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Weathering the Inflation Tsunami

As central banks approach the end of their tightening cycle and the global economy rides out its third significant crisis in 15 years in the form of high inflation and rates, we examine how infrastructure remains resilient despite, and in some cases due to, these factors.

The Inflation Tsunami

Not too long ago, consensus forecasts had anticipated a prolonged period of low inflation, with central banks grappling to meet the modest inflation targets prior to 2020. We have however seen a complete shift in this perspective in recent years, driven by significant disruptions in the global economy resulting initially from the COVID-19 pandemic and subsequently a rise in geopolitical tensions. Since mid-2021, inflation has been on the rise worldwide due to pandemic-related economic dislocation and supply chain disruptions, with many countries experiencing the highest inflation in decades - what we now refer to as the "Inflation Tsunami".

The rapid cycle of monetary tightening imposed by central banks in response to this tsunami has started to push inflation back down to central bank target ranges, and slow global economic growth, although this has taken longer than originally expected.

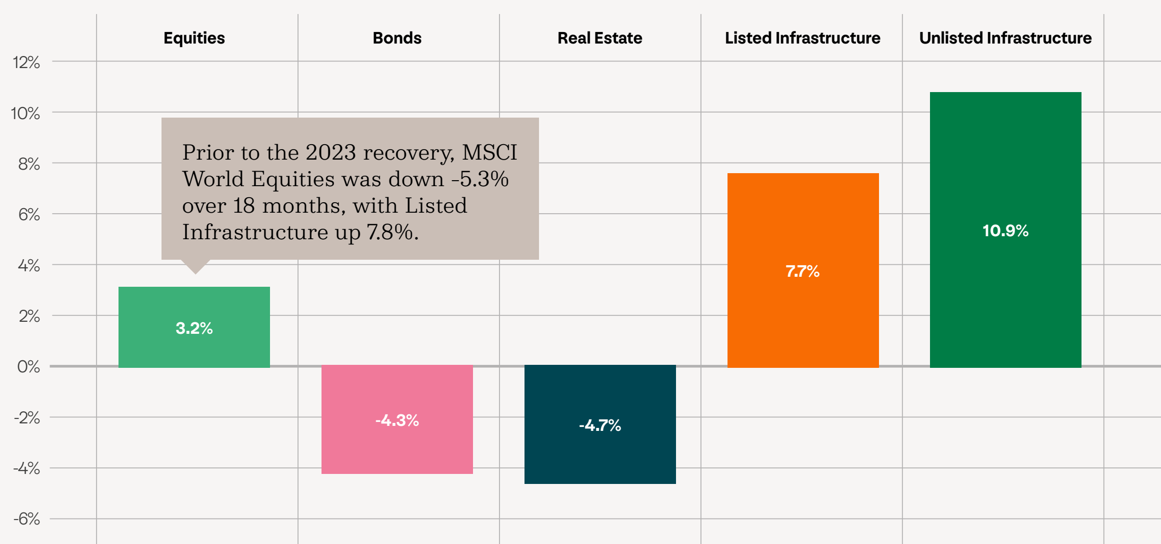
Surfing the wave

Infrastructure returns have demonstrated resilience over the past two years as both inflation and rates rose rapidly since the global economy emerged from the pandemic. Unlisted infrastructure in particular has exhibited heightened resilience compared to its listed counterparts and real estate, showcasing lower volatility in returns and reduced susceptibility to market sentiment, and therefore in our view playing a valuable role in investors' portfolio allocation.

We believe this resilience is underpinned by investing in essential real assets that provide a natural inflation hedge and greater protection from interest rate fluctuations than the broader market. Generally, the majority of core infrastructure assets have revenue streams directly linked to inflation or possess some form of indirect inflation protection. This linkage can take various forms, such as direct CPI escalators, CPI floors, fixed escalators, or a combination of these mechanisms.

FIGURE 1

GLOBAL MARKETS – ANNUALISED RETURN FOR THE TWO YEARS ENDED JUNE 2023



Sources: Bloomberg, MSCI

Equities: MSCI World 100% Hedged to USD Net TR USD; Bonds: Bloomberg Global-Aggregate Total Return Index Value Hedged USD; Real Estate: S&P Developed REITs USD-Hedged Net Total Return Index; Listed Infrastructure: S&P Global Infrastructure USD Hedged Net Total Return Index; Unlisted Infrastructure: MSCI Global Quarterly Private Infrastructure Asset index (Unfrozen).

Take a typical 'dual-till' airport for example: most aeronautical charges exhibit a direct linkage with inflation, whilst non-aeronautical revenues (including car parking, retail and property revenues) are all linked to inflation in either a direct or indirect manner. Similarly, most regulated utilities stand to benefit from a regulatory framework that ensures inflation protection by guaranteeing real returns or providing inflation indexation.

In the context of the accompanying rise in interest rates, two concerns commonly arise among investors: interest rate risk to cashflows and interest rate risk inherent in valuations through the risk-free rate component of the discount rate. The former is managed via conservative use of leverage, locking in long-term fixed rate debt and establishing laddered maturities across the portfolio; the latter is mitigated by the long-term normalised approach generally taken by external valuers to determine the risk-free rate.

