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A global equities-friendly environment: Opportunities in global small caps and infrastructure

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Research & Insights

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Despite significant negativity around inflation, interest rates and the global economy in general, we believe several factors are making global equity markets attractive. Two specific areas we like are listed global essential infrastructure and global small caps, both well placed to benefit from the global macro-economic outlook. Ausbil's Chief Economist, Jim Chronis, shares his outlook on the world economy. Ausbil's Global Listed Infrastructure and Global SmallCaps teams share how this macro-economic outlook may offer compelling opportunities in their sectors.

10 minute read

Key points

- Ausbil's house view is that the global economy is on a positive upward trajectory, with lower inflation and real rate cuts. The US Federal Reserve joined the growing list of central banks in the global rate cutting cycle which has been underway since the June quarter of 2024.
- Underlying resilient private demand, business investment, employment growth, and multiple rate cuts will sustain the expansion of the global business cycle. We remain vigilant on unpredictable geopolitical events that may materially impact our view.
- US President Biden's supply-side high priority on "industrial strategy and manufacturing reshoring" through the Infrastructure Investment and Jobs Act, Inflation Reduction Act, and CHIPS and Science Act, continues to provide sizeable fiscal policy support to the key sectors of infrastructure in the strategic areas of decarbonisation, renewable energy and grid expansion.
- We see growing opportunity in listed global essential infrastructure and global small caps, both of which have been at a significant relative value disadvantage to large-cap global equities.
- Listed global essential infrastructure underperformed when rates were rising fast, but as revenues also rise with inflation, these companies are now set to benefit in the easing cycle without giving back additional revenues.
- Global small-cap equities were similarly punished more than larger companies in the aggressive rate normalisation of 2022/23. However, with the major thematics and a softening rates outlook, we see global small caps retracing valuations and generating superior relative earnings growth.

Source: Ausbil as at September 2024.

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The outlook for global markets

Q: Jim, how do you see the global economy performing into 2025?

JC: Global macro settings are expected to remain within their 'back to normal' levels in 2025. We are forecasting growth, lower inflation and real rate cuts. The structural themes of decarbonisation and slowing globalisation continue to underpin activity. In the aggregate, global GDP growth is on a positive upward trajectory towards its trend rate as illustrated in Table 1.

Table 1: Global growth – on an upward path toward long-run trend

Real GDP % year average	Long run average 2010 to 2019	Ausbil 2024 (f) %	Ausbil 2025 (f) %
United States	2.3	2.1	2.2
Japan	1.2	1.1	1.2
Eurozone	1.4	0.9	1.6
China	7.7	4.8	4.6
India	7.0	6.7	7.0
Australia	2.6	1.2 to 1.5	2.5
Global GDP	3.7	3.3	3.5

Source: Ausbil, FactSet as at September 2024.

On economic growth. We are forecasting a resilient US and a Europe on a modest recovery. The US growth outlook is driven by a resilient labour market remaining within close range of full employment levels, and underlying strength in the consumer from real wages growth and the drawdown in excess savings. Europe has exited very shallow recessionary conditions and is on a sustained recovery, assisted by further ECB rate cuts. The Asia-Pacific growth engine will continue outpacing the rest of the world. China's expansionary fiscal stance, monetary easing and latest measures to stabilise the property sector should sustain growth in the mid 4% plus range. Finally, Australia's GDP is expected to rise in the second half of 2024 and move higher through 2025.

On inflation. Inflation is falling, and the forecast trajectory is for a return to above central bank target levels out to 2025, in the US and globally. Core inflation dynamics are switching, and we see persistent sticky services (ex-housing) inflation, lower housing inflation to a lesser degree, and upside risk from goods inflation.

On the outlook for rates. The US Federal Reserve is expected to deliver rate cuts in 2024 and into 2025. An ongoing improvement in Australia's inflation dynamics should provide an opening for the Reserve Bank of Australia to adjust rates in 2025.

In summary. This is a positive macro environment and represents good news for global equities. The global economy is on a positive upward trajectory, with lower inflation and real rate cuts. The US Federal Reserve has joined the growing list of central banks in the global rate cutting cycle which has been underway since the June quarter of 2024.

