Green and traditional infrastructure sectors – stability, visibility and medium-term opportunities

Summary

What to expect from 2Q22 earnings season?

We remain defensive as we head into 2Q22 earnings season, which starts in mid-July. Growth concerns continue to build given ongoing tightening in financial conditions and weaker June readings in some key US economic indicators. A steady stream of companies have downgraded guidance ahead of upcoming earnings, citing reasons such as faster-than-expected deterioration in macro trends, inventory build, and US dollar strength, pointing to further downward earnings revision risk.

S&P 500 index valuation has come back to reasonable levels (16x P/E[1]) and is near to the valuation bottom the index saw in previous lows e.g. in late 2018 and early 2020. We view the year-to-date (YTD) valuation derating as already substantial. While there may be another leg down from here as earnings adjust to reality, looking on the bright side, earnings cuts are not unexpected and are the first and necessary step to a durable bottom in the market.

We continue to like defensive sectors like Healthcare for its defensive attributes, valuation attraction and relative insulation from inflationary pressures. Opportunities here include pharmaceutical companies, health insurers, animal health companies and selected medical device manufacturers.

Spotlight on green and traditional infrastructure sectors

Amidst market volatility and heightened fears of an economic slowdown, we also want to highlight the infrastructure sector – both green and traditional – for their defensive/counter-cyclical elements, as well as their longer-term structural growth angle.

Cement and aggregates: the sector will benefit from the ~US$1.2 trillion Infrastructure Investment and Jobs Act approved last year, with full impact of funding felt in 2023.

Telco Towers benefit from long term contracts that often feature embedded growth, while 5G carrier spending remains supportive.

Waste management: solid waste disposal is an essential service, is recession resistant and strongly cashflow generative.

Utilities have predictable profitability and income generation, and will increasingly benefit from the structural push towards decarbonisation.

Lithium: demand is supported by increasing electric vehicle (EV) penetration globally and should continue to see tight demand/supply balance in the years ahead.

Green buildings: the buildings sector directly accounts for a significant portion of global carbon emissions and energy consumption. Globally there has been a push to improve the energy efficiency of buildings, both during retrofits and in new construction.

Green hydrogen: the potential for green hydrogen as an alternative fuel is immense, with utilisation potential in transport, green buildings, industrial applications, and power generation.

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1. P/E: Price Earnings Ratio

What to expect from 2Q22 earnings season?

We remain defensive as we head into the 2Q22 earnings season, which starts in mid-July 2022 with the major US banks reporting.

Growth concerns continue to build given the ongoing tightening in financial conditions and weaker June 2022 readings in some key US economic indicators. For example, flash manufacturing and service PMIs decelerated sharply from May, while the University of Michigan Consumer Sentiment Index continued its downward trajectory to levels below the Global Financial Crisis.

In terms of market action, cyclicals saw marked underperformance compared to defensives in June, with many commodities such as base metals rolling over. Energy was one of the key relative outperformer amongst commodities on worries around geopolitics and supply constraints.

A steady stream of companies have downgraded guidance ahead of earnings, citing reasons such as faster-than-expected deterioration in macro trends, inventory build, and US dollar strength. Reflecting this, the S&P 500 earnings per share (EPS) revision breadth has fallen below 50% recently (meaning there are more companies guiding down than guiding up) for the first time since the onset of the pandemic.

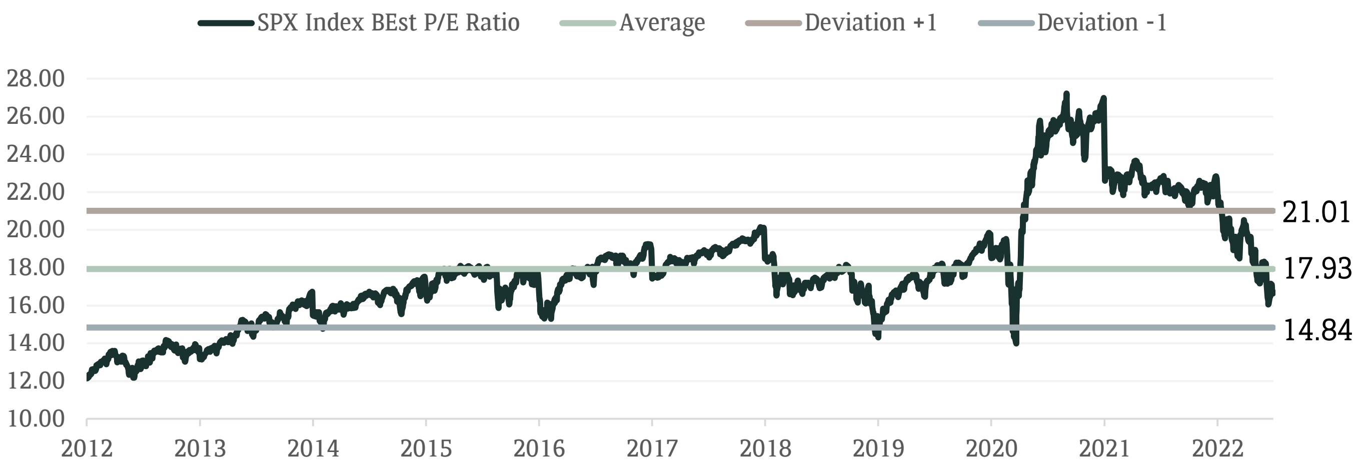
We think the upcoming results season will likely be another volatile one and from the read-through from early reports, the risk of further downward earnings revision is high.