Baltic Hub Container Terminal, Poland

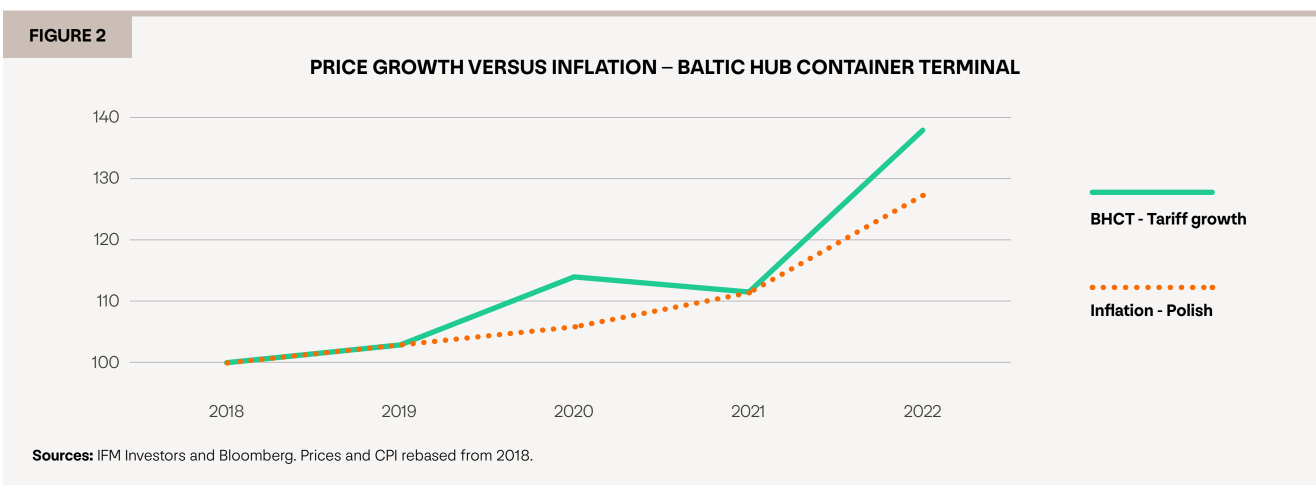
Price growth surpassing inflation

As outlined above, the resilience of the infrastructure asset class can be attributed to its inherent characteristics as a natural inflation hedge, with most core infrastructure assets typically having pricing mechanisms directly or indirectly tied to inflation. It is evident that many infrastructure assets have a track record of price escalation outpacing inflationary trend, and we provide an example of this below.

Baltic Hub Container Terminal ("BHCT")[1] has the ability to negotiate its tariffs directly with shipping lines, and importantly in recent years has shown its ability to pass through Polish CPI through indexed handling tariffs. BHCT's tariff growth has, on average, exceeded Polish CPI for four years from 2018 to 2022.

FIGURE 2

PRICE GROWTH VERSUS INFLATION – BALTIC HUB CONTAINER TERMINAL



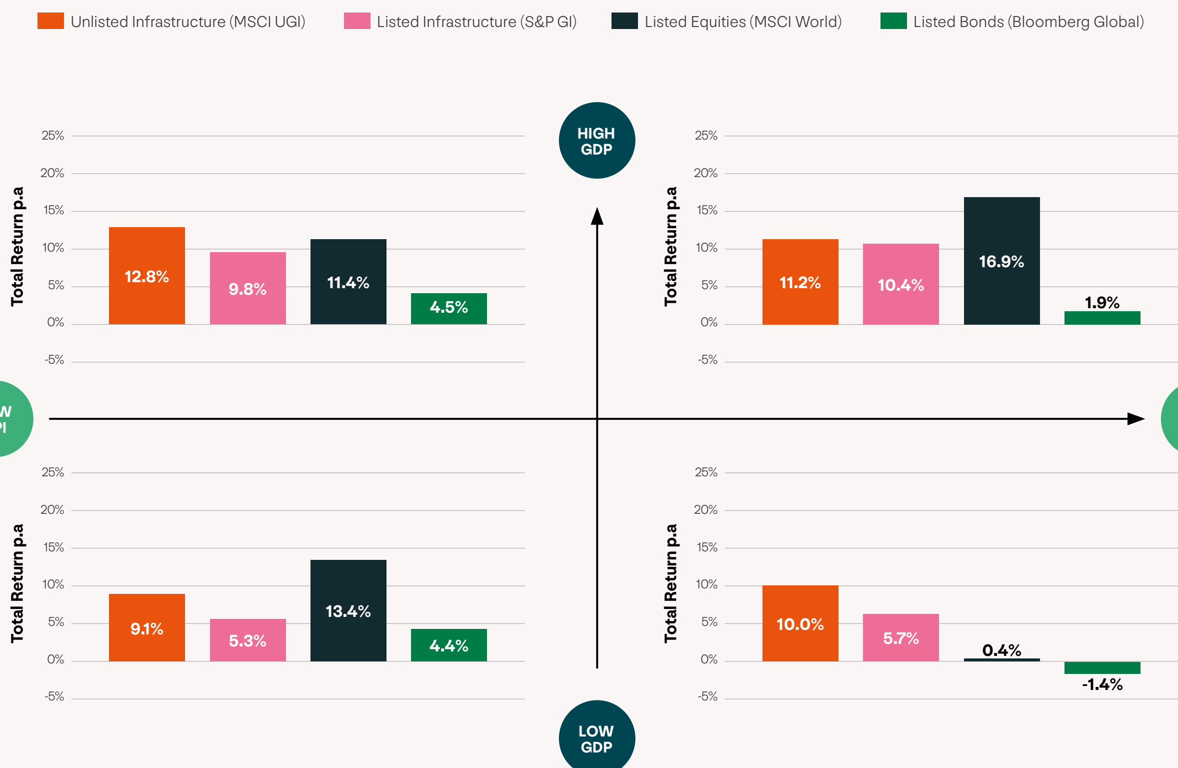
Sources: IFM Investors and Bloomberg. Prices and CPI rebased from 2018.

