Utility stocks have underperformed the market since the 2016 election, but we don't believe the main reason for this is necessarily any potential changes brought about by the Trump administration. There has been much discussion about possible policy changes regarding renewables, coal, the corporate tax rate, deductions for interest expense, etc., but, in our view, these factors will not have a major impact on utilities. However, the relatively more positive impact of lower tax rates on other sectors versus utilities has certainly contributed to the underperformance.

We believe utilities have lagged mainly, though, due to the actual and projected increase in interest rates (as measured by the 10-year Treasury bond). (See figure 1). Higher dividend-paying stocks like utilities tend to move opposite interest rates. As bond yields rise, the relative attractiveness of utilities' dividend yields declines. This can lead to a decline in utility stock prices as income-seeking investors move into bonds. As interest rates have risen since the election, the utilities sector has delivered total returns below the broad market and in the bottom half of all sectors. (through 1/15/18).

There has been much discussion about the above topics. In our view, a lower corporate tax rate will similarly affect most of the utilities we follow. There are some distinctions, but in general, any savings from lower taxes would eventually be passed along to customers of regulated utility businesses. However, utilities that own unregulated subsidiaries would likely benefit more directly. Also, utilities that hold large amounts of debt at the parent level might no longer benefit from the tax deductibility of interest expense, so these companies could be disadvantaged versus peers that hold most debt at utility subsidiaries. But we do not believe this would have a significant effect on earnings.

In terms of fuels used to generate power, the trend remains in favor of natural gas and renewables. While President Trump may wish to support...
coal, we do not believe most utilities will be swayed. Utility managements are making these decisions for decades to come, not just the next four or potentially eight years. They have admittedly been phasing out many old, dirty, inefficient coal plants due to environmental concerns, but they are also shuttering coal plants due to economics. With natural gas prices remaining historically low (and forecast to remain so for the foreseeable future based on the plentiful supplies unlocked by fracking), many companies have been running gas plants instead of coal.

Furthermore, due to technological advances, the price of wind and solar power continues to decline. New wind turbines and solar panels are becoming more and more cost-competitive, and of course, the fuels are free. Roughly two-thirds of states now have voluntary or mandatory targets for percentages of power produced by renewables, as well, and many corporations are aiming for zero emissions (see figure 2). Any change to federal law (such as the abandoning of the much-ballyhooed Clean Power Plan) would not have an impact on these factors. We believe the transition to cleaner power generation is here to stay.

Figure 2

Therefore, while some changes brought about by our new president will certainly affect utilities, we do not believe they will have a major impact. We do not think utilities will change much about the way they operate. We have noticed certain utility companies' stocks reacting to policy announcements, but these mostly affect unregulated companies. Our coverage remains focused on more heavily regulated utilities because we continue to believe these companies will produce more stable, consistent and predictable results.

Our most significant concerns remain the same – valuation, which is still significantly above historical averages, and the threat of rising interest rates. We believe the threat of rising interest rates has led to underperformance by utilities since the election, not potentially changing policies that affect utilities' operations.

Although we believe rising interest rates would not bode well for dividend-paying stocks like utilities, we do not advocate trying to time either the market or interest rate cycles. We remind clients to stay invested in a well-diversified portfolio of quality companies (including utilities) for the long term.

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