S&P 500 index valuation has come back to reasonable levels, trading at current year P/E of 16x, and is close to the valuation bottom the index saw in previous lows (e.g. late 2018 and early 2020 at ~14x P/E). We view the YTD valuation derating as already substantial. While there may be another leg down from here as earnings adjust to reality, looking on the bright side, earnings cuts are also the first and necessary step to a durable bottom in the market (see Chart 1).

Examining S&P 500 corrections associated with NBER[2] recessions since 1929, S&P 500 corrections showed an average and median drawdown of 32.5% and 27.1% respectively. While a recession is not our base case, this would point to an index level of 3,250 and 3,500 respectively.

We continue to like defensive sectors like Healthcare for its defensive attributes, valuation attraction and relative insulation from inflationary pressures. Opportunities here include pharmaceutical companies, health insurers, animal health companies and selected medical device manufacturers. This month, we also want to shine the spotlight on the infrastructure sector – both green and traditional – for their defensive/counter-cyclical elements, as well as their longer-term structural growth angle.

CHART 1. S&P 500 INDEX HISTORICAL P/E RANGE



Source: Bloomberg, as of 5 July 2022
Past performance is not indicative of current or future performance.

2. NBER: National Bureau of Economic Research

Spotlight on Green and Traditional infrastructure sectors

Amid heightened fears of an economic slowdown, we highlight the traditional and green infrastructure sectors as segments where underlying business trends would be resilient in the immediate/medium term.

Traditional infrastructure should have a more defensive/counter-cyclical element, while the pullback in green infrastructure names present opportunities for investors with longer time horizons.

We like the following sectors:

- Cement and aggregates
- Telco Towers
- Waste management
- Utilities
- Energy transition plays: lithium, green building solutions, hydrogen

Cement/Aggregates – support from infrastructure bill spending

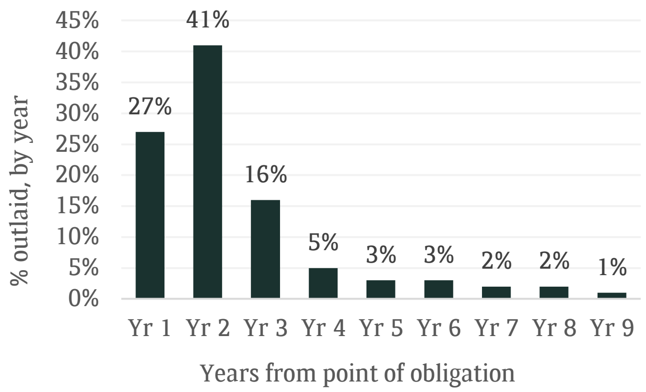
The cement/aggregate sector will benefit from the ~USD1.2 trillion Infrastructure Investment and Jobs Act approved last year, which provides USD550 billion in new spending over the next 5 years. Public infrastructure construction including highways, bridges, airports and schools typically drives ~40-50% of cement and aggregates demand.

Highway contract awards are up 21% YTD and set to accelerate even more in 2H22 as funding from the infrastructure bill is layered in, with full impact felt in 2023. The two largest cement and aggregate producers in the US have seen YTD transportation contract awards up 29%/36% year-on-year, and have 34%/42% of aggregate demand exposed to infrastructure.

While pricing momentum in aggregates and cement (up low-single-digits in 2021) have been offset by the spike in energy prices, the industry is stepping up price increases, with aggregates and cement prices expected to be up low-double-digits in 2022.

Strong growth in contract awards should support demand and pricing for aggregates and cement in 2023/24 (see Chart 2). As inflation stabilises, unit margins should accelerate and drive good earnings momentum.

CHART 2. INCREASE IN AGGREGATES VALUE FROM FEDERAL OBLIGATIONS (%)