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly- owned subsidiary of New York Life Insurance Company. As at 31 August 2024, Ausbil manage over $19.2 billion in funds under management.

Q: Do you see a risk of recession in the US or globally?

Ausbil believes fears of a US recession are unsubstantiated. Should this risk become tangible, it will be mitigated by the reassuring fact that central banks now have significant policy room to cut rates.

In the US labour market, we highlight the following features. The non-farm payrolls measure on a 3-month moving average rate is back at pre-pandemic levels. The ratio of job openings to unemployed persons is back at levels when prior tightening cycles commenced. Finally, the weekly jobless claims measure as a lead employment indicator has a run rate that is well below, and inconsistent with, market fears of a recession triggered by a surging unemployment rate.

In addition to these fundamental measures, financial markets are showing the US 2/10yr bond yield curve back with a normal upward slope from being inverted for the last two years, reflecting a series of cuts in the Fed funds rate. Moreover, non-investment credit spreads have narrowed year to date, the net worth of households has risen by 7.1% on a year ago, on rising equity and housing valuations, and the ratio of total private debt to gross domestic product declined further, approaching its historical average, with both business and household ratios lower.

Consumer debt servicing levels in the US appear manageable and have fallen for those with fixed rate mortgages, with credit growth flowing through to all sectors. Finally, financial system stability is sound and resilient according to the Federal Reserve's half yearly report. There is little sign of financial vulnerabilities triggered by valuation pressures, borrowing by businesses and households, financial-sector leverage, or funding risks.

In summary, Ausbil's house view is that the global economy is on a positive upward trajectory, with lower inflation and real rate cuts. We remain vigilant on unpredictable geopolitical events that may materially impact our view. That said, underlying resilient private demand, business investment, employment growth, and multiple rate cuts are expected to sustain the expansion of the global business cycle.

Listed global essential infrastructure equities

Q: What sectors do you like and why?

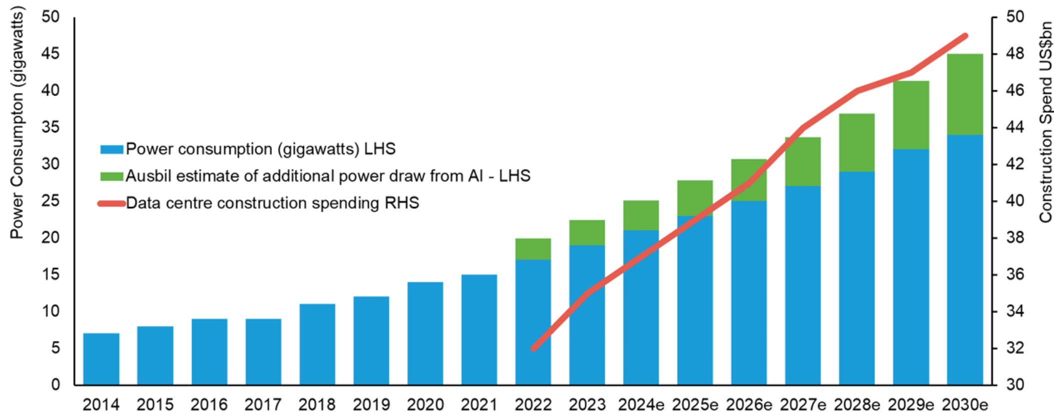
A: We see the value proposition for listed global essential infrastructure over the next twelve months as being a combination of three things.

Firstly, the short-term underperformance relative to global equities has led to what we believe to be a significant valuation upside opportunity.

Secondly, the benefits of recent higher inflation are yet to fully feed through into revenues and cashflow, and with inflation expected to remain above trend for the next few years, this benefit will take several years to be fully realised in higher profits. We do not think that the market fully appreciates this value. As inflation is falling, infrastructure assets are able to retain the upside in revenues while benefitting from cheaper funding in an easing environment.

Finally, the long-term secular growth drivers such as the energy transition and decarbonisation, repowering Europe, mobile phone technology transition from 4G to 5G, and the impacts of AI on the booming demand for electricity (Chart 2) have never looked better for the infrastructure players in these spaces.

