Utilities As Cyclical Stocks

Last week's column entitled "Bonds Turning Bearish" prompted the question, "What about the Utes?" I assumed this *RealMoney* reader was referring neither to the tribe for whom the state of Utah is named nor to the 1992 movie, *My Cousin Vinny* wherein Joe Pesci, playing a Brooklyn lawyer, tries to save the homonymous "two yutes" from frying in the electric chair.

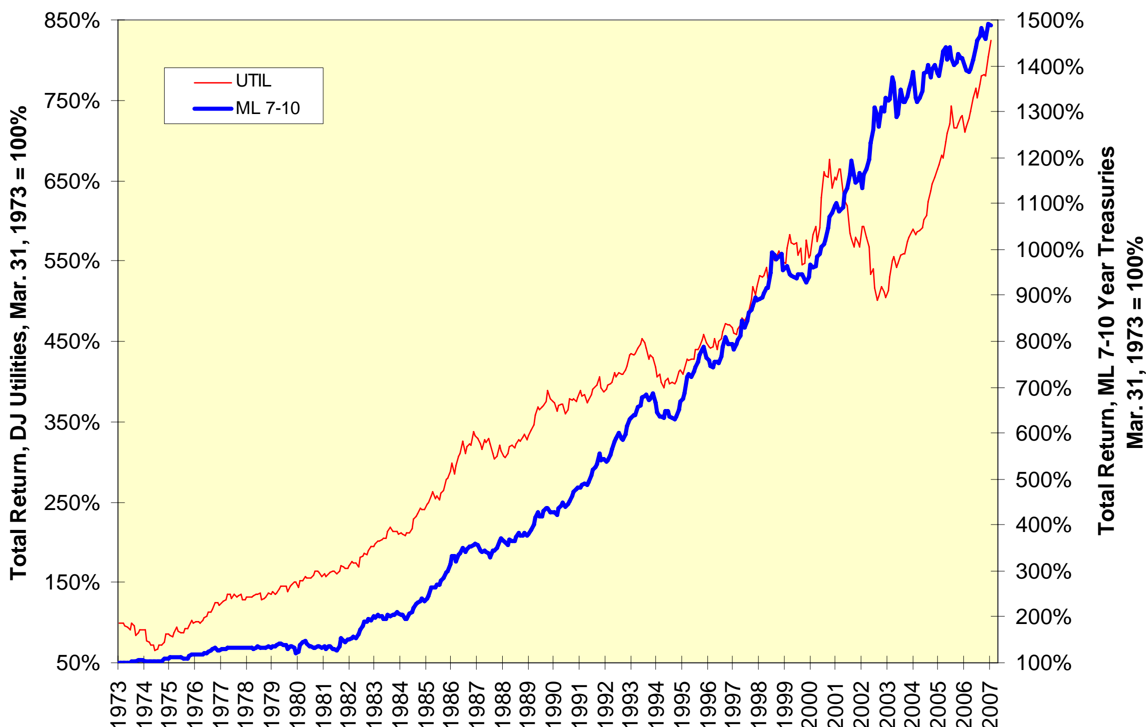
No, I deduced, the question was made in reference to utility stocks. Let's update a metric from a July 2005 column on utilities comparing the total returns of the three major Dow Jones averages since the start of the decade. The average annual total returns for the Industrials and Transports, respectively have been 3.1% and 8.1%, respectively. For the Utilities, the number has been 12.26%.

Turn your mental clock back to December 1999, and imagine how you would have been welcomed at your local Y2K (remember that?) planning festival had you advised chucking all those triple-digit returns then prevailing in the tech sector for a group of companies selling natural gas and electricity and making few friends in the process.

The Interest Rate Connection

This continued outperformance in the face of higher fuel costs and continuous regulatory headwinds is impressive. One might be tempted to add something about higher interest rates and a flatter yield curve, but these assertions would not be supported by the data. While utilities once were considered little more than bonds, that connection broke a long time ago and in a most surprising manner: Who would have guessed that while the Dow Jones Utility average would have seen a total return of 824% on a monthly basis since March 1973, the Merrill Lynch index of 7-10 year Treasuries would have seen a total return of 1488% over the same period?

Utilities Not A Fixed-Income Investment



This total outperformance has been anything but monotonic in nature. The 1970s were an awful decade for investors in general, but for bond investors in particular. By September 1981, the total return on that Treasury note index was 28%, or 2.89% per annum over a period when consumer purchasing power was declining at a 9.33% average annual rate.

