Global Water
2023 Outlook

VIRTUS FUNDS

2022 Review

Global equity markets experienced a tumultuous year in 2022, with elevated inflation, rising interest rates, and geopolitical tensions. The water sector was not immune and declined during the year, despite constructive fundamentals and an attractive long-term outlook. Over a longer period, performance in the water sector, as represented by the S&P Global Water Index, remains compelling, outpacing global equities, as measured by the MSCI ACWI, in the last 3-, 5-, 10-year time periods by an average of over 2% annualized for the three periods.

Like the equity markets, communities across the globe had a tumultuous year as they continued to grapple with water challenges stemming from pervasive droughts and floods, deteriorating infrastructure, and contamination. Today, 75% of the U.S. is battling drought or abnormally dry conditions and Europe is facing its worst drought in 500 years.[1] Conversely, some parts of the U.S. and countries such as Pakistan and Australia are still recovering from unprecedented flooding during the year. Poor infrastructure is compounding these issues, as evidenced by the crisis in Jackson, Mississippi, where decades of underinvestment culminated in the city losing access to clean water after a significant storm.

Given these ongoing challenges, governments and businesses are increasing their attention to water. The U.S., for example, had a banner year supporting the sector with the passage of the Infrastructure Investment and Jobs Act, the Inflation Reduction Act, and the CHIPS and Science Act, all of which provide tailwinds for investment in water infrastructure and technology. Businesses continued to advance water sustainability initiatives in 2022, with Proctor & Gamble the latest company to announce a "water positive" target by 2030. These initiatives underpin growth for companies offering water efficient equipment, treatment that enables reuse, and digitally connected systems that measure and optimize water use.

With these tailwinds, along with supportive fundamentals, earnings in the water sector remained resilient during the year, with companies reporting strong results and unwavering projections of attractive growth in the near-to-medium term. Despite the resilient earnings, multiples contracted due to broad market headwinds, driving the negative return on the year.

Looking Forward

We remain constructive on the outlook for the water sector into 2023, and our conviction remains high that secular tailwinds will produce attractive risk-adjusted returns over the long term. We believe water infrastructure and equipment and technology companies are well positioned headed into the new year.

Within water infrastructure, water utilities offer defensive positioning as the economy slows and a potential recession looms. Water utilities feature resilient cash flows supported by stable demand, regulated returns, and favorable regulatory constructs. Growth potential is driven by a robust slate of capital projects. In the developed markets, utilities are rehabilitating overaged pipes and treatment plants that clearly require attention, with water main breaks occurring every two minutes in the U.S. Emerging markets are focused on building out needed infrastructure to expand connectivity, improve water quality, and reduce pollution. These initiatives remain vital as 80% of wastewater currently goes untreated across the globe.[2]

[1] European Commission, "Drought in Europe August 2022."
[2] World Bank, "Wastewater A Resource that Can Pay Dividends for People, the Environment, and Economies, Says World Bank." As of 3/19/2020.

The water equipment and technology subsector is set to continue its growth trajectory, albeit unevenly across end-markets. The municipal end-market, comprised of investor- and government-owned utilities, remains the stalwart of the subsector with stable demand and visible growth. Utility budgets are flush following strong economic growth, rising water rates, and government support, with ~70% of project activity related to break-and-fix activity. Growth in the end-market is further supported by adoption of digital technologies that detect, communicate, and reduce water loss at compelling economics, as well as upcoming regulation on polyfluoroalkyl substances (PFAS) that decreases allowable limits in water. This represents a significant growth opportunity for companies offering technology that detects, treats, and removes the chemicals as more than 200 million Americans may be drinking water contaminated with PFAS.[3] The agriculture end-market is another bright spot, supported by elevated commodity prices, rising farm incomes, and an increased focus on resiliency following food shocks in 2022. These tailwinds provide support for irrigation equipment and technologies that reduce water use and increase crop yields. The industrial and commercial end-markets are currently constructive, with strength for water services in micro-electronics, life sciences, and food and beverage, though these end-markets may be exposed to a slowdown if the economy softens. The residential end-market faces headwinds as activity slows due to affordability challenges and a weakening consumer.

Entering 2023, equity markets face several uncertainties, including high (albeit declining) inflation, hawkish central banks, continued geopolitical tensions, and uneven economic growth with an elevated probability of recessions. We remain focused on companies that provide leading solutions in improving water supply, quality, and efficiency and are positioned to execute on secular growth and outperform through an economic cycle. As this occurs, we believe water investments will be rewarded over the long term.

[3] Environmental Working Group, “More than 2,000 communities have drinking water with ‘forever chemicals’ above new EPA levels.” As of June 2022.

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The MSCI AC World Index (net) is a free float-adjusted market capitalization-weighted index that measures equity performance of developed and emerging markets. The index is calculated on a total return basis with net dividends reinvested.

The S&P Global Water Index (net) is a modified capitalization-weighted index comprised of 50 of the largest publicly traded companies in water-related businesses that meet specific invest ability requirements. The index is designed to provide liquid exposure to the leading publicly-listed companies in the global water industry, from both developed markets and emerging markets. The index is calculated on a total return basis with net dividends reinvested.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.