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Aussie equities vs Sydney housing: Who's the marginal buyer?

Romano Sala Tenna

Working as a stockbroker during the *.com* boom, I overheard an interesting conversation.

In early 2000, the technology sector was white hot. Hundreds of small mining stocks were ditching their mineral prospects and re-inventing themselves as Silicon Valley look-alikes. The move had been underway in the US for about four years and Australia was late to the party, but CEOs were working hard to make up for lost time.

One of the best examples of how crazy things had become was Davnet (ASX:DVT). In July 1998, Davnet was trading at 1.2 cents per share. Post a tech deal and some 'enthusiastic' projections, Davnet reached 28.5 cents by mid-1999, and then an astonishing $2.30 by the end of the calendar year. The price pushed even higher and peaked at $6 on the 28 March 2000, turning over an astonishing $29 million on the day.

What does that have to do with the conversation I overheard? Well, in March 2000, I was sitting on the trading desk when the phone next to me rang. It was a client calling one of the older advisers. The client was doing her weekly ironing while watching a stock report on television. She phoned to demand that the adviser sell her bank and BHP shares and put it all into the latest tech hopeful. There was no discussion to be had, no advice sought. She had watched tech stocks go up for too long, and now she simply had to act.

How to anticipate a bubble burst

When the 'old hand' hung up the phone, he stood up, walked across to the office bell, and rang it, declaring the top of the market for tech stocks. His prediction was surprisingly accurate. Within three weeks the market peaked and the stocks turned.

What that seasoned veteran realised — and what I learned from that conversation — was that assets that are clearly overvalued can become even more expensive provided there is someone left to buy them, that is, a marginal buyer. The point at which everyone who is capable of buying has bought means there are no more buyers and the bubble will burst. In the case of the tech boom, stocks had been hugely overvalued since the beginning, but it wasn't until the buyers were exhausted that we saw the eventual peak.

We can spend an enormous amount of time and energy working out what something is worth to the fourth decimal point and, of course, understanding the fundamental or intrinsic value of an asset is paramount to

successful investing. However, fundamental valuations fail to assist in understanding the investor mindset. If something is cheap but there is no marginal buyer, then guess what — it remains cheap. Let me repeat that: if something is cheap but there is no marginal buyer, it remains cheap. Similarly, if something is fully, or overvalued, but a large proportion of the likely demographic has yet to purchase, then the pool of marginal buyers is substantial and the price may well rise considerably further.

Examining the demand profile

Let's now apply this thinking firstly to Australian listed equities and then secondly to the Sydney property market. For the purposes of this discussion, let's remain in the helicopter (high level) and put valuations aside, focussing on the demand profile.

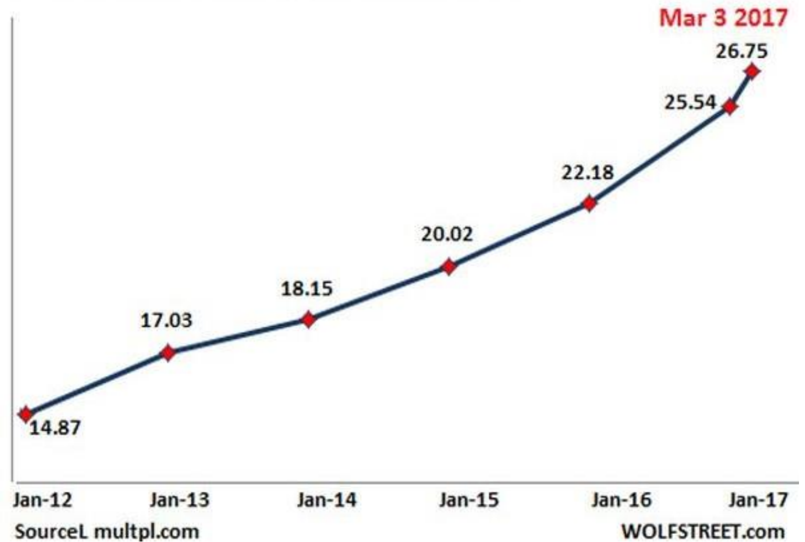
In the case of Australian equities, a number of things stand out. First, anecdotally there remains a high level of caution even to the point of scepticism. Cash levels in portfolios are elevated. Stock weightings remain below historic norms. In short, the asset class looks to be under-owned.

Second, and even more importantly from a demand perspective, the long-run bull market in bonds looks to be over. For 30+ years, bond yields have headed south, driving bond prices higher. This is now reversing. Bond prices are declining as the yield curve grinds higher. Even the renowned bond investor Bill Gross argues we have reached the inflection point and the risks are now materially higher.