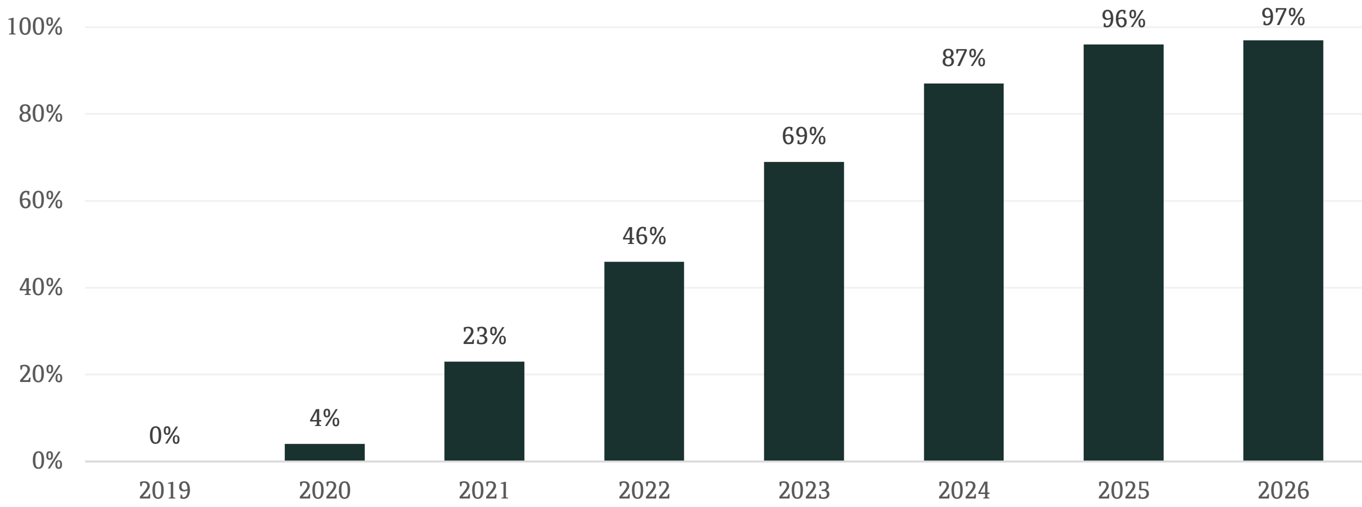
Source: Jefferies, as of June 2022
Past performance is not indicative of current or future performance.

Telco Towers – 5G penetration still has ways to go

Tower companies as a group have been resilient versus the broader market of late. We think this is a reflection of the fact that they benefit from long term contracts that often feature embedded growth, while 5G carrier spending remains supportive. Tower management teams remain universally constructive regarding the domestic 5G leasing cycle; and we continue to see several years of 5G deployments ahead with 2023 organic growth to outpace 2022 (see Chart 3).

While international markets such as Africa, Europe and Latin America are currently lagging behind the US in terms of 5G penetration, management are excited about the future tailwinds and growth potential in store for these markets. Within the sector, we like companies with balanced exposure to both domestic and international markets.

CHART 3. NORTH AMERICA 5G PENETRATION – STILL AT EARLY STAGES



Source: Morgan Stanley, as of June 2022
Past performance is not indicative of current or future performance.

Waste management and utilities – recession proof

Solid waste disposal is an essential service, is recession resistant and strongly cashflow generative in our view.

These companies provide collection, transfer, recycling and disposal services to residential, commercial and industrial customers – services that are needed regardless of economic conditions.

Longer term, we expect the waste management industry to benefit from increasing environmental concerns, continued industrialisation, increase in population and industry consolidation (through mergers and acquisition). Meanwhile, an emphasis on pricing and operating discipline has enabled the two largest waste disposal companies to impressively maintain their margins despite cost pressure.

Utilities are known for their predictable profitability and income generation, and may benefit from potential rotational flows should investors seek a more defensive portfolio positioning. Increasingly, there's also a growth angle as Utilities will be one of the key beneficiaries from the structural push towards decarbonisation (the Biden administration aims for 80% clean power generation and 50% carbon emission reductions by 2030).

Part of the concern around Utilities revolves around rising bond yields; but we think the recent correction has priced in the spike of bond yields to above 3%. We think the sector can likely absorb a gradual rise in bond yields given the increasing focus on the earnings growth angle. Our top picks would be names with a strong pivot towards renewable energy capacity growth.

Energy transition plays - lithium, green buildings, hydrogen

We remain constructive on materials geared toward energy transition like lithium, which should continue to see tight demand/supply balance in the years ahead. Lithium demand will be supported by aggressive pivot towards EVs globally, with lithium demand expected to increase as much as ~10x over this decade. This is likely to drive a sharp supply deficit in lithium towards the end of the decade.

We like green buildings/real estate energy efficiency plays with global reach. The buildings sector directly accounts for a significant portion of global carbon emissions – mostly via use of natural gas/oil for heating, as well as total final energy consumption. For example, buildings are responsible for ~40% of EU's energy consumption, and ~36% of its greenhouse gas emissions from energy, according to European Commission data.

Globally there has been a push to improve the energy efficiency of buildings, both during retrofits and in new construction. Retrofitting old buildings to improve their energy efficiency can be achieved by improvements including installing insulation, modernising glazing and installing more efficient appliances and advanced heating/cooling systems.

Beneficiaries include HVAC (heating, ventilation and air conditioning) and other building energy efficiency solution providers, as well as companies that produce high performance materials and construction materials.

We also believe in the potential for **green hydrogen** as an alternative fuel. Hydrogen has potential for utilisation, instead of fossil fuels, in a number of sectors, including transport (where deployment may lead to lower-carbon trucks, shipping, buses), green buildings, industrial applications including refining and potentially also power generation.

We like the three largest global players in industrial gas producers in the world, given their already significant footprint in the hydrogen economy and with aggressive investments into the green hydrogen sector. Adding to that, their business models are supported by onsite take-or-pay contracts, project backlogs and diversified end market exposures (including F&B, healthcare).

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