Utility Performance, Relative And Absolute

Lewis Carroll would have been right at home in the looking-glass world of performance analysis where someone who loses less money than an arbitrarily selected benchmark can be regarded as a relative success. Most of us who lose money lose our own money and would find our spouses focused more on these absolute losses than our relative "outperformance."

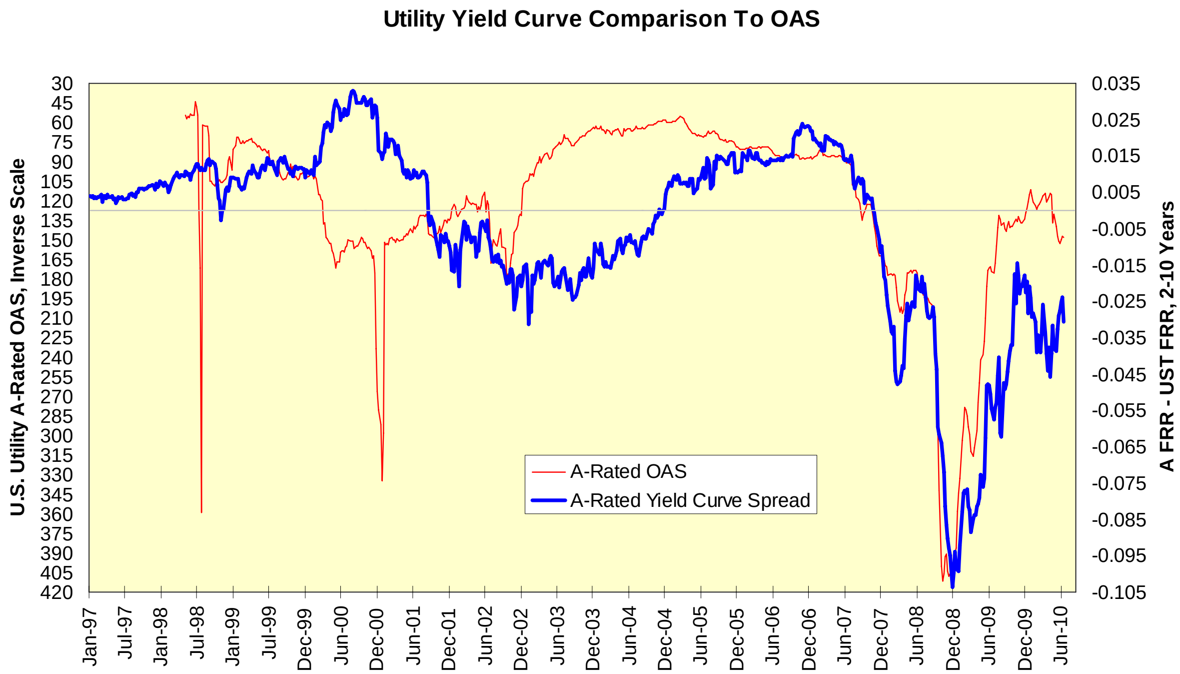
The utility sector has been a bit of an absolute dog in 2010; the S&P 1500 Utility sector has lost 5.71% through the first week of July, while the S&P 1500 itself lost 6.46% over the same period. The major difference, of course, is the broad market really looked like it had a fighting chance to do well in 2010 until things turned sour at the end of April.

Comparative Yield Curves

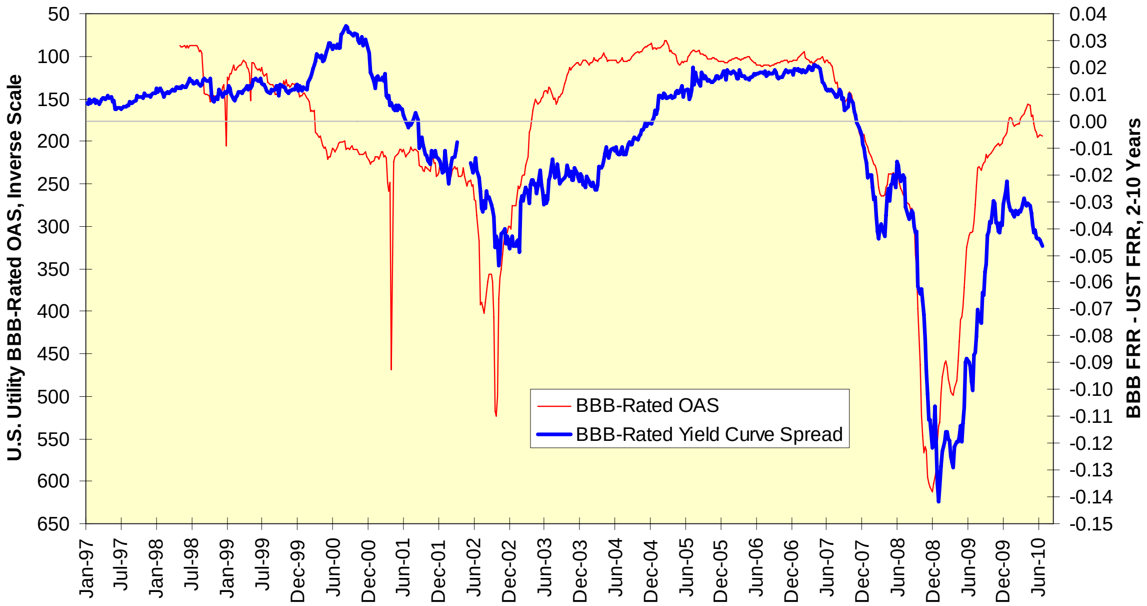
Of course, since the most important decision is the next one, we need to assess where the utility sector stands in relation to the broad market. One way is to compare the shape of the sector's benchmark yield curve against the comparable Treasury yield curve. This will involve creating the forward rate ratios (FRR) for both A- and BBB-rated utilities and for the Treasury between two and ten years. These FRRs are the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more this FRR exceeds 1.00, the steeper the yield curve.

A second tool, and one which mirrors the yield curve spread between the utility sector and the Treasury, is the credit spread (option-adjusted spread, or OAS) between A- and BBB-rated utilities and Treasuries. The higher the OAS, the more stress the sector is under.

If we map the yield curve spreads and OAS levels, the latter plotted inversely, over time, we see how OAS levels contracted and the yield curve spread narrowed during the 2009 rally all the way into early 2010.



Utility Yield Curve Comparison To Treasury Curve



After the April peak in the general market, both measures hit a wall. Both OAS measures failed just before the resistance established at the start of the credit crisis three years ago this month, and the yield curve spread for the lower-quality BBB-rated issues is breaking down from levels last since at the start of the 2008 calamity.

Taken by themselves, these indicators would advise you to stay away from the utility sector on an absolute basis. Whether the sector outperforms on a relative basis remains to be seen. If risk-aversion remains the order of the day, then utilities may be good places to remain in a defensive stance, but only if you are measured on a relative basis.

Finally, if measures such as cap-and-trade re-emerge as political issues, all bets are off on both an absolute and a relative basis. If the world suddenly becomes more risk-seeking, utilities will lose on a relative basis. In sum, the best we can do here is offer faint praise, which in reality is no praise at all.