Why is this significant? Because the bond market is substantially larger than the equity market. Globally the bond market is in the order of US$100 trillion versus all equity markets combined of circa US$64 trillion. If even a small percentage of investors reduce their exposure to bonds and re-allocate to equities, the effect of this 'marginal buying' would be pronounced.

I suspect this is already well underway, certainly in the US at least. Shares, which are fully valued in an historical context, continue to rise because of the 'weight of money'. The marginal buyer is switching from bonds to equities.

If we now turn our attention to Sydney property, there are possibly four main groups that constitute the 'demand profile'.



The first of these is the home-owner, the spent buyer. Whilst this group may upsize or downsize and may dominate turnover, their net impact on demand is neutral.

Second is the investor pool. Traditionally this category has been one of the major drivers, accounting for up to 40% of demand. This group is clearly in the sights of the regulators, with a directive from APRA instructing lenders to restrict growth to this segment to a maximum of 10%. With additional pressure being applied through the percentage of interest-only loans, loan to valuation ratios (LVRs) and net interest margin (NIM), this group is post-peak and on the way down.

Third is those non-owners wanting to buy their primary residence. This pool now appears more stretched than ever on two fronts:

a) those who can afford to buy have already capitulated and bought and,
b) the remainder looks less able to buy than ever.

On this second point, Demographia's 13th Annual International Housing Affordability Survey (2017) finds that Sydney is now the second most unaffordable major housing market in the world behind Hong Kong.

Offshore buyers a critical factor

This leaves the heavy lifting — the marginal buying — to the much-maligned offshore purchaser, and this is where some analysis falls down. Whilst the offshore buyer may only represent in the vicinity of one in 10 purchases, a very high percentage of these purchases represents new buying, that is, true marginal buying. So, this category is critical, especially because affordability and other metrics have less impact on their buying decisions. But while this category has the most financial capacity to continue to grow, it too appears to be post-peak given the increasing regulatory scrutiny.

Also, the supply side will be growing. The market requires steady buying or increased buying to maintain prices or drive them higher. With the three main categories of marginal buyer under duress, it's difficult to see how demand can be maintained, let alone increase.

In summary, despite both Australian equities and Sydney housing prices appearing fully valued, the outlook for each asset is noticeably different. In the case of Australian equities, there is latent demand in the system. In the case of Sydney property prices, the marginal buyer may have been largely marginalised!

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Risk to banks and markets of housing and construction boom

Ashley Owen

Unsustainably high house prices financed by extremely high levels of debt at unsustainably low interest rates presents a risk to the local banks, all of which are heavily exposed. But the main problem is not in owner-occupier housing but in high-rise investment units which are over-supplied in central Brisbane, Melbourne and Perth.

Bankers will lend until their banks are bailed out when the music stops. With the Basel Committee slow to act globally for fear of stifling the early recovery in Europe, the local regulator, APRA, has also been reluctant to act. Banks are now required to limit investor loan growth to 10%, but this is a laughable 'speed limit' which is guaranteed to further inflate the bubble.

Shadow banking and the risks in low-ranking security

APRA has also requested the banks limit interest-only loans to 30% of housing lending, another ludicrously high cap. Banks have also reduced lending to high-rise developers and end investors meaning more borrowers are obtaining finance from 'shadow banking' sources (just as in China) via products offering high yields to unwary investors (including many thousands of SMSFs) who think they are investing in property. In reality, they are lending to property developers on unsecured or low-ranking unregistered second or third mortgages on holes in the ground.

The outcome is likely to be similar to past speculative property cycles. Oversupply will lead to rising vacancy rates, falling rents, defaults by purchasers who can't get loans to settle, failure of over-geared property developers, bad debts for the lenders to purchasers and developers, failure of mortgage funds and consequent losses to retail investors.

When the music stops, tens of thousands of low ranking lenders to property developers will be left with nothing. The unit owners – even if they can find the money to settle the purchase – will be left with empty units or high vacancy rates and low rents for years until demand eventually catches up with supply. Unlike past booms, general price inflation will not magically lift prices and reduce the real size of the bad debts.