Chart 2: Data centre power consumption and capex growing rapidly with AI



Source: Ausbil, McKinsey & Company, 2023.

Electrification driving demand across multiple infrastructure sectors. Chart 2 shows the increase in power consumption from worldwide data centre construction. Whilst this immediately benefits utilities that are selling power to data centres, there are other benefits that flow to different areas of infrastructure. Transmission companies benefit in connecting data centres to the grid and connecting the excess demand in the grid to renewable energy. Gas pipelines are essential in delivering gas to gas fired generation that is increasingly utilised in the new energy mix. Renewable energy companies are increasingly building renewable energy infrastructure (wind, solar and batteries) to power these data centres. Mobile phone tower companies are also huge beneficiaries as 5G becomes more widespread and AI drives data demand growth.

By way of an example, the rapid growth of autonomous vehicles (AVs) is expected to generate an unprecedented amount of data, with one AV generating 4TB of data every day, the same amount of data as 3,000 internet users, according to Intel. Moreover, as AVs communicate with each other, the data generated by just two cars will be comparable to that of 8,000-9,000 internet users. This growth in data is exponential, and 1,000 cars could produce more data than is currently produced by the entire planet.

Importantly, growth in electricity demand in the US has been stagnant for the past 20 years. This has meant that utility companies focused on maintaining existing assets, optimising costs and capital allocation. However, powerful forces have combined to awaken these sleepy utilities and turned them into new energy growth companies. We think that this extra growth should see an improvement in the valuation multiples ascribed to these assets by the market.

Therefore, we expect that there are many opportunities for listed global essential infrastructure companies not only to increase revenue growth, but also to reduce costs, increase margins, and as a result, profit and dividends. To us as infrastructure investors, this is both compelling and exciting, and we are positioned in our Ausbil Global Essential Infrastructure strategy to benefit from these trends over the coming months and years.

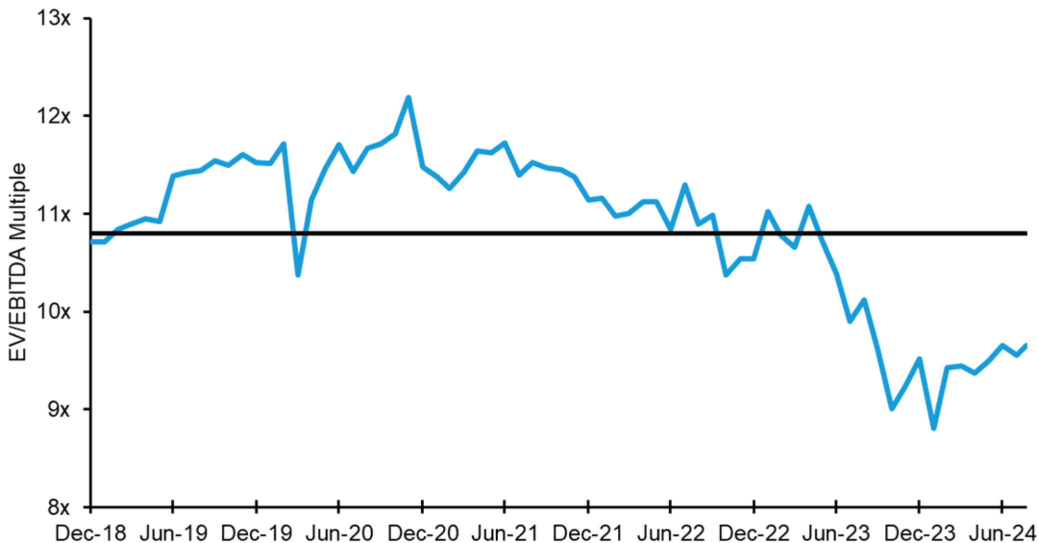
Q: How is the global outlook impacting your view of listed global essential infrastructure?

A: Listed global essential infrastructure company fundamentals remain sound. Our central scenario involves interest rate cuts late in 2024, which we perceive as a favourable catalyst for listed global essential infrastructure, a trend we highlighted back in 2022.

