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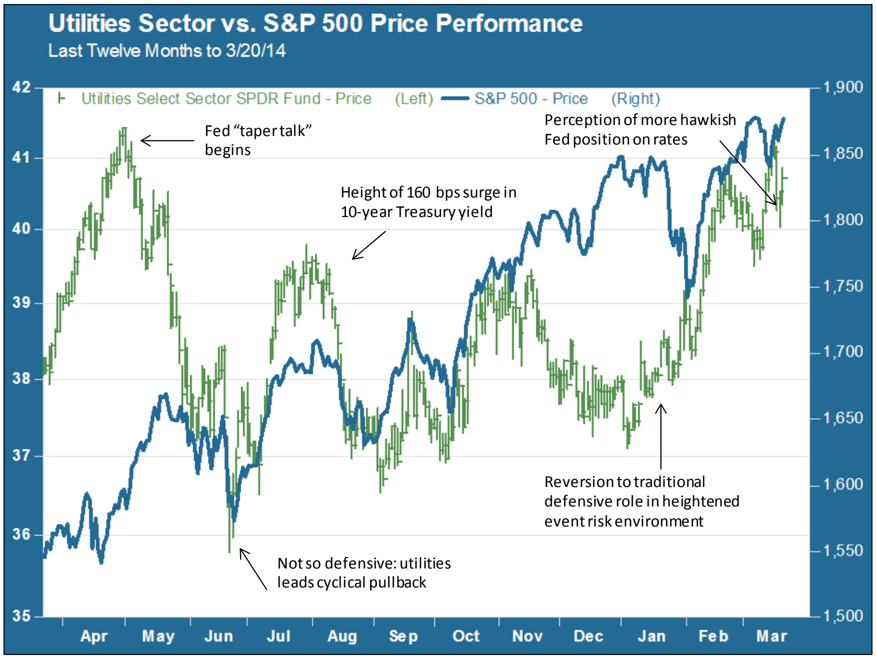
MV Capital Management Weekly Market Flash

Utilities: The Wild Ride Continues

March 21, 2014

The utilities sector is the traditional safe port in a storm among the nine major industry groups that make up the U.S. stock market. It is typically the last space investors vacate when risk turns up and the threat of a market correction looms. Over the last twelve months, however, the world of power grids and water treatment facilities has been anything but boring or predictable. This has very little to do with the basic business models of the sector, which mostly involve collecting regular, easily quantifiable monthly payments from residential and business customers. Rather, the volatile price performance of utilities stocks illuminates the far-reaching and sometimes unexpected ways that the Fed's monetary policy decisions continue to impact the equities market. It was on display again this week, as Janet Yellen made her debut post-Fed meeting press conference.



Utilities Sector vs. S&P 500 Price Performance

Last Twelve Months to 3/20/14

Fed "taper talk" begins

Height of 160 bps surge in 10-year Treasury yield

Perception of more hawkish Fed position on rates

Reversion to traditional defensive role in heightened event risk environment

Not so defensive: utilities leads cyclical pullback

Source: FactSet, MVF Research

Tapering Down

The chart above shows a close correlation between the performance of the utilities sector (shown here by the SPDR S&P 500 Utilities Sector ETF) and key Fed events over the past year. During the first four months of 2013 utilities, along with health care and consumer staples, led a broad-based market rally. But in early May utilities parted company with those other two traditional defensive sectors as the word "taper" escaped from Ben Bernanke's lips into the market lexicon. Having led the market up, utilities was now at the leading edge of a cyclical pullback, falling twice as far from its peak to trough as the overall S&P 500. That is not typical behavior for an asset class typically thought of as a relatively safe haven. Why did utilities fall so far, so fast, and then go on to do a repeat performance later in the summer of '13?

All About Yield

The answer to that question is summed up in one word: yield. In the yield-parched world of the past several years, investors have gone hunting outside the traditional confines of investment grade fixed income products to increase their portfolios' yields. Utilities names have been one of the big beneficiaries of this trend: dividends tend to make up a larger percentage of the total return for utilities than is the case for other sectors. Of course, owning shares in utilities companies is riskier than owning triple-A corporate or U.S. government bonds, but investors increasingly put these risk concerns on the back burner in the quest for yield.

When the "taper talk" began last May, yields on Treasuries and other interest rate-sensitive securities soared. The 10-year Treasury yield, a key benchmark interest rate, surged a nearly unprecedented 160 basis points from May to September. Suddenly those yields from the utilities sector started looking less appetizing. Even when the Fed pulled back from a widely expected tapering decision in September, the consensus view had already set in that rate increases were only a matter of time. The utilities sector finished the year far behind the broader market: a total return of 13% versus 32% for the S&P 500.

Permanent Casualty?

Will utilities be a permanent casualty of a long-term structural trend towards higher rates? For now it's too early to make that case, partly because we don't know with any certainty what that rate trajectory will look like. In her inaugural post-meeting press conference on March 19 Fed Chairwoman Yellen removed quantitative benchmarks from the forward guidance equation. With the unemployment rate hovering just above the earlier 6.5% benchmark, the Fed has given itself more leeway to hold down rates for longer if it believes that is more advisable.

Of course, the markets blithely overlooked that and reacted instead to a slight rise in the Governors' consensus views on the likely Fed funds rate in 2015-16. Treasury yields shot up, and utilities stocks duly tumbled. Whether this presages another irrational rate surge is anybody's guess, but it could make for another tough year for utilities.

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