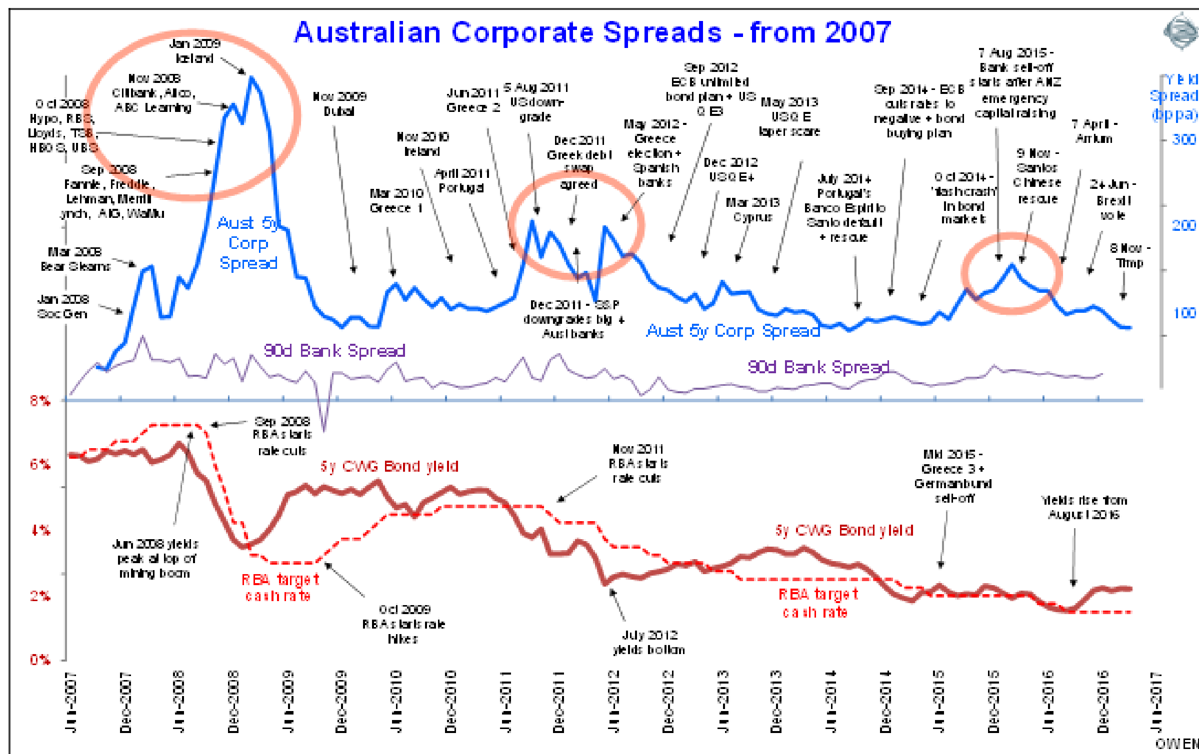
When developers finally get the message to stop developing new projects, rising unemployment from the collapse in construction activity will cause a wider slowdown in spending and demand. It has been 25 years since the last recession, which followed the same pattern. In the last recession, the main culprit was bad lending by banks and finance companies to commercial property developers and purchasers, but this time the focus will be on residential property developers and purchasers.

Bond spreads are not recognising the risks

Widespread negative impacts from the impending unwinding of the high-rise construction boom are probably a while away yet. Buyers are still eager to buy, with many projects still selling off the plan in hours to novice 'investors' and speculators, and developers are still getting finance from non-bank sources. Many are financed directly with cash from China. The RBA is giving mixed messages about possible further rate cuts and is certainly not warning of rate hikes.

Because of the heavy reliance on housing and construction finance from local banks, and because local banks are highly reliant on foreign debt markets for funding, the local banking market (which makes up some 30% of the Australian stock market value) is extremely vulnerable to global debt markets and the global events that drive it. Credit ratings on the big local banks were downgraded in late 2011 when the RBA started cutting rates. As cracks appear in the local high rise market, global sentiment toward our local banks will sour, raising their cost of foreign debt and hitting share prices.

One useful barometer of market perceptions of local bank risk is credit spreads. Here's how spreads on Australian AA-rated bank senior debt have changed over the past 10 years.



Perceived risk (and pricing for risk) for the local banks seems to have almost completely evaporated in the year since the February 2016 crisis. Prices of bank shares and low ranked debt and hybrids have risen rapidly over the same period. Nobody can predict the exact timing of when sentiment will change, but eventually, complacency in portfolios will be punished.

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Perfect storm brewing for local retailers

Roger Montgomery

There is a sector on the ASX whose risks include, but are far from limited to, the slowing construction-activity cycle that is receiving a lot of attention. That sector is retail and consensus is not considering the headwinds.

Take JB Hi-Fi, the owner of the eponymously labelled music and electronics retail franchise and The Good Guys, as an example of a company whose share price reflects the indifference to the risks that typify the sector. Its share price is down 21% from its recent high but it remains more than 300% higher than its lows of 2008.