We are also likely to see continued focus on politics given the US election on 5 November, and equity markets will continue to focus on what different election outcomes might mean for US fiscal and monetary policy but also policies relating to the oil and gas sectors, renewables and the Inflation Reduction Act (IRA). We are monitoring this closely. However, while volatility will likely be the order of the day in the short term, given the ongoing combination of attractive valuations, and exciting opportunities, we remain convinced that long-term investors in the asset class will be rewarded.

We are seeing some significant and potentially valuable disconnects between the share prices and intrinsic value of infrastructure assets. We believe infrastructure valuations do not currently reflect the cashflows generated by infrastructure companies, and that they are cheap in the current market.

Chart 3: The earnings multiple for listed global essential infrastructure has fallen significantly

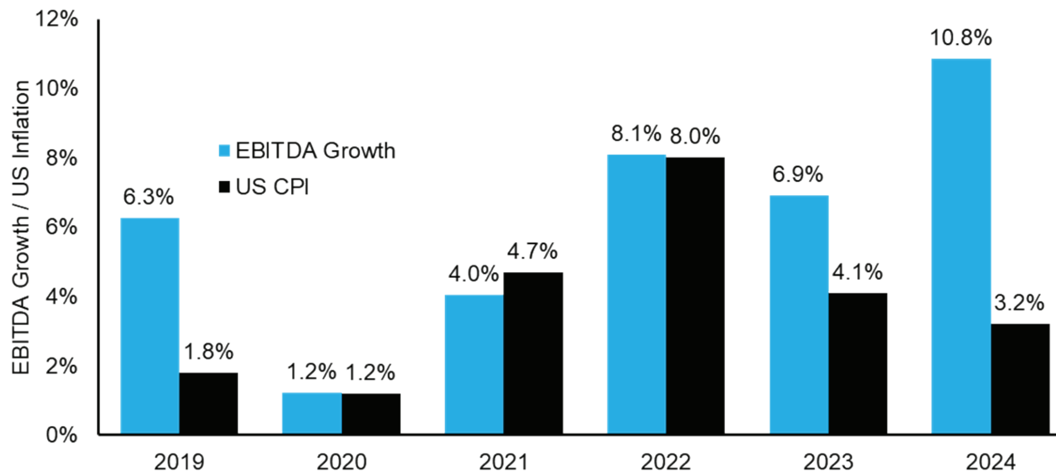


Source: Ausbil, Bloomberg.

Chart 3 illustrates the relative value for infrastructure based on enterprise value (EV) to EBITDA (earnings before interested, tax, depreciation and amortisation) compared to the period average represented by the black line. The impact of rapid rate rises can be seen from 2022 to the present. With the pivot to an easing environment as signalled by the Fed in October 2023, and with the Fed announcing their first rate cut in September 2024, we have seen the infrastructure market start to retrace valuations in a positive direction.

Infrastructure revenues rise with inflation. An additional tailwind for certain infrastructure companies is the 'ratchet effect' of rising inflation on revenues. This means that when inflation rises, revenues rise, but importantly, revenues do not fall when inflation falls. While costs can rise with inflation, costs can also fall with inflation. This means that there is an opportunity to improve margins and further grow profits beyond pure revenue growth. Chart 4 shows some of this effect, with CPI rising, then falling, but underlying EBITDA continuing to improve.

Chart 4: EBITDA growth for listed global essential infrastructure companies compared to increase in US Inflation (CPI)



Source: Ausbil, Bloomberg. 2024 EBITDA growth is an annualised estimate. US CPI for 2024 is the annual read to June 2024.

Listed markets are currently not pricing in the revenue benefit of the inflation pass-through that most listed global essential infrastructure companies enjoy. Nor are they valuing the inherent inflation protection that underpins the defensive nature of the asset class. By contrast, when compared to privately held infrastructure assets whose performance is 'market to model', listed global essential infrastructure companies are significantly discounted by the market regardless of their underlying financial performance.

