ClearBridge
A Franklin Templeton Company

Global Infrastructure Income Strategy


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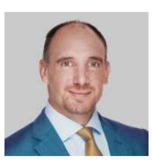
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Key Takeaways

- Listed infrastructure trailed global equities in the fourth quarter as potentially reflationary policy from the Trump administration, such as tariffs, as well as slight upticks in inflation, put some upward pressure on interest rates.
- North American gas and energy infrastructure was the top contributor to portfolio performance, while more rate-sensitive renewables and communication towers declined; disappointed with the pace of growth in carrier capex in the current 5G cycle, we reduced our towers exposure.
- We are tilted somewhat defensively, toward utilities, though not purely for reasons of defense, as many have very strong growth profiles, particularly in the U.S., driven by AI data center power demand, industry decarbonization and resiliency spending.

Market Overview

Infrastructure traded down in the fourth quarter along with most broad global equity indexes. Economic news was mixed, as a boost in animal spirits following the U.S. presidential election and a third interest rate cut for the year came amid strong economic data that began to support the case for a slower easing cycle from the Federal Reserve than had been expected. This, along with potentially reflationary policy from the Trump administration, such as tariffs, as well as slight upticks in inflation, put some upward pressure on interest rates, causing some market weakness. U.S. equities, in particular growth segments, made gains, while global indexes were generally weaker, as were income-oriented and rate-sensitive sectors across the board.

Infrastructure sectors were led by gas utilities and energy infrastructure pipelines, which have performed well amid the growth of power demand from AI data centers, the trend of converting coal-fired plants to gas for electricity generation, strong LNG exports and manufacturing reshoring, which increases demand for LNG production. Trump's U.S. election win in November also supported optimism for the sector, given his positive stance toward fossil fuels and reducing red tape.

Trump's victory put into question the fundamentals of renewables businesses, causing weakness in that sector. In addition, the prospect of interest rates remaining elevated further pressured renewables as well as rate-sensitive communication towers.

North American gas and energy infrastructure was the top contributor to portfolio performance, with the top performers TC Energy and Enbridge. U.S. electric utility Entergy was also a strong contributor. Entergy is a pure regulated electric utility, providing services to approximately three million people in the Gulf Region. Entergy reported strong third-quarter results and raised guidance, as it is seeing higher energy demand driven by a number of factors, including AI/data center power needs, and is looking to add incremental gas-fired generation capacity to service the higher demand outlook.

Conversely, the renewables sector was weak, with European renewables company EDP-Energias de Portugal, an integrated utility based on the Iberian Peninsula with a growing exposure to global renewables, the bottom performer. The sector was hurt by concerns of a potential rollback in the U.S. Inflation Reduction Act (IRA) provisions. Nonetheless, our expectation is changes to the IRA will be less than the market anticipates and hence the selloff in renewables pre- and post-election is overdone.

Rate-sensitive U.S. communications towers were also a key detractor to quarterly performance. This was driven by the rise in bond yields, coupled with market perception that the sector is a relative loser in the wake of Trump’s victory. Within the sector, the bottom performer was Crown Castle, a leading independent owner and operator of wireless communications infrastructure in the U.S. with a portfolio of approximately 40,000 towers. We have reduced our exposure to the sector as, following a recent research trip to meet with tower companies as well as telecommunication carrier customers in the U.S., we were disappointed with the pace of growth in carrier capex in the current 5G cycle.

Western Europe electric utilities were also key detractors due to higher European bond yields over the quarter. Nonetheless, changes in bond yields have an immaterial impact on the fundamental valuations for these regulated utilities as they can be passed through during the price control determination. Within the sector, electric utility E.ON, one of the largest distribution companies in Germany, was the bottom performer. In addition to higher bond yields, the upcoming snap election in Germany weighed on sentiment. We remain positive on E.ON’s outlook and its ability to benefit from the grid investment required to support Germany’s Easter Package, which targets 80% renewables by 2030.

Outlook

We expect robust global growth in 2025, in particular in the U.S., with moderating inflation through the first part of the year. Uncertainty surrounding Trump policies will affect both the economic and market outlook for the year, however. We have the ability within our portfolios to tilt toward more defensive positioning through our exposures to regulated and contracted utilities, or to take on some more economic sensitivity through exposure to GDP growth and the business cycle, through energy infrastructure, airports, rail and toll roads, for example. Today we are tilted somewhat defensively, toward utilities, though not purely for reasons of defense. We find utilities undervalued at present, as peak bond yields have resulted in multiples coming down in that space, although the utilities themselves have very strong growth profiles, particularly in the U.S., driven by AI data center power demand, industry decarbonization and resiliency spending. At the same time, European utilities with transmission businesses are getting additional capital expenditure approved by their regulators and are seeing returns tick up as well. We believe there is some upside there, as well as in U.K. water, where a final decision on investments in the next five years from the regulator should be supportive.

Portfolio Highlights

We believe an absolute return, inflation-linked benchmark is the most appropriate primary measure against which to evaluate the long-term performance of our infrastructure strategies. The approach ensures the focus of portfolio construction remains on delivering consistent absolute real returns over the long term.

On an absolute basis, the Strategy saw positive contributions from three of nine sectors in which it was invested in the quarter, with gas and energy infrastructure sectors the top contributors and the electric utility and renewables sectors the main detractors.

Relative to the S&P Global Infrastructure Index and on a U.S. dollar basis, the Strategy underperformed in the fourth quarter, driven primarily by stock selection in the renewables, gas, energy infrastructure and toll roads sectors as well as an overweight to communication towers. Stock selection in the water utility sector and an overweight to the gas sector was beneficial.

On an individual stock basis, the top contributors to absolute returns in the quarter were Entergy, TC Energy, Enbridge, South Bow and Fraport. The main detractors were Crown Castle, EDP, NextEra Energy, E.On and American Tower.

During the quarter, we initiated positions in U.S. energy infrastructure company ONEOK, Australian gas utility APA Group and French toll road operator Vinci. We received shares of Canadian energy infrastructure company South Bow upon its spinoff from holding TC Energy, which we retained. We also exited our positions in Spanish gas utility Enagas, Brazilian toll road operator CCR, U.S. electric utility Public Services Enterprise Group and Spanish electric utility Iberdrola.

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All returns are in local currency unless otherwise indicated.

Performance source: Internal. Benchmark source: Standard & Poor's.