In 2016, the company reported earnings per share of $1.52. Consensus estimates currently anticipate earnings per share rising to $2.17 in 2019, a compounded average annual growth rate of 12.6%. And while this growth produces a worrying decline in return on equity — to about 18% in 2019 compared to over 48% in 2009 — it does not contemplate any exogenous disruptions, some of which we are confident management is seriously worried about.

Crane count signals trouble for construction industry

Before touching on what we believe is a concern of JBH's management, it is worth stepping back to address those exogenous shocks about to confront much of the retailing industry in Australia, and by extension their listed REIT landlords.

In the past few years, Australia has experienced a boom in high-rise residential construction. That boom is perhaps best illustrated by the revelation in October 2016 by construction consultants Rider Levett Bucknall, in its biannual crane-count survey, that a record 528 cranes were working above apartment blocks in Sydney, Melbourne, and Brisbane. This was more than the total number of cranes operating in New York, Boston, Chicago, San Francisco, Los Angeles, Toronto and Calgary.

That an oversupply in apartments has been created is not in dispute; witness the discounting already underway by developers to clear stock. Around Australia, incentives ranging from frequent flyer points to holidays to free electric cars and 10-year rental guarantees are a signal that all is not well.

Slump ahead

Debt brings forward purchases but once the debt binge has run its course, a slump typically ensues. That observation is as true for retail consumption (and we note record credit card debt in Australia of $32 billion) as it is for the business cycles of almost all industries, construction included. Epochal low interest rates fuelled a debt binge that found a willing recipient in the form of property developers who now form the largest customer base for Ferrari and Lamborghini dealerships on the eastern seaboard.

But between 2000 and 2016, household debt-to-GDP rose from 70% to over 124%. In the same period of time, residential construction completions grew from 40,000 dwellings per year to an estimated 220,000 this year and next. After that the slump begins. Approvals have already declined from an annual rate of 250,000 in October 2016 to circa 200,000 today. The expectation is that failed settlements combined with actions by regulators, as well as jawboning by politicians, will produce further declines in the desirability of high-rise property as an investment and, therefore, further declines in construction activity.

The construction industry employed over one million workers in February 2016, according to the ABS, and developers say any slowdown would 'easily' see them lay off 20% of their full- and part-time workforce. When Australia's monthly trend employment numbers move up or down by 10,000 individuals, a slowing in the construction industry would have a serious impact on consumer sentiment, if not on the statistics and spending.

In short, it is reasonable to expect a slowdown in residential construction activity, with second-order implications for employment. Of course, the toxicity and term of any bust are related to the level of debt upon which the prior bubble was fuelled. Given the record levels of debt, it can be assumed that financial stress will rise accentuating a problem already highlighted by the significant increase in calls to the National Debt Helpline.

Combining the employment and debt picture, it is not a stretch to believe the growth in revenues and profits enjoyed by the likes of JB Hi-Fi, Harvey Norman, Bunnings, Reece, Adairs, and even the automotive retailers, in recent years may be hard to replicate in the next few years.

Amazon arrival heralds end for some

The other risks for retailers are more dangerous changes that are structural rather than cyclical.

The arrival of foreign brands such as Uniqlo, Zara, and H&M signalled a significant change in the required competitiveness of local franchises to survive. Already brands including Marcs, Rhodes & Beckett, Pumpkin Patch, David Lawrence, Howards Storage, Payless Shoes, and Herringbone have succumbed to the more competitive environment. And there'll be more. I say this with confidence because it is the arrival of Amazon in Australia that will mark the end for many more businesses whose only offer is assortment and range. Think JB Hi-Fi, Harvey Norman, Big W, Target, K-Mart and Temple & Webster.

Amazon launched its IPO two decades ago and now generates about US$4.2 billion in profits (although highly variable). At a market capitalisation of US$400 billion, it is the world's fifth-largest company, receiving 50% of all new spending online.

Unlike our listed retailers, the company has been given latitude by its shareholders to place an emphasis on long-term viability of its services over short-term profits. Its learn-adapt-grow approach to entering and growing in a country, as well as its heavy investment into all facets of logistics from truck trailer and aircraft ownership to warehousing, AI and robotics, gives Australia's incumbent retailers a great deal to worry about.

Amazon's pricing policy is what justifiably worries most retailers. Margins for retailers of the same product vary by as much as 1000 basis points (10%). Amazon uses an automated pricing engine which analyses trends and online product searches, then selects the products selling well and sets prices to match the lowest price offered

by a reputable seller or just below. For example, if the lowest price offered is $100, Amazon will set prices at $99 or $95, with free delivery, too.