A classic example of this problem can be seen in airports. When the global COVID pandemic struck in March 2020, airport traffic effectively ceased with lockdowns. Melbourne Airport (privately held) was impacted in exactly the same way as Sydney Airport (which was publicly listed at the time), with the cessation of trading for air traffic, retail operations and services. Our estimates for the negative impact of the pandemic on valuations was around 10% based on modelling cashflows. This was a similar figure that the private owners of Melbourne Airport assumed in their valuations and was therefore applied to their performance. However, holders of the listed Sydney Airport had to carry a 50% fall in its share price because of market sentiment, even though the underlying true value was far higher. What is clear is that listed markets can overreact when turning points occur. Similarly, and currently, the likelihood of a turn in the interest rate cycle has presented an opportunity to take advantage of listed global essential infrastructure companies that are trading on a significant discount to fair value.

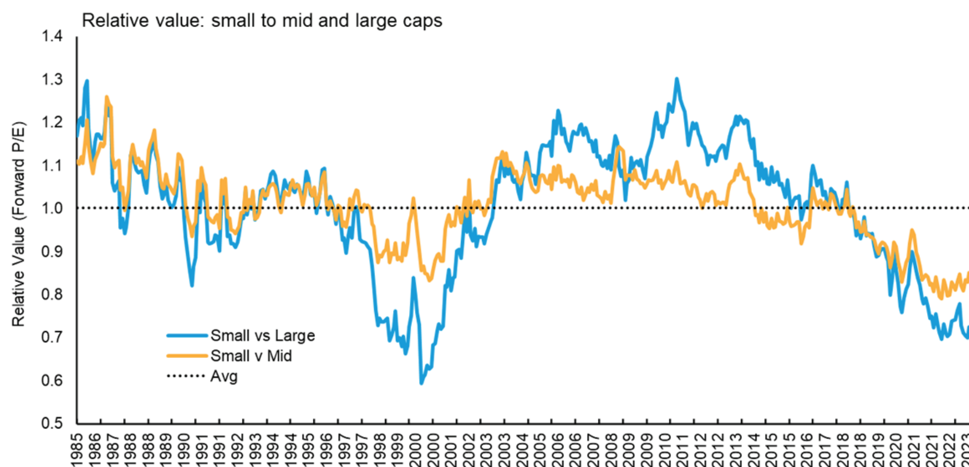
In summary. We believe that the outlook is very positive for listed global essential infrastructure companies. There is currently an opportunity for investors to benefit as listed global essential infrastructure is potentially rerated. With valuations depressed but revenues rising on inflation - and driven by the compelling growth economics of the energy transition, 5G, electrification, artificial intelligence (AI), and demand for essential services like water - we believe that these are compelling reasons to allocate to listed global essential infrastructure in the current environment.

Global small-cap equities

Q: How is the global outlook impacting your view of global small-cap equities?

A: In the rush by central banks to normalise rates, among the unfairly penalised in the flight up the market-cap spectrum were global small caps, but this is also the reason that we see significant opportunity as we move into 2025. The relative value of small caps to large caps took a beating in the normalisation (Chart 5) and was exacerbated by the emergence of the 7 mega-caps that have dominated the market since the pandemic.

Chart 5: US small caps took a beating on relative value, but are primed to resurge



Source: Bank of America, Bloomberg. Russell 1000, Russell 2000, Russel Mid Caps as at June 2024.

Key value catalysts for global small-caps. Global small-cap equities are still clawing back their relative value position against larger companies following the rapid normalisation of interest rates in 2022 and 2023. In addition to underlying thematics like decarbonisation, upgrading the electrical grid, and artificial intelligence, we see the current easing bias in global rates as an additional tailwind for the sector. The large fiscal stimulus provided by the US administration is a robust tailwind for US and global growth going forward, and is expected to prevent any material recession in the Western economies. We are expecting significant investment from European governments and utility companies into the European grid upgrade in the coming years. Specific focus areas that we see benefitting from this growth environment include the manufacturing renaissance in the US; onshoring; data centre investment and the evolution of artificial intelligence; and finally, the move to decarbonisation and the associated electrical grid upgrade. These catalysts continue to provide exciting investment opportunities within the global small-cap market.

