Focus on Finance

by Linda C. Byus

Market uncertainty

The tumultuous summer of 2016 resulted in attractive returns for utility equity investors. Economic, political, and social unrest in the United States and around the world drove financial market volatility. The June 23 vote by the United Kingdom to leave the European Union—known as Brexit—shocked world economies, including that of the United States. The upcoming U.S. presidential election has created financial policy uncertainty. Terrorist attacks in the United States and abroad contribute to the perception of global risk. Amid all the uncertainty, investors have been buying utility stocks. Why has the utility sector performed so well year-to-date, and what does the future hold?

The outcome of the United Kingdom's vote to leave the EU sent shockwaves through world financial markets on June 24, and the market reaction carried over into trading on June 27. While the United States is not a member of the EU, and trade between the United Kingdom and the United States makes up only about 0.5 percent of U.S. economic activity, the U.S. stock market participated in the equity market selloff. This, however, was a reaction to the drop in world markets rather than a specific reaction to Brexit. Over the two days of trading, June 24 and June 27, the S&P 500 dropped more than 5 percent, with other major indexes experiencing similar losses. But the S&P 500 utilities sector rose 1.4 percent over those two days.

Those working in the utility industry are well aware of the spectrum of challenges facing individual companies, specifically regulatory and environmental uncertainty. But the financial markets are focused on the big picture. Utilities have maintained their identity as low-risk investments with a relatively high yield. As a regulated industry that provides an essential service, earnings and cash flow are fairly predictable. In addition, utilities continue to provide an attractive yield. Low interest rates provide a boost to the value of utility stocks. Utilities are capital intensive, and low interest rates result in a lower cost of capital for utilities accessing the capital markets. As of July 29, the yield on the S&P utilities was 3.08 percent, compared to the 1.46 percent yield on 10-year U.S. Treasury bonds.

The U.S. stock market rebounded sharply after the Brexit selloff and has regained the lost value, and more. At the same time, the utilities have retained their value and continue to outperform the market. At the end of July, the S&P 500 was up 7.6 percent year-to-date as compared to the S&P utilities, which are up 22.56 percent for the same time period.

Since the U.S. presidential election campaign is a process rather than an event, the market impact of the upcoming November election is as yet unknown. Candidate Clinton offers a continuation of current financial policy; Candidate Trump promises change to create economic growth, including a cut in tax rates. With regard to energy policy, Clinton supports renewables, while Trump believes generation should include an "all-of-the-above" approach. Trump supports renewable energy sources, but he would be friendlier to both fossil fuel and nuclear generation than his opponent. Overall, the election creates financial uncertainty, and Trump's lack of experience and lack of a track record escalate the level of uncertainty.

The occurrence of international terrorist attacks, especially in large cities, could disrupt financial markets in the short run, but the major impact of such attacks on investors is uncertainty and a sense that events are not within our control. Political unrest, such as the failed coup in Turkey, could cause a shift in political allies, with significant trade implications longer term. Any political disruption in oil-producing nations could have economic implications in the United States, as well as a direct impact on energy companies.

The ultimate impact of the United Kingdom's separation from the EU is expected to take years, but the participants are determined to make the process efficient and structured in order to avoid economic and political disruption. The dramatic financial reaction to the vote in June illustrated the fragility of economic markets. While the markets fully recovered from that initial reaction, as the process goes on, more volatility can be expected. The uncertainty of the presidential election will be resolved in early November, but a Trump victory would not likely lead to economic stability. The level of international political risk is a reality the financial markets will continue to deal with.

Utility investors have benefited from the uncertainty of the financial markets and the view of utility stocks as a safe investment with an attractive yield. But the run-up in utility stock prices as a defensive play may not have recognized the challenges facing the industry, especially regulation and market structure issues. At current valuation levels, the utility industry does not offer fundamental investment value based on sales growth prospects or innovation. Interest rates are at record lows, and the eventual increase in rates will hurt the valuation of utility stocks. The outlook for financial markets in the United States includes a high level of uncertainty. While utility investments are viewed as a safe haven, there is significant downside risk going forward. **FoF**

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