outcomes over long periods. As such, in downturns and economically weak environments listed markets should provide plentiful opportunities to find good liquid infrastructure companies at attractive valuations.

About the Author

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- 26 years of investment industry experience
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