Competing on price with Amazon places a company in an 'automated' pricing death spiral that Amazon will always win. The only way to survive is to invest in offering a better experience, training staff to be experts, focusing on specialty brands that don't want their product on Amazon and be hyper focused on local markets, while offering in-store pick up and advice.

Unfortunately, the result is still a niche business whose further growth may, in fact, depend on Amazon's third-party Marketplace platform, putting Amazon in control.

With clouds brewing on so many fronts for retailers, a perfect storm seems to be developing and investors don't appear to be attuned to the risks.

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Why 'total superannuation balance' is important for SMSFs

Monica Rule

'Total superannuation balance' is a term all superannuation fund members should understand, especially those people with large balances. It will impact how much a person can contribute into their SMSF, whether they qualify for certain superannuation entitlements, and which method their fund can use to determine tax-exempt income from 1 July 2017.

A member's total superannuation balance is calculated by adding together their accumulation account balance, retirement pension account balance, and any money rolled into their SMSF that has not been allocated to either their accumulation or retirement accounts, and then subtracting any structured settlement contributions received in their SMSF.

Many articles have been written on the $1.6 million transfer balance cap. This is the total amount an SMSF member can have in their retirement pension account from 1 July 2017. However, a member's total superannuation balance is equally important, as the following shows.

- **Non-concessional contributions**: a member's total superannuation balance must be below the general transfer balance cap ($1.6 million for 2017/2018) in order to make non-concessional contributions into their SMSF from 1 July 2017. The balance is measured at 30 June of the previous year in which the contribution is made and is tested each financial year. This means a member under the age of 65 will not be able to use any unused portion of their bring-forward non-concessional cap if their total balance is $1.6 million or over. As the limit is tied and indexed to the general transfer balance cap, it will increase over time.

- **Spouse contribution tax offset**: A spouse can claim a tax offset of up to $540 for making up to $3,000 in non-concessional contributions for their low-income spouse. This is provided the low-income spouse's total superannuation balance does not exceed the general transfer balance cap of $1.6 million and their total non-concessional contributions received in the relevant financial year do not exceed the $100,000 annual limit. The low-income spouse must also be under the age of 70 and meet the part-time work test (i.e. 40 hours over 30 consecutive days) if aged 65 to 69, both the contributing spouse and the low-income spouse must be Australian residents for income tax purposes and not be living apart on a permanent basis at the time the contribution is made. The income threshold for the low-income spouse must not exceed $40,000 from 1 July 2017.

- **Catch-up concessional contributions**: The new law allows any unused concessional contributions (the annual cap will be $25,000) from 1 July 2018 to be carried forward for up to five consecutive years. This is provided the member's total superannuation balance is less than $500,000. Only unused amounts accrued after 1 July 2018 will be eligible. Amounts carried forward that have not been used after five years will expire. It is important that members maintain accurate records of contributions made into their SMSF.

- **Superannuation co-contributions**: In order to be eligible for up to $500 of the Government's superannuation co-contribution, from 1 July 2017 a member's total superannuation balance must be less than the transfer balance cap on 30 June of the year before the relevant financial year. The member must also not have contributed more than the $100,000 non-concessional contributions cap, their total income must be below the higher income threshold (i.e. $51,021 for 2016/2017), and 10% of their total income must be from employment related activities, carrying on a business or a combination of both.
- **Segregated assets method**: From 1 July 2017, SMSFs will no longer be permitted to apply the segregated assets method to determine their tax-exempt income if any member has more than a $1.6 million superannuation balance and the member is in pension phase.

SMSF members must understand how their entitlements will be affected under the new 'total superannuation balance' concept to not only avoid penalties but to also take advantage of opportunities to accumulate more for their retirement savings.

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Catch-up contributions are a tax planning opportunity

Stephen Lawrence

As part of the latest superannuation reforms, from 1 July 2018 individuals with a total superannuation balance of less than $500,000 before the beginning of the financial year will be able to make 'catch-up' concessional superannuation contributions.

These individuals will be able to access their unused prior years' concessional contributions cap (that is, the amount by which those contributions are less than $25,000) on a rolling basis for five years and claim a tax deduction for those contributions in the year in which they are made. Any unused concessional contributions cap for the year will expire after five years.

The aim of the measure is to make it easier for people with interrupted work patterns, and with varying capacity to save over periods of time, to accumulate wealth in superannuation and gain access to the same tax concessions as those people who have regular and steady work patterns and income.

Reform offers planning opportunity

It also provides a planning opportunity. By deferring concessional contributions to a year in which an individual's taxable income is higher, and making them as 'catch-up' contributions in the year when they are in the higher tax bracket, they will be able to create a larger tax arbitrage between tax at the super fund level and tax at the personal level. An example illustrates the point.