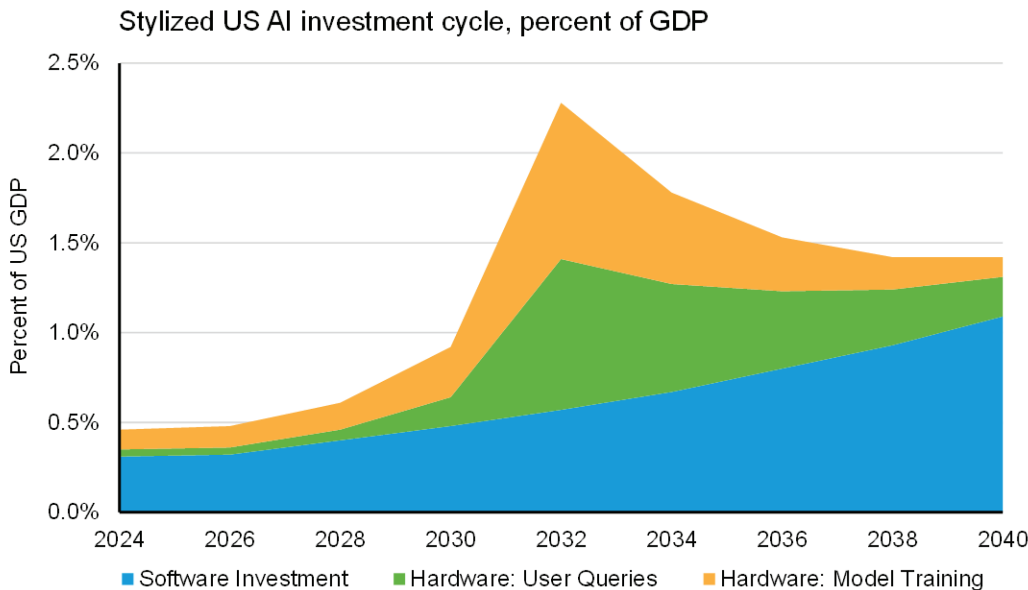
Q: What sectors do you like and why?

A: Several themes are driving the positioning of our portfolio. Companies involved in the upgrade of the energy grid are one area of focus. According to the US Department of Energy (2022), over 70% of transmission and power transformers in the US energy infrastructure are over 25 years old. Increasing demand will require an estimated 60% expansion in US transmission systems by 2030 and a three-fold increase in existing capacity by 2050.

The US electricity grid has been described as the largest machine in the world, comprising eleven thousand power plants, three thousand utilities, and over 3.2 million kilometres of power lines. Underlying this massive web of wires, power stations and transformers across the US are three key macro-grids that link to one another, but are each their own ecosystem, the East, West and Texas grids. We have found several companies whose order books are swamped with demand related to the energy grid upgrade, names like Powell Industries which is the leading US provider of electrical switch gear, essential for the safe operation and maintenance of electrical grids.

Another area is AI and the explosive expansion of data demand. With ChatGPT heralding a new age across the globe, the potential for AI to be truly transformative has been demonstrated, as has the opportunity for investors. Capital is now truly AI ready, and investment is expected to accelerate rapidly in the coming decade, as Chart 6 shows. According to projections from Goldman Sachs, investment in AI will ramp up to a peak of around 2.25% of US GDP, before settling to a more long-run 1.5% of GDP annually.

Chart 6: AI investment is expected to accelerate rapidly before stabilising



Source: Goldman Sachs Research.

