Why infrastructure stocks can withstand higher interest rates

Gerald Stack | Portfolio Manager

The shock election of Donald Trump as US president sparked excitement that his pro-growth policies would reinvigorate the US economy. Talk these policies would be accompanied by faster inflation boosted US long-term interest rates by about 50 basis points over November. While Trump inspired a 14% rally in US equity markets that month, global infrastructure stocks fell 4% (as global equities overall rose 1.4%) because they were lumped among bond-proxy stocks that are considered to be vulnerable to higher rates.[1]

The term bond proxy is often used to describe any security with bond-like features that benefited in recent years when low or even below-zero bond yields tied to ultra-loose monetary policies forced investors to look elsewhere for higher-yielding but still-dependable returns. Many turned to the safest of stocks including infrastructure stocks. After all, a primary characteristic of the infrastructure asset class is that the regulatory frameworks governing essential services generally ensure fair and predictable returns for owners.

The outlook is for tighter monetary conditions and higher bond rates. The Federal Reserve has raised the cash rate three times in the past 16 months because the US economy is progressing towards full employment. Recent evidence suggests that the global economy is picking up and seems to be winning its battle against deflation. This prospect of higher bond rates is prompting concerns that infrastructure stocks are set to underperform.

If interest rates were to jump then history suggests that infrastructure stocks would be likely to lag. But experience has been that this is a short-term phenomenon. Over the longer term, the relationship between infrastructure assets and interest rates is muted – whether rates are rising or falling. Interest rates have less sway on infrastructure stocks than many might think because these businesses are generally insulated from the business cycle. If interest rates were to rise, infrastructure stocks would be likely to recover quickly in relative terms, the more so because higher interest rates are already factored into infrastructure valuations.

Infrastructure stocks are certainly more sensitive to interest rates these days than the energy, materials and consumer-discretionary stocks that aren't classed as 'yield plays'. Circumstances could be such that infrastructure stocks could underperform. An unexpectedly large surge in interest rates would be one such circumstance. If rates rise modestly as expected, investors can be confident the embedded valuations and the protected nature of their earnings mean that infrastructure stocks are well placed to ride out the increase.

Split analysis

Higher interest rates have two distinct impacts on a portfolio of global infrastructure stocks such as those in our strategy, which can largely be divided into regulated utilities and transport stocks. First, higher interest rates can affect the financial performance of businesses. But the nature of how infrastructure is regulated makes this less of an issue with such stocks.

Regulators of utilities around the world typically set prices for water, electricity or energy services to allow the utility company to earn a 'fair' return on the equity invested – a return on equity in the range of 9% to 10% is typical. If an increase in interest rates or in some other variable cost threatens profitability then utilities are able to increase their prices so that they can maintain their return on equity. The essential nature of their services means that higher prices don't reduce demand and dent revenue. All up, higher interest rates pose limited or no burden for regulated utilities.

With infrastructure companies such as airports and toll roads regulators focus on the prices companies charge rather than their returns. Most of these companies have contracts that adjust charges for inflation. When the CPI rises, for example, up go tolls on privately owned roads. Transport companies are thus protected from higher interest rates when, as would be the case now, the increase in interest rates would reflect a pickup in inflation.

As an aside, many infrastructure companies are now well protected from higher rates because they have taken advantage of low interest rates over the past five years to lock in cheap debt for long periods. Atlantia, for instance, which controls much of the Italian motorway system, in January sold 750 million euros worth of bonds with an eight-year maturity at a rate of just 1.63% p.a.

The other side to an increase in interest rates is what it means for valuations. We view the value of any investment as reflecting two factors: the expected cash flows the asset will generate and the risks associated with those cash flows. Under this approach, investors account for risks by discounting the expected cash flows at a rate that reflects the risks. An increase in interest rates will increase the discount rate and reduce the value of expected cash flows, reducing the value of the investment. Hence, the assumptions investors make about interest rates has a direct impact upon valuation.

As a consequence of the ultra-loose monetary policies of recent years, 10-year US government bonds are trading well below average historical levels – the yield ranged from 2.31% to 2.63% over the first three months of 2017. Our analysis suggests that infrastructure stocks today are priced on expectations that the US 10-year government bond yield will rise to about 4%. As such, while we would expect to see some short-term underperformance if US long-term yields were to rise, we wouldn't expect longer-term valuations to be threatened by a 10-year US government bond yield that remained below 4%.

If US 10-year Treasury yields were to increase significantly beyond 4%, infrastructure stocks would most likely come under pressure. The yield on US 10-year Treasuries on March 31, however, was 2.39%. That means that valuations today are factoring in a 1.61-percentage-point increase in the rate in coming years. Infrastructure stocks thus appear well insulated against any modest rise in interest rates sparked by Trump or some other factor.

[1] Benchmarks used are the S&P 500 Index in US dollars for US stocks, the MSCI World Index TR in US dollars for global stocks, the S&P Global Infrastructure Index TR in US dollars for global infrastructure stocks and Bloomberg 10-year government generic bond for 10-year US Treasury yields, which rose 52 basis points over November.

www.magellangroup.com.au

info@magellangroup.com.au