



Global Infrastructure Income Strategy



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Key Takeaways

- ▶ Infrastructure assets trailed global equities in the first quarter amid a robust rally for equities, although March saw a reversal as cyclical strength and a slight sentiment shift for utilities helped infrastructure outperform.
- ▶ We have been increasing our cyclical exposure through additions in U.S. rails as a restocking cycle should lift rail volumes, while adding selectively to towers and renewables on weakness we believe is transitory.
- ▶ We remain constructive on, and selective with, U.S. utilities, where the energy transition and data center growth remain long-term positive drivers.

Market Overview

Infrastructure assets trailed global equities in the first quarter amid a robust rally for equities, in many ways a continuation of the bull market begun in late 2023 as softening inflation and resilient economic growth have spurred risk-on sentiment. Defensive asset classes such as infrastructure outperformed equities in March, however, as cyclical sectors such as energy infrastructure did well and utilities began to get some credit for some of their long-term drivers, such as surging demand for electricity from AI-powering data centers.

Strong economic and jobs data and the return of the ISM Manufacturing PMI to expansionary territory led to higher energy prices and further solidified the soft landing narrative, helping midstream energy performance in the portfolio for the quarter. GDP-sensitive toll roads and rail also saw positive results. On the flip side, economic strength and the pushing back of potential interest rate cuts weighed on yield-sensitive sectors such as towers and long-duration renewable energy businesses.

On a regional basis, the U.S. and Canada was the top contributor to Strategy performance for the quarter, with U.S. electric utilities Constellation Energy and Eversource Energy, a new addition to the portfolio, the lead performers. Constellation is primarily a nuclear generation company and the largest producer of carbon-free electricity in the U.S., serving states including New York, Illinois, Maryland, Pennsylvania and New Jersey. The company's combined generation capacity is more than 32 GW and 90% of annual output is carbon free. Constellation has been a beneficiary of AI and

A more normalized inventory-sales ratio and a strong consumer still spending look poised to trigger a restocking cycle, helping rail volumes.

subsequent power demand as its 24/7 base load nuclear generation can get premium contracts.

Eversource is the largest regulated utility in New England. It owns and operates electricity, gas and water utilities servicing Connecticut, Massachusetts and New Hampshire. In a JV structure with Orsted since 2016, Eversource also owns stakes in offshore wind projects. Eversource's share price rallied with the company's offshore wind exit catalyst playing out after years of delay, and a better-than-expected EPS guidance given at the fourth-quarter results announcement.

Portuguese renewables utility Energias de Portugal (EDP) and U.S. communications company American Tower were among the largest detractors. EDP is an integrated utility based in the Iberian Peninsula, operating electricity distribution, generation and energy supply businesses. It has a growing exposure to global renewables through its 83% owned subsidiary EDPR, which primarily consists of onshore wind farms. EDP also operates electricity distribution and generation businesses in Brazil. EDP's share price was negatively impacted by a focus on lower power prices, along with El Nino impacts across the U.S., which affected wind production.

American Tower is a leading independent owner, operator and developer of wireless and broadcast communications infrastructure. The company has 41,000 sites in the U.S. and a further 139,000 sites across 19 countries, predominantly emerging markets (75,000 in India, 40,000 in Latin America and 18,000 in Africa). Shares underperformed as the market favored more cyclical sectors, while tower stocks, being notably sensitive to interest rates, experienced further declines due to the uptick in bond yields.

Portfolio Positioning

European utilities are heading into what we believe will be an elevated capex cycle over the next decade to support the energy transition and upgrade aging infrastructure. This is further supported by policy such as the REPowerEU, which incentivizes investments. In the U.K., for example, over the next five years, the sector is proposing to invest £96 billion, or nearly double what was invested in the past five years. With higher capex and higher allowed returns, we think this translates to better earnings and dividends for our companies, while valuations are looking attractive.

We have been increasing exposure to U.S. rails, which over the past two years have been in a freight recession as retailers were left with bloated inventory as consumers balanced their goods/services spending after exiting COVID-19 lockdowns. However, with increasing evidence of a more normalized inventory-sales ratio following two years of destocking, and a strong consumer still spending, we believe this will trigger a restocking cycle, meaning rail volumes have likely bottomed and will inflect higher.

The other recent addition to cyclical exposure we have made is our initiation of French airport operator ADP, which significantly underperformed in 2023. We think recent issues are overblown and expect traffic recovery to continue to reverse 2023's stock price weakness.

The month of March notwithstanding, we are seeing moderation of inflation and bond yields. Inflation has been trending down thanks to the cooling off in areas such as wage inflation and rents, leading to increasing confidence by market participants that we are at the end of the rate-hiking cycle and now looking toward the start of the rate cutting cycle. We believe this could be the start of the turn for many of our long-duration assets that underperformed for most of 2023, such as towers and renewables. Both sectors have had their own idiosyncratic issues for much of the past year (towers, due to reduced carrier spending; renewables due to interest rate impacts and supply chain issues). We think that these issues are largely behind them. As a result, we have started to increase our weights into towers further, via American Tower and Crown Castle. We continue to work through our positioning on renewables, adding slightly to NextEra Energy Partners LP and EDP.

U.S. utilities have been an unloved sector of late in the context of a bull market that has evolved as recession fears have subsided. We remain constructive on longer-term fundamentals, which are supported by the energy transition driving mid-single-digit rate base growth. Selectivity will be important here, as we now have the added theme of manufacturing reshoring (mostly in Southeastern states) and data center growth (in Virginia, for example) driving long-term sales.

Outlook

We remain defensively positioned as lagged impacts of tightened financial conditions are still expected to influence the economy and ultimately corporate earnings. The Fed and many other central banks around the world have moderated in response to inflation data. Economic data has surprised to the upside this year and, in a continuation of 2023, defensive sectors such as utilities have continued to struggle. As a result, we are reviewing our positioning and increasing cyclical exposure, for example in rail and airports benefiting from economic growth, where it makes sense.

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 four of the eight sectors in which it was invested in the first quarter, with the electric sector the standout positive contributor and energy infrastructure and rail making strong contributions as well. The main detractors were renewables and communications.

Relative to the S&P Global Infrastructure Index and on a U.S. dollar basis, the Strategy underperformed in the first quarter, driven primarily by overweights to the renewables and communications sectors (the latter with no holdings in the index), and stock selection in the gas and water sectors. Conversely, stock selection in the renewables and rail sectors and a lack of exposure to ports proved beneficial.

On an individual stock basis, the top contributors to absolute returns in the quarter were Constellation Energy, Eversource Energy, Entergy, Ferrovial and Gibson Energy. The main detractors were EDP, American Tower, Pennon Group, Crown Castle and Enel.

In addition to portfolio activity discussed above, we exited our positions in Australian toll road operator Transurban, Australian gas utility APA Group and U.S. electric utility Edison International.

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