Dennis is a consultant operating as a sole practitioner. It is June 2019 and his taxable income for the 2019 year will be $80,000. He has not made any superannuation contributions for the year and has a superannuation balance of $300,000. Dennis expects that his taxable income in 2020 will be $165,000 higher because of a net capital gain that he is likely to crystallise due to the disposal of an investment property that he has just put on the market. That is, his taxable income in 2020 will be $245,000.

If Dennis makes a concessional contribution of $25,000 to his super fund in June 2019 and then another $25,000 in 2020 he will create a total tax arbitrage of $12,375. This could be considered a 'standard' contribution pattern.

In 2019, his personal taxable income will go from $80,000 to $55,000 and his tax will reduce from $17,547 (not including Medicare levy or small business tax discounts to which he might be entitled) to $9,422. A saving of $8,125 in personal income tax.

His super fund will pay tax of $3,750.

In 2020, his personal taxable income will go from $245,000 to $220,000 and his tax will reduce from $84,782 (not including Medicare levy or small business tax discounts to which he might be entitled) to $73,032. A saving of $11,750 in personal income tax.

His super fund will again pay tax of $3,750.

$8,125 + $11,750 – $3,750 – $3,750 = a $12,375 tax arbitrage.

Without catch-ups in 2020 (standard)

	2019	2020	Total
Taxable income	80,000	80,000	
Net cap gains		165,000	
Taxable income	80,000	245,000	
Tax on taxable income	17,547	84,782	
Contribution	25,000	25,000	
New taxable income	55,000	220,000	
New tax on taxable income	9,422	73,032	
Personal tax saved	8,125	11,750	19,875
Super fund tax	3,750	3,750	7,500
Total arbitrage			**12,375**

How catch-ups will work

If Dennis defers the 2019 concessional contribution and makes a catch-up contribution in 2020 (along with the $25,000 allowed for that year) then Dennis will create a tax arbitrage of $16,000.

There is no personal tax saving in 2019. And no tax at the super fund level.

However, in 2020, his taxable income will go from $245,000 to $195,000 and his tax will reduce from $84,782 (not including Medicare levy or small business tax discounts to which he might be entitled) to $61,282. A saving of $23,500 in personal income tax.

His super fund will pay tax of $7,500.

$23,500 – $7,500 = a $16,000 tax arbitrage. $3,625 more than the standard approach of making the maximum $25,000 in each year.

With catch-ups in 2020

	2019	2020	Total
Taxable income	80,000	80,000	
Net cap gains		165,000	
Taxable income	80,000	245,000	
Tax on taxable income	17,547	84,782	
Contribution	-	50,000	
New taxable income	80,000	195,000	
New tax on taxable income	17,547	61,282	
Personal tax saved	-	23,500	23,500
Super fund tax	-	7,500	7,500
Total arbitrage			**16,000**

By deferring the superannuation contribution from 2019 until 2020, the tax rate arbitrage goes from 17.5% (32.5% – 15%) to 32% (47% – 15%). The extra 14.5% arbitrage on the $25,000 catch-up concessional contribution amounts to $3,625.

Same amount in super with less tax

Under a 'standard' contribution pattern, over the three years**,** Dennis will get $75,000 into super with $16,750 in total tax arbitrage.

Under a 'catch-up and reserve' strategy, over two years Dennis will get $75,000 into super with $23,000 in total tax arbitrage.

Denis has created a 30% return, in two years, on his $75,000 contribution.

The strategy will work best where there is a large jump in taxable income from one year to the next resulting in changing tax brackets. Taxpayers would need to know that their taxable income in subsequent years is going to be (much?) higher than the current year.

And, of course, there is the risk that waiting to make catch-up contributions could back-fire if the taxable income drops or the catch-up contributions bring the taxpayer into a lower tax bracket in the catch-up year than they were in in the previous year. Or, indeed, if future government generosity leads to the lowering of the marginal tax rates or expanding of the lower tax brackets or the rules change.

But circumstances could arise where taxpayers will know with a degree of certainty that their taxable income will jump up in a particular year (and then maybe fall again). For example, as in the above scenario where a property is being prepared for sale which will finalise in a later year. Or where a person is party to an option contract which, upon exercise, will result in the disposal of a CGT asset at a price which the person knows will result in a taxable capital gain. Or large dividends might be paid from private companies.

In such circumstances, a person might wish to consider deferring concessional contributions and make them as catch-up contributions in the year when the taxable income increases to maximise the total tax arbitrage. Don't forget, though, the savings are tied up in super.

