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Road to recovery

by Andrew Hardy, CFA

Following a third consecutive Monday of hugely encouraging news in the fight against COVID-19, global equities are well on track to delivering their best one month return in over a decade, up 11% and counting. Vaccine developments have propelled economically sensitive sectors such as energy, financials and industrials higher in November – with tech stocks in the slow lane for a change – resulting in one of the most rapid shifts in market leadership ever seen in markets. The recovery potential in 'value' stocks remains massive in our opinion, particularly in the areas hardest hit by the pandemic, but investors don't necessarily have to take on high levels of risk or sacrifice quality in their portfolios, in order to access this opportunity. The infrastructure sector is a prime example of an area that we believe has plenty of open road ahead.

Infrastructure stocks – which span the owners of toll roads, airports, pipelines, utilities and beyond – are typically regarded as being defensive, due to reasonably steady and predictable demand for their services, even during periods of economic contraction. That hasn't been the case this year due to the unique nature of the crisis and the crippling effect of national lockdowns and travel restrictions; the sector has lagged broader global equity markets by over 10% while certain parts, notably the first three subsectors listed above, remain much more depressed despite a recent bounce. There are a few reasons to question the market's assessment at this point.

Firstly, despite the sector often being maligned for its pedestrian growth rates – the flip side of more dependable levels of returns – the prospects for longer term growth look good in many areas. For instance, communications towers are benefiting from the rollout of 5G networks, while utilities are expected to enjoy higher growth rates as a result of substantial investment in renewable energy sources. Toll roads could even come out of this crisis stronger, as commuters potentially steer more towards private modes of transport in future, as opposed to public ones. The strong possibility of a large infrastructure investment bill in the United States at some point would add another substantial growth dimension, with many other governments also eyeing infrastructure as a leading candidate for stimulus spending.

Secondly, the sector should benefit more than most others from low interest rates. That is because infrastructure businesses typically carry higher levels of debt, but also because their steady cash flow and dividend streams become more attractive on a relative basis. Readily achievable yields of 3-4% with the potential for growth over time start to look very attractive when compared against most government bonds around the world yielding 1% or less. Add to that the benefit of being able to pass through the effects of inflation – which nominal bonds can't offer and which we feel may become more of an issue for investors in the future – and we could well see a long period of outperformance from the sector driven by a global search for yield, as was the case following the global financial crisis.

Then there is the rebound potential for earnings across the sector, particularly amongst areas that have been hardest hit by the pandemic. That's most relevant for toll roads, airports and pipelines, where there is arguably only limited rebound potential priced in at present. Admittedly air travel in particular is unlikely to recover to pre-pandemic levels for several years, but infrastructure businesses are valued based on their long-term cash flow generation potential, and a return to normality is likely well within such a horizon. Nonetheless a selective approach is warranted in order to avoid some of the inevitable potholes that lie in wait, not least amongst those businesses without sufficient resources to weather what will likely be a tough winter in the northern hemisphere.

The path to recovery is rarely a smooth one; while uncertainty remains high, the usually defensive and more predictable nature of infrastructure is appealing whilst it remains out of favour. As the world gradually casts COVID-19 off over time, these characteristics will increasingly come back into focus and be prized. Now is the time for building solid foundations in portfolios in order to deliver on future outcome targets.

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