Infrastructure: Inflation Protection for the Long and the Short Term

- Real asset values are likely to track inflation-sensitive replacement costs over the long term
- Capacity utilization rates affect inflation sensitivity in the short run
- Infrastructure appears likely to provide both long- and short-term inflation protection

Inflation Outlook

Concern about the prospects for higher rates of inflation is at the forefront of many investors’ minds amid growing uncertainty over the potential impact on global markets, the economy and real investment returns.

With the economy still weak and labor markets depressed, inflation is unlikely to flare up in the near term. The longer-term outlook is less sanguine. Worrisome signs have begun to fan inflationary concerns, e.g., increasing commodity prices and of course a tremendous buildup of government debt. While employment and labor income appear about to turn the corner, we do not see this improvement proceeding far enough and fast enough to preclude further government stimulus and debt issuance. The situation clearly bears watching for signs that inflation may be heating up and/or that policymakers, more concerned with growth than inflation, are not adequately responding to the warning signals.

In this environment, can infrastructure assets help protect portfolios from the ravages of inflation—even as government stimulus provides capital to expand infrastructure capacity? We think so—and here is why.

Inflation and Infrastructure

Inflation is not always kind to fixed income investments, but there are other types of income-producing assets that may fare better when the CPI ticks higher and higher, for example real assets in general, and infrastructure in particular. But it is important to understand that how real assets (buildings, regulated utilities, toll roads, airports, seaports, etc.) perform amid inflation depends on several key factors. It’s also useful to make a distinction between conditions in the short run, say two or three years, and over the long term.
Inflation Protection over the Long Term

Let’s start with the long term. Over time, prices of materials and labor increase with inflation. Consequently, replacement costs for tangible assets such as buildings, toll roads and airports follow inflation, and asset values tend to track these replacement costs. To be sure, real assets may trade for more or less than replacement costs at a point in time, but for long-term investors, these investments offer solid prospects for keeping pace with inflation.

While price indices are readily available to support this case for real estate, they generally do not exist for infrastructure. However, cash flow (EBITDA) for U.S. infrastructure investments are available and, as seen in Exhibit 1, have generally tracked or exceeded the Consumer Price Index (CPI), supporting the case that infrastructure can provide inflation protection over the long term.

Inflation Protection in the Short Term—Where Regulated Infrastructure May Have an Edge

How real assets respond to a near-term flare up in inflation depends critically on two factors:

- **Contractual provisions** that allow asset owners to pass through inflation, at least in part, through higher unit prices (rents, utility rates, tolls, etc.) particularly for real assets that provide services for which demand is not very sensitive to price

- **Capacity utilization**, i.e. whether there is a shortage or an excess in capacity

These factors drive the near-term inflation sensitivity of income streams produced by real assets.

For example, in commercial real estate (CRE), building leases may allow landlords to pass through increases in operating expenses to tenants. But, when there is an excess supply of office space, this pass-through can be limited as the landlord must absorb increases in expenses for the unleased space.

However, the case for infrastructure, particularly regulated infrastructure, is somewhat different. For example, in rate case decisions for regulated utilities, allowed price increases are often specifically tied to inflation. Moreover, periodic regulatory reviews typically allow positive real returns, covering all costs including inflation. In the U.S. and other OECD countries, this means that allowed Returns on Equity (ROE) for regulated utilities are often raised during high inflation periods, protecting real earnings. What’s more, demand for utilities is relatively fixed; even in the worst of times, the demand for light, heat and water persist and price increases can, to a large extent, be passed through.

Investors should keep in mind, however, that not all infrastructure investments are equally effective in providing near-term inflation protection. Unregulated sectors, especially those that experience demand fluctuations across economic cycles (e.g. trade and transportation related sectors) may offer less protection as growth and inflationary pressures pick up. For example, airport and seaport traffic declined with the recent recession and while activity is picking up, excess slack might

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**EXHIBIT 1: ANNUAL CASH FLOWS (EBITDA INDICES) FOR U.S. INFRASTRUCTURE GREW FASTER THAN CPI**

![Graph](https://via.placeholder.com/150)

Source: J.P. Morgan, FactSet, FAA, Federal Highway Administration, Maritime Administration, and company websites
mean modest pricing power and a subdued ability to react to inflationary pressures. On the other hand, for regulated utilities rising ROEs coupled with monopolistic pricing power and demand that is relatively insensitive to price (Exhibit 2), mean greater certainty that inflation can be passed through and investment returns protected.

Conclusion

In the current environment, accelerating inflation is viewed less as an immediate risk and more as a concern several years out. But we believe that investors who would like to add some inflation protection to their portfolios, especially those concerned with both long-term inflationary trends and the potential for near-term pricing surprises, should consider infrastructure investments—with a focus on regulated infrastructure.

While some have questioned whether the amount of U.S. government stimulus targeted at improving infrastructure could lead to over-capacity and a weakening of pricing power, we do not see this as a cause for concern. According to the 2009 Report Card for America’s Infrastructure, issued by the American Society of Civil Engineers, infrastructure in the U.S. rates a cumulative grade of “D” and requires $2.2 trillion of investment over the next five years just to bring the nation’s existing infrastructure up to par. Since OECD governments (local and national) are facing large deficits as well as a need to maintain and improve existing infrastructure and build new infrastructure, we expect the role of the private sector to grow. We believe at current valuations, attractive infrastructure investment opportunities can be identified to help protect against inflation in the long and the short term.
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