Utilities Sector Outlook

Over the past few years, utility stocks have appeared to be trading on interest rate movements rather than fundamentals. However, during the recent downturn, utility stocks have traded down with interest rates. The utilities sector has not acted as defensively as we have seen in previous downturns. We believe that traditional regulated utilities are some of the companies least affected by changes in the health of the economy. The regulated segments will continue to earn a return on the capital invested on utility infrastructure. Utility companies with exposure to nonregulated businesses, especially those related to the energy sector, have underperformed utilities without that exposure. We would expect that trend to continue should we see continued volatility in the overall market. We believe the recent market decline has presented clients an opportunity to buy high-quality utility companies, ones that we view as relatively less affected by the decreased activity in various sectors of the economy, at significantly cheaper prices.

In this report, we will discuss recent developments in both the utility industry and interest rates and summarize our current view on utility fundamentals, as well as discuss how valuation has changed over the past several years:

- In the most recent downturn, utilities stocks traded down with interest rates. That is the opposite of what we have seen historically.
- We believe utility industry fundamentals will remain healthy and supportive of reasonable earnings and dividend growth.
- We continue to recommend that investors remain focused on principles, not predictions, and invest in a diversified portfolio for the long term as opposed to trying to time the market.

We believe it is important to periodically review portfolios to ensure that they remain properly diversified and appropriate for an investor's individual situation. This is especially true now given the changing interest rate environment and its impact on utility stocks.

**Why have utility stocks done well over the long term?**

Utility investors enjoyed good performance over the past decade as well as consistent dividend growth from many utility companies (see **Figure 1** on the next page). We believe a combination of utility-related factors, as well as macroeconomic issues, have created and sustained this positive environment. Within the utility sector, companies increased their emphasis on infrastructure and environmental investments, which has led to improved earnings growth (as utilities are allowed by regulators to earn a specified return on approved investments). This, combined with many utilities' management teams refocusing on core regulated businesses, has been attractive to investors.

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Source: FactSet, 1/5/21. The S&P 500 Index is based on the average performance of around 500 widely held common stocks. The S&P 500 Utility Index consists of 28 utility companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

On a separate plane, macroeconomic factors, such as the ongoing historically low-interest-rate environment and a corresponding lack of options available to investors to generate current income, have helped boost utilities in most years since the financial crisis. Many investors have used utilities and other defensive sectors as substitutes for bonds, as equity dividend yields often exceed bond yields for the same company. This philosophy has worked well in an ascending market for utility stocks, as some investors have been happy to realize significant capital appreciation in addition to healthy and often rising dividend payments. Over the past couple of years, utility stocks oscillated primarily due to increases and decreases in interest rates. Utility stocks have seemed to perform well when interest rates fall (or there is an indication that they will not rise further) and fall when rates rise. That changed recently when utilities traded down with interest rates.

**Utility company fundamentals remain solid**

In our view, utility industry fundamentals remain healthy and supportive of reasonable earnings and dividend growth for the next several years. Regulated utilities hold virtual monopolies in their service territories, and they earn an allowed return on approved investments, of which there are hundreds of billions of dollars' worth needed in the U.S., according to independent sources. The national average for allowed returns for both electric and gas utilities remains at just under 10%, a level that we believe will enable utilities to sustain profit growth. Additionally, many utility companies have realized that infrastructure spending to update, maintain, repair and expand power lines, pipes and power plants is a lower-risk way to grow earnings than diversifying into unregulated businesses. Companies have identified approved projects that they are able to finance and that can potentially lead to higher earnings. We have seen companies focusing on such investments and divesting ancillary, unregulated businesses, leading to more stable, reliable earnings. We believe well-managed utilities can increase earnings at 5% to 6% on average for the foreseeable future, with corresponding dividend growth.

**Absolute valuations closer to historical average**

Utility valuations have become more attractive as shares have fallen from recent highs. On a price-to-earnings basis, shares are now trading closer to their historical averages, after trading near all-time highs. Until early this year, we have seen utility valuations moving with interest rate movements, although there have been exceptions to this. Overall, however, we believe the low-interest-rate environment has been the biggest factor in pushing utilities higher since many investors buy them for their dividend yield.

**What about interest rates?**

Let us turn our attention to the relationship between utility stocks and interest rates (the 10-year Treasury yield). We believe that investors should be aware that, historically, utility stock prices and the 10-year Treasury yield have tended to have an inverse relationship. This means that when interest rates rise, utility stock prices tend to move down, and vice versa. We saw a weakening of this relationship post-2002 (see Figure 2), but we believe this was largely due to unusual circumstances. We do believe that this relationship generally still holds.

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Moves up in rates have spurred declines in utility stocks, while retreats in interest rates have driven utilities higher. We reiterate that making interest rate predictions and trying to time entry and exit points for stocks based on interest rate predictions is a risky endeavor. Nevertheless, we again caution investors that, especially with valuations elevated, we believe a significant rise (or indications of a significant future rise) in interest rates could have a negative effect on utility stocks.

Should I adjust my portfolio as interest rates move?
We think it is appropriate to periodically review portfolios and rebalance sector weightings. Certain life events or macroeconomic changes can demand timely examination of portfolios. We are aware that many investors have a weighting in excess of 4% in utilities, and we understand that there may be individual reasons why this is appropriate. Importantly, we recommend investing based on principles and not trying to move in and out of stocks based on predictions, whether for the economy, the stock market as a whole, or interest rates in particular. We preach diversification and quality and advocate owning a portfolio of dividend-paying stocks for the long run, through the ups and downs of the interest-rate cycle.

Coming out of the recession in 2009, most people thought interest rates had nowhere to go but up, but they have yet to move significantly higher, relative to historical levels. The main point to remember is that even professionals find it very difficult to predict the direction and magnitude of interest rate changes, so we would not recommend making major changes to portfolios based on predictions. We continue to believe utility stocks have some attractive characteristics, and we believe they should always be part of a diversified portfolio, regardless of short-term movements in interest rates.

While utilities offer a number of positives for investors, we note the risk of having too heavy a weighting in any one sector. For those investors whose utility holdings are significantly higher than our 4% recommendation, we suggest looking to the Edward Jones Equity Income Buy List for ideas in other sectors. The Equity Income Buy List consists of a mix of dividend-paying stocks from different sectors recommended by the Edward Jones Securities Research Department. The list is designed to provide an above-average dividend yield and the potential for rising income.

Risks besides valuation
Despite their regulated nature, utility stocks carry various risks that investors should consider. Risks to the relative performance of utility stocks would include better-than-expected or faster overall economic growth, evolving or new legislation concerning environmental guidelines and/or renewable power sources, and rising long-term interest rates. Utility-specific risks would include the potential for declining allowed returns, rate-case fatigue as companies repeatedly seek reimbursement of capital spending, fluctuations in commodity prices, and managing regulatory relationships.

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