

Weekly Digest

Week ending 23 July 2017

Listed infrastructure: real opportunities

One of the main talking points within the investment industry since Donald Trump took office last year has been his infrastructure investment plan, a proposed trillion dollar investment that will be used to “rebuild everything”! As soon as the election result became apparent this led to strong buying of stocks in sectors that were likely to benefit from this, such as construction related businesses, many of which saw rapid and large share price gains of 20% or more. As much as one could criticise this predictable market reaction for being knee-jerk and speculative, it is the rational response given these are the businesses with the greatest chance of benefitting from increased infrastructure spending. Many such “Trump trades” have tracked sideways since then though, reflecting a growing probability that the plans may not come to pass.

Investors that indiscriminately bought into an infrastructure fund may however be disappointed once they examine the underlying holdings. This is because not all infrastructure funds have been created equal. The key distinction is between developing and owning infrastructure assets. Many businesses engaged in the former (such as contractors, equipment manufacturers and materials suppliers) are high risk ventures that have high operating leverage and are heavily reliant on the business cycle. In contrast the owners of infrastructure assets - so called real assets such as airports, toll roads, pipelines and telecom towers - are often regarded as somewhat boring businesses with limited upside potential. In fact, the underlying characteristics of businesses that own infrastructure assets are generally so distinct from other equities that for many investors it warrants being viewed as a separate asset class entirely. Some academic research disputes such treatment but that usually reflects using too low a hurdle for qualifying a company as being a true infrastructure investment.

To qualify as a true infrastructure investment, businesses must demonstrate a few key characteristics. They must offer an essential service that is used regularly and widely with little substitution risk. They should have a strong competitive position, often a monopoly, with significant barriers to entry. Critically, they should also have very stable cash flow streams resulting from long term (often inflation linked) contracts or concessions and their inherently strong pricing power. While there are a large number of businesses that meet these criteria - think Groupe Eurotunnel, National Grid or Transurban Group - there are many more that have some of these characteristics but cannot offer the same level of dependability. This could be for a number of reasons, such as they do not have a

strong enough competitive position or are overly dependent on the economic cycle through volume or commodity price risks (ports or power generation, for example).

The aggregate earnings and cash flows of a universe of sufficiently ‘pure’ infrastructure businesses is much more stable than that of general equity markets, even during severe recessions. During upswings in the economic cycle these investments will often lag other sectors, but over a full cycle they should still deliver mid to high single digit returns, with many offering the added advantage of inflation protected revenues. As a result, this asset class brings strong diversification benefits to portfolios.

The devil is in the detail though, and therein lies the opportunity for those able to dedicate the time and resources to extensive research. This is a complex asset class to analyse; one needs to worry about future changes in regulations, question whether contracts have been tested in courts, project expected cash flows over many years etc. Too many investors take key considerations at face value and discount returns into perpetuity, hence many of these businesses have been maligned as ‘bond-proxies’, despite substantial downside risk in the event that circumstances change. Satellite businesses are a good recent example as their model has been severely disrupted by over the top (internet) broadcasting. Indeed the portfolio manager’s experience is that many generalist investment teams overlook this sector or fail to analyse the risks adequately, while much broker research suffers the usual shortcomings of being backward looking and short term focused. This creates opportunities for the specialists in the area that we partner with, who truly understand the assets, management teams, regulators and environment, through extensive on the ground research.

The listed infrastructure universe remains small in a global context but has grown substantially over the last decade, particularly through spin-offs and government privatisations. Historically, the small universe and relatively short history has made it an overlooked area however we think that this is a mistake as good infrastructure investments can enhance portfolio risk adjusted returns. Admittedly, betting on the back of the latest Trump tweets might be a more exciting pastime for some, but at the portfolio manager’s are happy to compound less volatile returns from assets that already exist and - as much as Trump might disagree - that probably aren’t going anywhere soon!

The Marketplace

- US equities advance to all-time highs
- Bank of Japan revises inflation target deadline
- Euro surges 1.8% versus US Dollar, spurred by ECB meeting
- US Healthcare reforms quashed by lack of congressional support
- US Press Secretary Sean Spicer resigns

Market Focus

Global

- The IMF released headline global growth forecasts of 3.5% in 2017 and 3.6% in 2018, stating that “the recovery in global growth is on firmer footing”.

US

- Jobless claims fell 15k to 233k, below expectations of 245k.
- Press secretary Sean Spicer resigned on Friday after telling President Trump he vehemently disagreed with the appointment of communications director Anthony Scaramucci.
- Congress agreed to advance a bill detailing sanctions to punish Russia for their involvement in the 2016 election whilst also restricting President Trump’s ability to revise the sanctions.
- Efforts to replace and repeal Obamacare were defeated after it was revealed there was a lack of Republican support. It is likely the administration will move their efforts to further issues such as tax reforms and infrastructure.
- US Equities rose 0.6% during the week, with most benchmarks hitting new highs.