[1] Baltic Hub Container Terminal ("BHCT"), formerly known as DCT Gdańsk, is the largest and fastest growing Polish container terminal. Located in the heart of the Baltic in the Port of Gdansk, it is the only deep-water terminal in the Baltic Sea region having direct ocean vessel calls from the Far East.

What if the wave breaks? Infrastructure's resilience

Market dynamics have become more complex and no longer follow the conventional wisdom of prior decades. There is considerable uncertainty about the longevity of the expansionary period we find ourselves in, and therefore in how inflation and rates will continue to impact market sentiment and returns. We find that unlisted infrastructure not only provides relatively robust returns in an inflationary environment but also demonstrates resilience through a variety of macro conditions. Taking a look at the long track record of various asset classes across distinct macro seasons, segmented into quadrants where real GDP growth and CPI were above or below average levels (set as 2%), unlisted infrastructure (represented by the MSCI Global Private Infrastructure Fund Index) consistently exhibited nearly double-digit returns across all scenarios. In contrast, listed equity (represented by the MSCI World Index) demonstrated suboptimal performance in the stagflation quadrant characterised by low GDP and high CPI, yielding a flat annual return of 0.4% p.a., while the Bloomberg Global Aggregate Total Return Index delivered returns ranging from -1.4% to 4.5%.

FIGURE 3



Source: Bloomberg, MSCI, The Organisation for Economic Co-operation and Development, S&P Capital IQ.

Unlisted Infrastructure proxied using MSCI Global Quarterly Private Infrastructure Asset index (Unfrozen)("MSCI UGI"), Listed Infrastructure proxied using S&P Global Infrastructure USD Hedged Net Total Return Index ("S&P GI"). Equities proxied using MSCI World 100% Hedged to USD Net TR USD ("MSCI World), Bonds proxied using Bloomberg Global-Aggregate Total Return Index Value Hedged USD ("Bloomberg Global").

High/Low CPI and GDP are based on US Consumer Price Index (CPI) and US real Gross Domestic Product (GDP), respectively, and are defined as quarterly changes on the annual four-quarterly rolling basis exceeding or falling below a 2% threshold. Total returns represent the annual four-quarterly rolling data from 31 March 2010 to 30 September 2023.

It is worth noting two key examples of resilient performance of infrastructure through the most recent market dislocation, the COVID-19 pandemic.

First, whilst the transport of people faced substantial disruptions, the movement of goods (i.e. the freight component) across roads and ports was particularly robust and recovered rapidly. Despite lockdowns and travel restrictions, heavy vehicle traffic across toll roads dipped only marginally in 2020 and has since recovered to pre-covid levels.

Secondly, a number of infrastructure assets possess a countercyclical nature. For instance, the demand for essential services such as utilities tends to remain relatively stable regardless of economic conditions, and in a so-called contango global fuel market scenario (where the future price of crude oil surpasses the spot price due to oversupply), the demand for storage of crude oil and refined products can increase. This countercyclicality serves to enhance the resilience of a portfolio during economic downturns. This countercyclical protection is not offered by other asset classes, with the paradigm changing for some in the wake of the pandemic, such as the shift to remote work undermining the previously stronger performance of commercial real estate.

A35 Brebemi Toll Road, Italy

Sticking the landing

Whilst it seems as though the inflation tsunami may have crested, how long it takes to taper remains highly uncertain, bringing with it a series of asset allocation challenges for investors.

The infrastructure asset class's inherent characteristics include the essential nature of the services provided, the strong linkages to inflation and the resilience in the face of macroeconomic volatility and market dislocation.

These characteristics can help meet the asset allocation challenges that investors face, and we believe that investments in well-structured and well-diversified unlisted infrastructure portfolios will continue to play an important role for long-term investors looking to build resilient portfolios that will weather the conditions ahead of us.

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