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Why infrastructure stocks can withstand higher interest rates

Gerald Stack

The shock election of Donald Trump sparked excitement that his pro-growth policies would reinvigorate the US economy. The talk that these policies would be accompanied by faster inflation boosted US long-term interest rates by about 0.5% over November 2016. While Trump inspired a 14% rally in US equity markets that month, global infrastructure stocks fell 4% (as global equities overall rose 1.4%) because they were lumped among bond-proxy stocks that are vulnerable to higher rates.

The focus on bond proxies

The term bond proxy is often used to describe any security with bond-like features that benefited in recent years when low or even below-zero bond yields tied to ultra-loose monetary policies forced investors to look elsewhere for higher-yielding but still-dependable returns. Many turned to stocks including infrastructure. After all, a primary characteristic of the infrastructure asset class is that the regulatory frameworks governing essential services generally ensure fair and predictable returns for owners.

The outlook is for tighter monetary conditions and higher bond rates. The Federal Reserve has raised the cash rate three times in the past 16 months because the US economy is progressing towards full employment. Recent evidence suggests the global economy is picking up and seems to be winning its battle against deflation.

If interest rates were to jump then history suggests that infrastructure stocks would be likely to lag. But experience has been that this is a short-term phenomenon. Over the longer term, the relationship between infrastructure assets and interest rates is muted – whether rates are rising or falling. Interest rates have less sway on infrastructure stocks than many might think because these businesses are generally insulated from the business cycle. If interest rates were to rise, infrastructure stocks would be likely to recover quickly in relative terms, more so because higher interest rates are already factored into infrastructure valuations.

Infrastructure stocks are certainly more sensitive to interest rates these days than the energy, materials and consumer-discretionary stocks that aren't classed as 'yield plays'. Circumstances could be such that infrastructure stocks could underperform. An unexpectedly large surge in interest rates would be one such circumstance. If rates rise modestly as expected, investors can be confident the embedded valuations and the protected nature of their earnings mean that infrastructure stocks are well placed to ride out the increase.

Split analysis

Higher interest rates have two distinct impacts on a portfolio of global infrastructure stocks such as those in our strategy, which can largely be divided into regulated utilities and transport stocks. First, higher interest rates can affect the financial performance of businesses. But the nature of how infrastructure is regulated makes this less of an issue with such stocks.

Regulators of utilities around the world typically set prices for water, electricity or energy services to allow the utility company to earn a 'fair' return on the equity invested – a return on equity in the range of 9% to 10% is typical. If an increase in interest rates or some other variable cost threatens profitability then utilities can increase their prices so that they can maintain their return on equity. The essential nature of their services means that higher prices don't reduce demand and dent revenue. All up, higher interest rates pose limited or no burden for regulated utilities.

With infrastructure companies such as airports and toll roads regulators focus on the prices companies charge rather than their returns. Most of these companies have contracts that adjust charges for inflation. When the CPI rises, for example, up go tolls on privately owned roads. Transport companies are thus protected from higher interest rates when, as would be the case now, the increase in interest rates would reflect a pickup in inflation.

As an aside, many infrastructure companies are now well protected from higher rates because they have taken advantage of low interest rates over the past five years to lock in cheap debt for long periods. Atlantia, for instance, which controls much of the Italian motorway system, in January sold 750 million euros worth of bonds with an eight-year maturity at a rate of just 1.63% p.a.

The other side to an increase in interest rates is what it means for valuations. We view the value of any investment as reflecting two factors: the expected cash flows the asset will generate and the risks associated with those cash flows. Under this approach, investors account for risks by discounting the expected cash flows at a rate that reflects the risks. An increase in interest rates will increase the discount rate and reduce the value of expected cash flows, reducing the value of the investment. Hence, the assumptions investors make about interest rates has a direct impact upon valuation.

Because of the ultra-loose monetary policies of recent years, 10-year US government bonds are trading well below average historical levels – the yield ranged from 2.31% to 2.63% over the first three months of 2017. Our analysis suggests that infrastructure stocks today are priced on expectations that the US 10-year government bond yield will rise to about 4%. As such, while we would expect to see some short-term underperformance if US long-term yields were to rise, we wouldn't expect longer-term valuations to be threatened by a 10-year US government bond yield that remained below 4%.

If US 10-year Treasury yields were to increase significantly beyond 4%, infrastructure stocks would most likely come under pressure. The yield on US 10-year Treasuries on March 31, however, was 2.39%. That means that valuations today are factoring in a 1.61-percentage-point increase in the rate in coming years. Infrastructure stocks thus appear well insulated against any modest rise in interest rates sparked by Trump or some other factor.