UK

- Headline Consumer Price Index inflation was 0.0% in June versus expectations of 0.2%, pushing annual inflation down to 2.6%. Producer Price inflation has started to fall month on month, with prices falling 0.4% in June, pushing annual rates down to 3.3%.
- Recent reports suggest the cabinet will agree to free movement of EU citizens for up to 4 years, suggesting a consensus among the cabinet has been achieved.
- UK equities advanced 1.1% during the week.

Europe

- Brent crude fell 1.7% during the week following news that OPEC supply this month is expected to be at highest levels since December.
- The European Central Bank (ECB) left monetary policy unchanged in its July meeting. Markets interpreted comments regarding policy tightening by ECB President Mario Draghi as dovish, with Bunds falling 9 basis points whilst Italian bonds fell 22 basis points.
- The ECB’s corporate sector purchase programme holdings went above EUR 100 billion for the first time, taking the ECBs balance sheet to EUR 4.2 trillion, the largest of all central banks.
- Continental European equities fell 1.9% during the week, partly attributed to the Euro’s 1.8% gain versus the US Dollar.

Asia

- The Bank of Japan kept monetary policy unchanged and revised growth targets upwards, noting that growth will remain above its potential in 2018. Inflation forecasts were revised lower with the Bank of Japan delaying its timeframe to achieve 2% inflation to fiscal 2019.
- China’s economy grew 1.7% in the second quarter, taking year on year growth to 6.9%. It is likely China will meet its growth target of 6.5% for 2017.

Andrew Hardy (CFA) & Oliver Cooper

Asset Class/Region	Currency	Currency returns			
		Week ending 21 July 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.6%	2.1%	11.3%	15.9%
United Kingdom	GBP	1.1%	2.1%	6.9%	15.6%
Continental Europe	EUR	-1.9%	0.3%	9.0%	17.5%
Japan	JPY	0.3%	1.1%	8.6%	24.4%
Asia Pacific (ex Japan)	USD	1.3%	4.2%	24.9%	24.1%
Australia	AUD	-0.7%	0.0%	3.2%	8.3%
Global	USD	0.6%	2.3%	13.2%	17.1%
Emerging markets equities					
Emerging Europe	USD	0.4%	5.0%	9.0%	22.9%
Emerging Asia	USD	1.4%	4.7%	29.0%	28.0%
Emerging Latin America	USD	0.9%	7.8%	18.7%	17.3%
BRICs	USD	1.3%	6.5%	24.4%	27.2%
MENA countries	USD	0.0%	1.0%	5.2%	11.9%
South Africa	USD	2.5%	7.4%	16.0%	11.0%
India	USD	0.2%	4.7%	29.1%	23.1%
Global Emerging Markets	USD	1.3%	5.3%	24.7%	24.5%
Bonds					
US Treasuries	USD	0.6%	0.5%	2.5%	-1.7%
US Treasuries (inflation protected)	USD	0.5%	0.5%	1.4%	-0.3%
US Corporate (investment grade)	USD	0.8%	1.0%	4.9%	2.4%
US High Yield	USD	0.6%	0.9%	5.9%	10.4%
UK Gilts	GBP	1.4%	0.8%	1.0%	-0.3%
UK Corporate (investment grade)	GBP	1.1%	0.9%	3.4%	4.2%
Euro Government Bonds	EUR	0.9%	0.4%	-0.6%	-2.8%
Euro Corporate (investment grade)	EUR	0.5%	0.8%	1.4%	0.8%
Euro High Yield	EUR	0.5%	0.6%	4.8%	8.2%
Japanese Government	JPY	0.1%	0.0%	-0.4%	-3.5%
Australian Government	AUD	0.1%	-0.1%	2.3%	-1.6%
Global Government Bonds	USD	1.4%	1.3%	5.5%	-1.7%
Global Bonds	USD	1.3%	1.4%	5.8%	0.3%
Global Convertible Bonds	USD	0.7%	1.8%	8.7%	8.5%
Emerging Market Bonds	USD	0.7%	0.9%	7.2%	3.7%

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	0.7%	0.6%	2.7%	-4.8%
Australian Property Securities	AUD	0.9%	-0.5%	-6.4%	-15.6%
Asia Property Securities	USD	1.5%	2.7%	18.9%	12.2%
Global Property Securities	USD	1.3%	1.9%	10.0%	2.8%
Currencies					
Euro	USD	1.8%	2.2%	10.9%	5.8%
UK Pound Sterling	USD	-0.8%	-0.2%	5.0%	-1.9%
Japanese Yen	USD	1.4%	1.1%	5.3%	-4.7%
Australian Dollar	USD	1.2%	3.0%	9.9%	5.5%
South African Rand	USD	0.8%	0.9%	5.8%	10.0%
Swiss Franc	USD	2.0%	1.4%	7.7%	4.2%
Chinese Yuan	USD	0.3%	0.3%	3.0%	-1.1%
Commodities & Alternatives					
Commodities	USD	-0.1%	0.0%	-5.7%	-0.5%
Agricultural Commodities	USD	0.8%	0.9%	2.4%	1.6%
Oil	USD	-1.7%	0.3%	-15.4%	4.0%
Gold	USD	2.1%	0.9%	8.8%	-5.8%
Hedge funds	USD	0.2%	0.9%	3.5%	5.5%

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