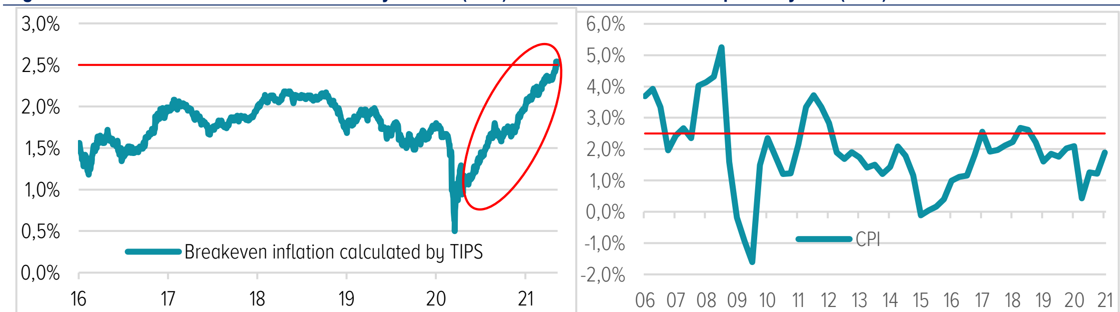
Kempen Global Listed Infrastructure

MAY 2021

INFLATION HEDGE

Economies are progressively reopening thanks to rising vaccinations. Monetary and fiscal policy remains accommodative. Hence, investors' worries about inflation are reignited: bond yields have traded higher recently and breakeven inflation has increased to 2.5%. Inflation is expected to pick up in the US eventually, fueled by higher commodity prices and trade bottlenecks, while economic growth should accelerate. For investors the question is: how to protect investment portfolios if inflation would remain persistently high going forward?

Figure 1: US Breakeven inflation based on 10yr bonds (LHS) and US inflation over the past 15 years (RHS)

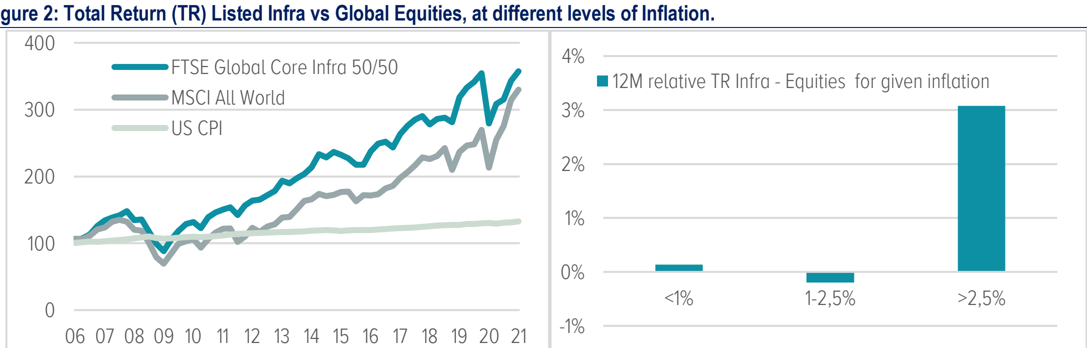


Source: Kempen, Factset, May-21

In the past 15yrs, global listed infrastructure has delivered returns in excess of inflation. It has also outperformed global equities (see LH chart below).

Furthermore, during the same period, global listed infrastructure has tended to outperform global equities materially, whenever (US) inflation expectations was above 2.5% pa (see RH chart below). Hence, to hedge investment portfolios against inflation, global listed infrastructure seems to be an even better asset than "pure" global equities. Why is that so?

Figure 2: Total Return (TR) Listed Infra vs Global Equities, at different levels of Inflation.



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INFRASTRUCTURE BY VIRTUE OF ITS CONTRACT CAN PASS ON INFLATION TO CUSTOMERS

To protect earnings from inflation, a company needs pricing power. A majority of infrastructure companies have the right to pricing power. Inflation protection comes through regulation or (concession) contracts - where inflation pass through is written into contracts. Even in the case where there is no explicit link, the infrastructure assets often have the pricing power given barriers to entry.

Examples from the Infrastructure asset class: Communication towers and toll roads have contracts linked to inflation. The French toll-road operator Vinci can increase prices by at least 70% of CPI every year, while most of Transurban's roads in Australia are allowed to increase prices by the greater of CPI or 4%. Airport regulation varies, but most regulation allows to recover inflation. Most ports and rail companies are not regulated, but have reasonable pricing power and also benefit from (GDP-linked) volume growth. The regulated utilities tend to offer greater protection than integrated utilities as regulated prices are linked to inflation. By way of example, the regulated asset base of Terna, the grid operator in Italy, is adjusted annually for inflation, and the UK water utilities are premitted to earn a real return.

As inflation concerns come back, so does the opportunity for Infrastructure assets that can protect earnings.

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Kempen

Beethovenstraat 300
1077 WZ Amsterdam
The Netherlands

P.O. Box 75666
1070 AR Amsterdam
The Netherlands

T + 31(0)20 348 8700
F +31 (0)20 348 8750

www.kempen.com

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