Utilities started to outperform bonds in the late 1990s and into 2000 on the illusion, almost comic in retrospect, that all utilities would start to adopt the asset-light Enron model and become high-multiple trading and risk management

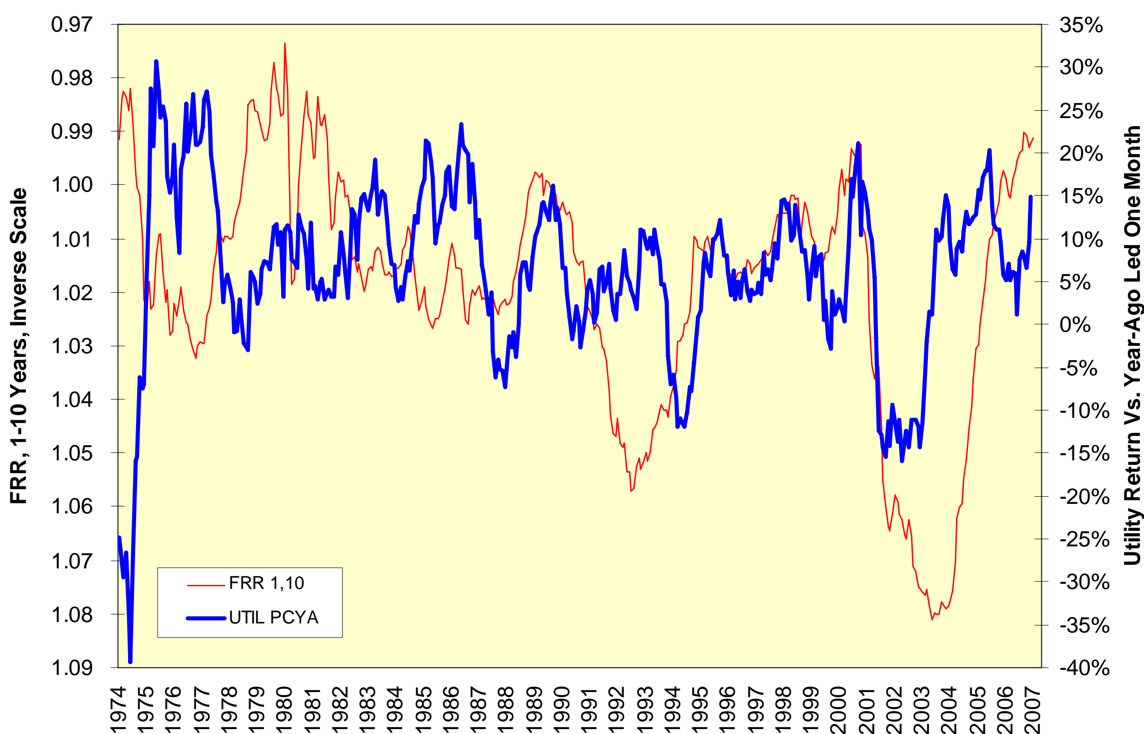
firms. After that blow-up and the ensuing bear market to which Enron contributed mightily, Utilities underperformed into March 2003 and have outperformed bonds steadily since.

The Yield Curve Connection

I predicted last month the yield curve would start to steepen. The knee-jerk reaction of many to a steeper yield curve is it benefits all borrowers, but the conclusion I offered then and repeat today is:

> *But the pattern of losers is clear: Stay away from financials, housing-related stocks and electric utilities.*

