America's infrastructure frustrations

By Maxwell Gold – Director – Investment Strategy | maxwell.gold@etfsecurities.com

Summary

Market and political factors are currently favourable to support additional US infrastructure investment.

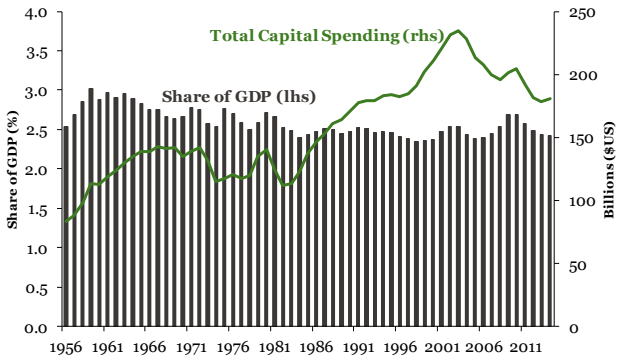
Due to continued budget deficits, private capital will most likely need to supplement public infrastructure spending.

Renewed investment in US infrastructure should help drive US growth, labour and commodity demand.

America is showing its age

US infrastructure is in dire need of an upgrade as its quality currently lags levels seen in other developed economies[3]. Many of the US's aging assets (roads, bridges, airports, waterways, and mass transit) continue to deteriorate due to the lack of new investment. In 2013, the American Society of Civil Engineers (ASCE) conducted their Report Card for America's Infrastructure and assigned a grade of D+ (defined as poor) to the US national infrastructure. They also estimated an additional $200 billion in annual spending over the next eight years was needed to bring the nation's infrastructure up to par.

US Infrastructure spending has trended lower



Source: Congressional Budget Office, ETF Securities as of close 23 August 2016. Exhibit data from 1/1/1956 to 12/31/14

This is partly a result of three decades of underinvestment with a 23% drop since 2003 in real capital spending across the two largest infrastructure categories: transportation and water. While overall federal infrastructure spending has remained fairly steady at 2-3% of annual GDP since 1956 it has also seen a slowing trend since the post-war period.

Recently, there have been signs of changing attitude in US fiscal spending towards its deteriorating infrastructure. In December 2015, the Fixing America's Surface Transportation (FAST) Act was passed and allocated $305 billion over the next five years for highway and transportation[4]. This, however, is only a small step in the right direction as the projected funding gap is estimated at over $1.6 trillion across all segments (see table).

Investment gap in American Infrastructure

Billions (USD)	Total Needs	Estimated Funding	Funding Gap
Roads/Bridges/Transit	$1,723	$877	$846
Energy (Electricity)	$736	$629	$107
Airports	$134	$95	$39
Dams/Waterways /Ports	$131	$28	$103
Rail	$100	$89	$11
Other	$811	$306	$505
Total	**$3,635**	**$2,024**	**$1,611**
Annual Investment	**$454**	**$253**	**$201**

Source: American Society of Civil Engineers 2013 Report Card for American Infrastructure. Other = public parks & recreation, schools, water & wastewater, hazardous & solid waste, ETF Securities as of 23 August 2016.

Pricing and populism bode well for US public works spending

The present economic and political climate is primed for increased US fiscal spending on infrastructure. The current interest rate environment remains near record lows highlighting that borrowing and financing costs are currently cheap, therefore an opportune moment for the next political administration to invest in infrastructure. Additionally, since rates are expected to remain lower for longer, this may extend the window of opportunity for policymakers to enact on more infrastructure projects.

Commodity prices remain well below their average prices in 2003 (the start of a commodity bull market) which saw the beginning of a marked decline in US real capital spending. The reduced costs across key building and construction materials and fuel for machinery and vehicles presents an attractive opportunity for the US to enter into projects to rebuild its infrastructure.

The growing rise of populism in global politics is also increasing public support for economic growth through infrastructure

[3] World Economic Forum. See "Commodity demand to increase with rising global infrastructure needs"

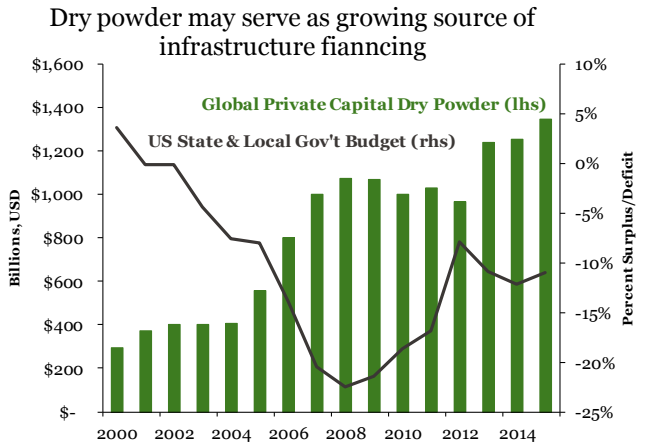
[4] U.S. Department of Transportation Federal Highway Administration

