RARE Insights

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2020 Market Outlook

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As we move into 2020, Senior Portfolio Managers Shane Hurst and Charles Hamieh, present RARE's view on the market and what it will mean for global listed infrastructure investors.

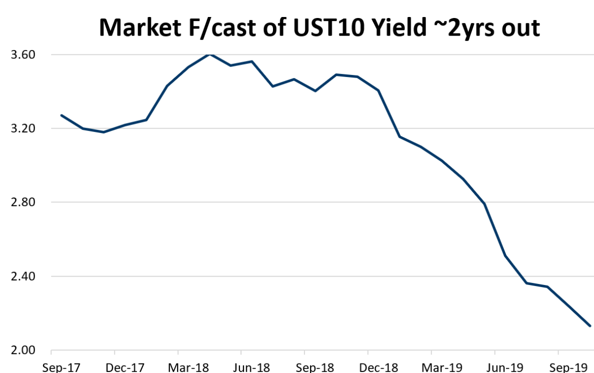
Q. What are the key trends or themes from 2019 you see carrying over into 2020?

2019 saw a continuation of the 2018 trend of decelerating global growth, but we believe this has likely troughed for key economies – think of it as a late-cycle pause rather than a slide into recession.

Inflation was missing in action in 2019, and we see no signs of a breakout anytime soon, which should result in bond yields being lower for longer. During 2019 RARE reduced its long-term bond yield forecasts – we feel there is still a dispersion of market views on this topic, but participants are trending toward a lower-yield environment.

Central banks continue to move to the accommodative end of the spectrum, and we see that trend continuing into 2020, anchoring yields at the lower end of recent trading ranges. We have seen a steady decline in the market's expectations for bond yields, which could lead to a further expansion of earnings multiples for equities as the market factors in a lower cost of capital in the long term (Chart 1).

Chart 1



Source: Bloomberg and RARE. As at 31 October 2019

There is now general acceptance that monetary policy has become less effective, and that central banks don't have the levers to offset a large downturn. Negative interest rates and quantitative easing (QE) are not the silver bullet to offset slower growth. Furthermore, productivity improvements (jobs growth), which tend to result in quality of life improvements, are virtually absent. On top of this, fiscal stimulus has been slow and small in contrast to the slowdown we've seen in global growth. Chinese stimulus, in particular, has been lacklustre. We believe this has underpinned global social upheaval in 2019 and will provide the backdrop for potential changes in the political landscape in 2020.

Political uncertainty and the shift toward nationalistic policies have created uncertainty for corporates and delayed investment decisions. Infrastructure has been spared this scepticism as regulators continue to approve projects, driving near-record asset base growth and giving certainty to future earnings growth across the sector.

Key takeaways

- Decelerating global growth is likely more a late-cycle pause rather than a slide into recession.
- Lower inflation and interest rates could lead to a further expansion of earnings multiples for equities.
- Infrastructure has been spared much scepticism from political uncertainty as regulators continue to approve projects, driving near-record asset base growth and giving certainty to future earnings growth across the sector.

Market perspective and infrastructure positioning

We are at the later stages of the economic and market cycle. However, the market has been too pessimistic for growth prospects in 2020, particularly in the U.S. As the likelihood of a U.S. recession diminished, we saw a cycling toward growth and value from defensive stocks. We expect this to continue into at least mid-2020. However, we recognise the later stages of a market cycle are characterised by periods of market volatility, and we have certainly seen that in 2018 and 2019.

The challenges to this upbeat thesis may come from:

- Underlying macro-economic data not recovering as quickly as the market expects and hence pressure on earnings growth expectations. For example, consensus earnings growth of 10% for 2020 in Europe seems optimistic.

- Continued sensitivity around currency markets, with the eurozone and China both needing a lower currency, but weaker countries and emerging markets threatened by a higher U.S. dollar. Currency wars will likely continue ad infinitum.

2020 will likely see increasing pressure on public policy from a range of different but connected directions – central banks will want fiscal stimulus for economies, climate change activists will continue to pressure for change and populist groups will pressure for governments to ease the cost of living pressures and begin to address wealth gaps. How public policy evolves will have critical implications for markets in 2020.

The importance of earnings growth and confidence that companies will not disappoint, continues to support higher multiples in the infrastructure sector, which are now at the high end of the relatively tight trading range since the Global Financial Crisis. RARE is comfortable with the current multiples given the confidence in the underlying growth in asset bases driving growth in earnings, cash flows and dividends across the sector.

Key takeaways

- We are comfortable with current multiples in the infrastructure sector given the underlying growth in asset bases, though multiples are on the high side.
- Risks include slower than expected recovery from 2019 economic weakness and continued currency wars.
- How public policy responds to climate change and wealth gap challenges will be key.

Q. What will the key drivers for infrastructure be in 2020?

We have seen a broader global acceptance of ESG principles in investing and investors are actively adjusting positions to take account of this. We believe the market has been too focused on the environmental component and not focused enough on social issues.

This imbalance is creating opportunities, particularly in the infrastructure sector, where companies operating "dirty" infrastructure are out of favour. For most of these companies, regulators have approved the original expenditure and building (for example, of coal-fired generation), which will continue to provide appropriate returns on investment.

The pressure placed on household bills from the increasing speed of the transition from fossil fuels to renewables is, however, an upcoming challenge.

Infrastructure will likely remain in the headlines for all the right (and wrong) reasons. Global initiatives to reduce carbon emissions are resulting in local actions to support the further development of renewable energy and the drive toward greater electrification. Governments are setting targets for electricity sourced from renewable energy (EU 32% by 2030, California 60% by 2030, Virginia 0% carbon by 2050) and the Bloomberg New Energy Finance researchers expect 80% of new capacity growth through 2050 will come from renewables.

Meanwhile, significant capital is being spent to mitigate the effects of climate change and adapt networks and infrastructure to cope with more volatile climatic events (such as ice storms and wildfires), increase the efficiency of infrastructure (e.g., through the development of electricity storage) and reduce wastage (such as from leaking pipes in water networks). This is driving near-record rate base growth across the sector.

We expect infrastructure to be the centrepiece of several governments' efforts to stimulate their economies

Key takeaways

- Broader global acceptance of ESG principles is leading investors to adjust positions, which can create some market inefficiencies and thus some opportunities, particularly in the infrastructure sector.
- Significant capital is being spent to mitigate the effects of climate change, increase efficiency and reduce wastage, and this is driving record rate base growth across the infrastructure sector.
- We expect infrastructure to be the centrepiece of several governments' efforts to stimulate their economies.

Click **here** to view our 2020 Market Outlook video or **here** to view our Key Drivers for Infrastructure in 2020.

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