(Benchmarks used in the opening paragraph are the S&P 500 Index in US dollars for US stocks, the MSCI World Index TR in US dollars for global stocks, the S&P Global Infrastructure Index TR in US dollars for global infrastructure stocks and Bloomberg 10-year government generic bond for 10-year US Treasury yields, which rose 52 basis points over November 2016).

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Three drivers of attractive infrastructure opportunities

Greg Goodsell

Infrastructure has become a hot topic in recent months. Donald Trump has promised a US$1 trillion infrastructure investment programme, while in Indonesia immediately to our north, the Joko Widodo administration has committed to a doubling of infrastructure spending in 2017 compared with 2014.

Locally, the national political debate is escalating on the adequacy of South Australian and east coast electricity generation capacity, and how we might meet any shortfall. The latest plan from Prime Minister Malcolm Turnbull explores a $2 billion expansion of the Snowy Hydro Scheme.

Increased investment in infrastructure is long overdue. This is true in both developed and emerging economies, and has become increasingly acute over the past 30 to 40 years. In the United States, for example, the recently released 2017 Infrastructure Report Card from the American Society of Civil Engineers (ASCE) gave America's infrastructure an overall score of D+, stating:

"*… our nation is at a crossroads. Deteriorating infrastructure is impeding our ability to compete in the thriving global economy, and improvements are necessary to ensure our country is built for the future"*.

ASCE estimates US$4.6 trillion is needed in US infrastructure investment between now and 2025, of which they estimate approximately US$2.5 trillion is funded, leaving a massive funding gap.

The main factors driving the need for investment

Three main factors drive the escalating need for infrastructure investment around the world:

1. Long-term chronic underspend

A 2015 study by the B20 (the business arm of the G20) estimated that by 2030 approximately US$60-70 trillion will need to be spent on infrastructure around the world just to keep up with demand. It believes only US$45 trillion will be funded, leaving a gap of US$15-20 trillion.

This spend is largely to bring existing assets up to standard and keep pace with growth, and would offer little expansion in the infrastructure stock.

2. A growing middle class, especially in emerging economies

The growth of a substantial middle class in emerging markets will demand not only more but better infrastructure to complement their improved living standards and increased disposable income.

3. Governments with limited funding capacity

Historically governments have been the primary provider of national infrastructure. However, in the post-GFC world, many governments are running substantial fiscal deficits and have fragile, highly geared, national balance sheets. Their ability to invest in public sector infrastructure is highly constrained. In fact, the demand to improve infrastructure comes at a time when governments' funding ability is at its weakest in a longtime.

Enter the private investor

Infrastructure assets possess a number of attractive investment characteristics including:

- long dated, resilient and visible cash flows
- regulated or contracted earnings streams
- monopolistic market position or high barriers to entry
- attractive potential yield
- inflation hedge within the business
- low maintenance capital spend
- largely fixed operating cost base
- low volatility of earnings.

These characteristics are ideally suited to both the listed and unlisted infrastructure markets where the quality and predictability of earnings are highly valued. The public, or listed, market also offers liquidity which allows entry into or exit from an investment more easily than in the unlisted market.

A current example in NSW is the State Government privatising its electricity assets with the proceeds to be recycled into new infrastructure investment. The Government is entering long-term leases of the energy businesses Transgrid, Ausgrid and Endeavour. The major purchasers of these assets have been superannuation and unlisted infrastructure funds, with some involvement from listed market investors.

Given the popularity of infrastructure assets amongst unlisted investors, demand currently far outstrips supply, meaning that investors in an unlisted fund can be waiting on the sidelines for some time before a suitable asset is secured by their fund, and their cash deployed for investment.

Regulated v user-pay assets

An important definition in the world of infrastructure investing is the distinction between *regulated* and *user-pay* assets.

Regulated assets are the typical essential service utility such as gas, electricity and water companies. Given the natural monopoly position they enjoy, a free market economy will typically 'regulate' the returns they can earn and rates they charge customers.

In contrast, *user-pay* assets, such as airports, ports and toll roads, typically operate under the governance of a '*concession deed'* with a government authority. It is this deed that determines the scope and scale of the business emanating from it.

This distinction offers a different investment profile. In the current environment of strong global growth, user-pay assets should do relatively better as they are better positioned to immediately benefit from increased demand and pass through any inflationary pressures. Alternatively, in an environment of sluggish global growth and falling interest rates, regulated utilities would be preferred as their defensive, safe haven characteristics become more highly valued by investors.

The global listed infrastructure market will grow rapidly over coming decades, along with its unlisted cousin. Public equity markets will form a crucial component in the funding solution for how the world meets its acute and rapidly growing infrastructure needs.

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