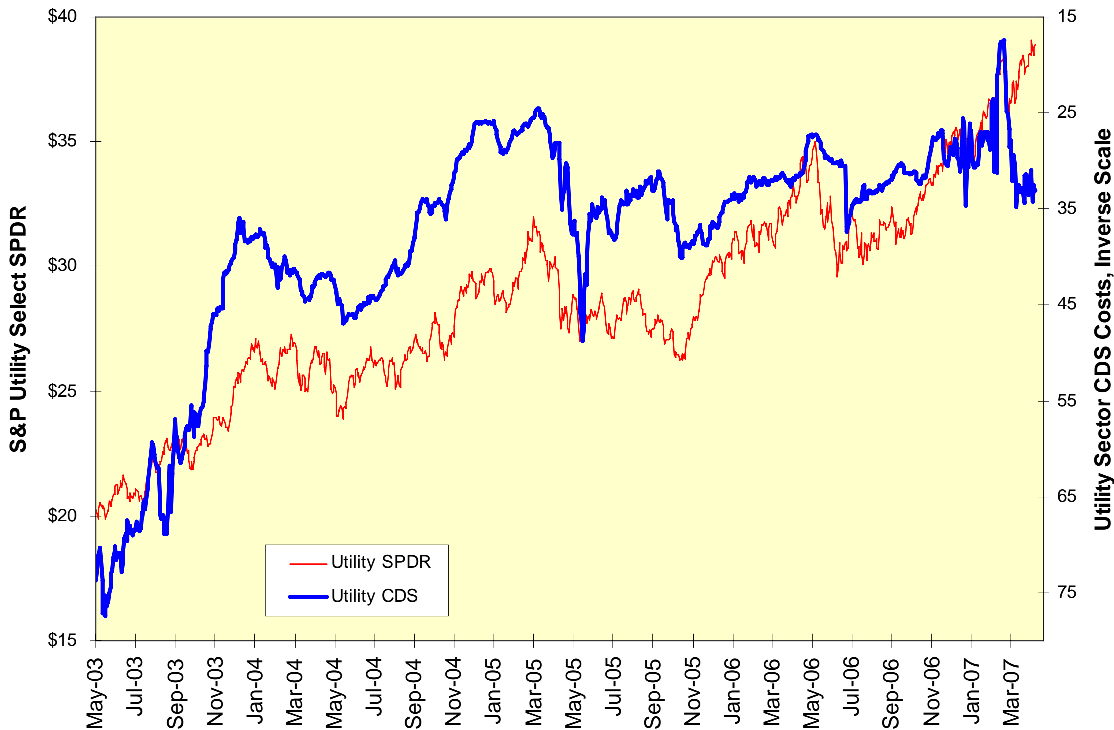
We can put this into a little historic perspective by comparing the yield curve as measured by the forward rate ratio between one and ten years, the rate at which we can lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself, to the year-over-year total returns for utilities. The forward rate ratio is plotted inversely. Over the past three decades, the FRR has led changes in the year-over-year gains for utilities by one month on average. If the forecast for a steeper yield curve is correct, the pressure on utilities will derive not from higher long-term interest rates per se but rather from the steeper yield curve.



Financial Stress Low

Now let's detour quickly into a topic first introduced in May 2005, sector-specific credit default swap (CDS) costs. A CDS acts like a put option on corporation's bonds; as credit stress rises, the price of the CDS in basis points should rise apace. A second set of conditions, a corporate restructuring such as a leveraged buyout wherein the stockholders are rewarded in favor of the bondholders, increases CDS costs as well.

We should expect these CDS costs to fall when the stock rises, and vice-versa: You should not be interested in the stock if you find the bonds too risky. If we map an index of CDS costs for members of the S&P 500 utility sector against a Select SPDR tracking this index, we find this relationship has held through the late February TXU leveraged buyout offer. Right now, however, utility CDS costs are on the rise even as the Select SPDR plows ahead. One of these markets is out of step with the other; if the above comments on the yield curve hold, utility shares are overpriced relative to their credit situation.



The Energy Connection

Now let's conclude with one of the most counterintuitive relationships in the market, the positive impact of rising crude oil and natural gas prices on utility stocks. Even though utilities are net buyers of energy commodities, their relative performance betas to the broad market as a function of crude oil and natural gas are positive. For crude oil, the beta for Electric Utilities is .0225, for Multiline Utilities .0379 and for Gas Utilities .0669. For natural gas, the beta for Gas Utilities is .0171.

The best explanation here is in a strong economy where utility capacity remains a scarce resource, utilities are able to pass on their rising fuel costs to their customers. This same scarcity explains much of the group's relative strength over the past four years: When the value of existing plant and equipment is not threatened by a surge of new plant and equipment its value – the value of the capital stock – rises.

This is entirely consistent with the counterintuitive argument proffered for the group's success during yield curve flattenings. It also brings us to the final paradox for utilities. They have been viewed as defensive stocks over the years, and with good reason. Just like you have to eat, you have to heat. But if the relative performance of utilities is linked to macroeconomic growth rates and the ability to pass costs through to customers, they are a cyclical group.

In decades past, declining utilities were a sign of rising interest rates. In this environment, declining utility shares will be a sign of declining macroeconomic activity. We don't know what the yutes of America think about this, but these are not your father's – or grandfather's – utility stocks.