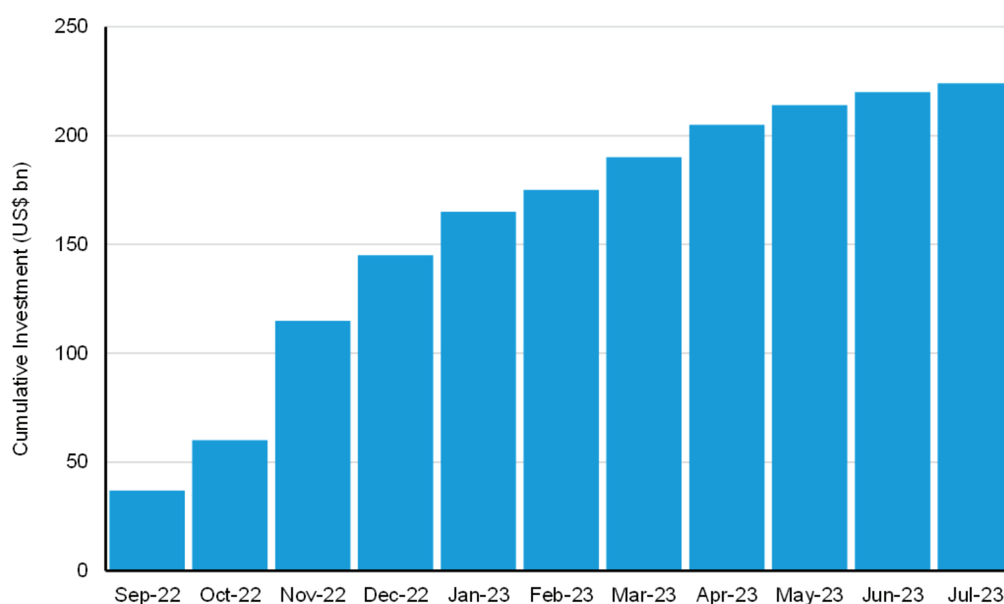
Finally, the shift in the US and many other developed markets including Australia to onshoring is providing myriad opportunities for unrecognised earnings growth. To understand the shift to onshoring, you have to remember the confluence of issues that surfaced during the pandemic from 2020 through to 2022, and beyond, including geopolitics, national security concerns, energy security and global intellectual property (IP) rights.

While the world was dealing with a global emergency through the biggest coordinated fiscal and monetary stimulus in history, a slow breakdown in US-China relations was occurring in parallel, some based on trade and security, and on differences in opinion between these nations on the origins of COVID-19, and some specifically on IP rights. Australia-China relations, and indeed those with US allies in general, had deteriorated. The political response to this was a policy of re-internalisation of manufacturing (also called

'onshoring'). The crisis in semiconductor supplies exacerbated the problems in the US, sharpening resolve amongst bureaucrats and politicians to move towards self-reliance on critical inputs. Moving beyond the pandemic with the invasion of the Ukraine by Russia, and the consequent energy crisis, the focus on onshoring broadened to include energy security.

As a result of the change in political sentiment, and now with focused stimulus and support programs in place like the Infrastructure Investment and Jobs Act (2021), Inflation Reduction Act (2022) and the CHIPS and Science Act (2022), investment in US manufacturing has accelerated, particularly in the clean technology and semiconductor space, as illustrated in Chart 7.

Chart 7: The boom in clean tech and semiconductor investment since the announced US stimulus in 2022 (IRA and CHIPS acts) – cumulative investment



Source: FT analysis of company and state press releases and data from fDi Markets, Rystad Energy, and Semiconductor Industry Association.

Q: How are you positioning your portfolio?

A: We continue to see unrecognised earnings growth opportunities in excellent management teams based in the US who are leveraging the growth tailwinds of onshoring, data centres and electrical grid upgrades. Core positions continue to be Sterling and EMCOR which are exposed to these thematics.

With respect to decarbonisation opportunities, we are overweight in electrical equipment with exposure to continued investment in the electrical grid in the US and Europe, as well as to increased spend in construction and infrastructure.

Ausbil expects robust economic growth in the US in 2025, therefore, we are overweight select high-quality consumer discretionary sectors, and key cyclicals like US insulation installers TopBuild and Installed Building Products which both have strong exposure to the US housing market.

As a caution on the cost of living, we are underweight the consumer, specifically apparel and core retail exposure as the US and global consumer is still at risk from elevated interest and inflation rates, although we believe the peak in these is behind us. The financial sector is an underweight alongside the real estate sector; ongoing elevated interest rates continue to put downward pressure on real estate earnings.

In summary. Global small-cap equities were punished more than larger companies in the aggressive rate normalisation of 2022/23. However, with major thematic tailwinds and a softening rates outlook, we see global small caps retracing valuations and generating superior relative earnings growth.

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United States
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