investment. In this year's US Presidential election, the only topic both party candidates seem to agree on is the need to increase fiscal spending on America's deteriorating infrastructure. Hillary Clinton, the Democratic Party candidate, has outlined a plan to increase federal infrastructure funding by US$275 billion over a five-year period of which US$250 billion would be used in direct public investment. The remaining US$25 billion would be levered to fund up to US$225 billion in direct loans, for a total spending increase of US$500 billion. Donald Trump, the Republican Party candidate and real estate entrepreneur, has expressed similar intentions to drastically increase the federal spending on infrastructure.

Utilising the growing populist sentiment, politicians appear very keen to increase employment, US competitiveness, and economic growth in manufacturing and construction related sectors. With mass public support and growing populist sentiment, the current climate may help expedite fresh investment into US infrastructure which has hit political hurdles in the past.

Funding the future

There appears to be a greater commitment from federal spending to offset the multi-decade decline, but historically state and local governments have carried the majority of financing for public projects. As of 2014, state and local governments accounted for over 75% of total public infrastructure spending[5]. This burden, however, may be difficult to sustain in the years ahead as budget deficits (-11% as of 2015) continue to plague state and local governments in the US. Given the continued weak economic recovery, raising tax revenue to combat these shortfalls is a politically unpalatable option.



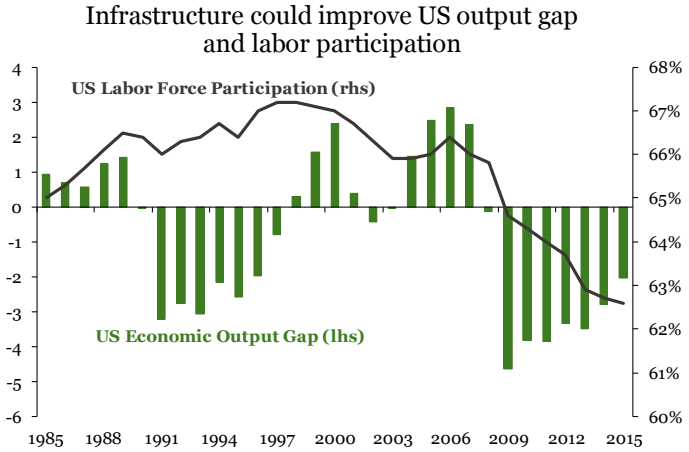
Source: Preqin, NIPA, US Bureau of Economic Analysis, ETF Securities as of close 23 August 2016.

In order to avoid spending cuts on future infrastructure investments, local governments may find supplemental funding in the form of public-private partnerships and direct private investment funds, which as of June 2015 hold over US$1.2trn in dry powder. Against the landscape of stretched equity valuations, record low interest rates, and negative real yields on cash, private investment may find attractive opportunities in infrastructure deals.

Nearly half of the projected funding gap in US infrastructure is tied to bridges, roads, and transit all of which operate on tolls and income. This potential cash flow would be an attractive option for many yield hungry investors. This is particularly attractive to institutional investors like endowments and pensions, which have long time horizons matching the tenor of infrastructure investments. Further private investment is expected to rise in the near term since 66% of US-based infrastructure investors are currently below their target allocation to the asset class[6].

Infrastructure can reignite US economy

Public infrastructure spending is vital to boosting the US economy, particularly when the impact of monetary stimulus appears to have diminishing returns. Increased public projects would see a rise in US import and demand for copper, steel, cement, aluminium, petroleum and other cyclical commodities. This would also provide a boon to the US manufacturing, materials, and construction sectors which have slowed of late.



Source: OECD, US Bureau of Labor Statistics, ETF Securities as of close 23 August 2016

Additionally, the US labour market could benefit by not only improving the labour participation rate - which has been in structural decline for several decades - but also by creating new low-skill jobs, which have become scarce due to automation and globalisation. With more infrastructure activity and higher labour participation translating into GDP growth, this could further help close the US's current negative output gap.

After years of reduced investment, the current economic and political backdrop has reached a confluence that is supportive of a boost in US infrastructure spending. This should prove a boon for US growth which has remained sluggish in recent quarters and remains below its long term potential growth. Additionally, US labour markets and materials sectors should benefit from an expected increase in public spending.

[5] Congressional Budget Office

[6] Preqin Special Report: US Infrastructure. May 2016