

How Utilities Fare In a Rising Rate Environment Relative to Bonds

By Fred Meissner, CMT
www.theFREDreport.com

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4514 Chamblee-Dunwoody
Dunwoody, GA 30338

Web:

www.theFREDreport.com

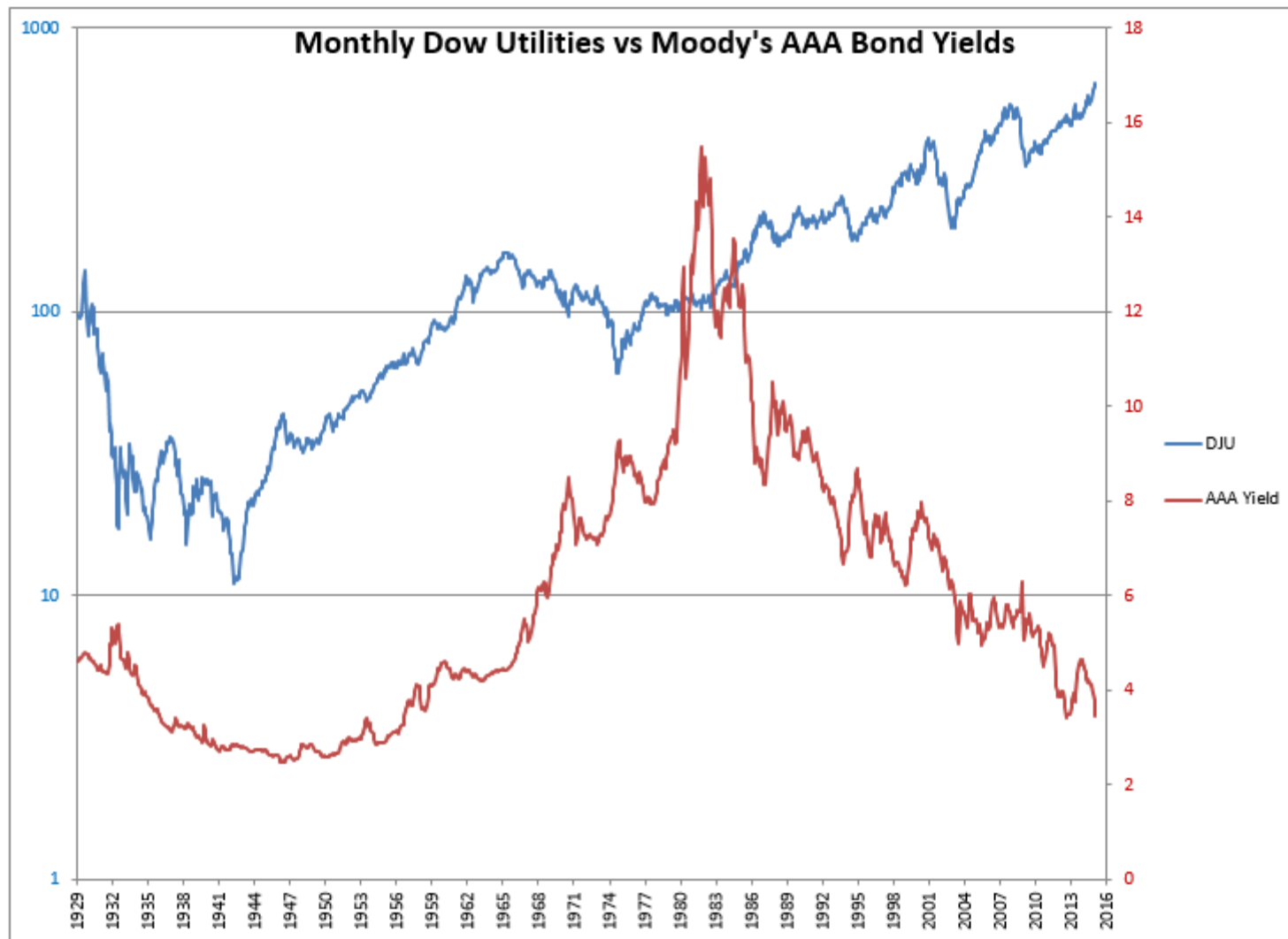
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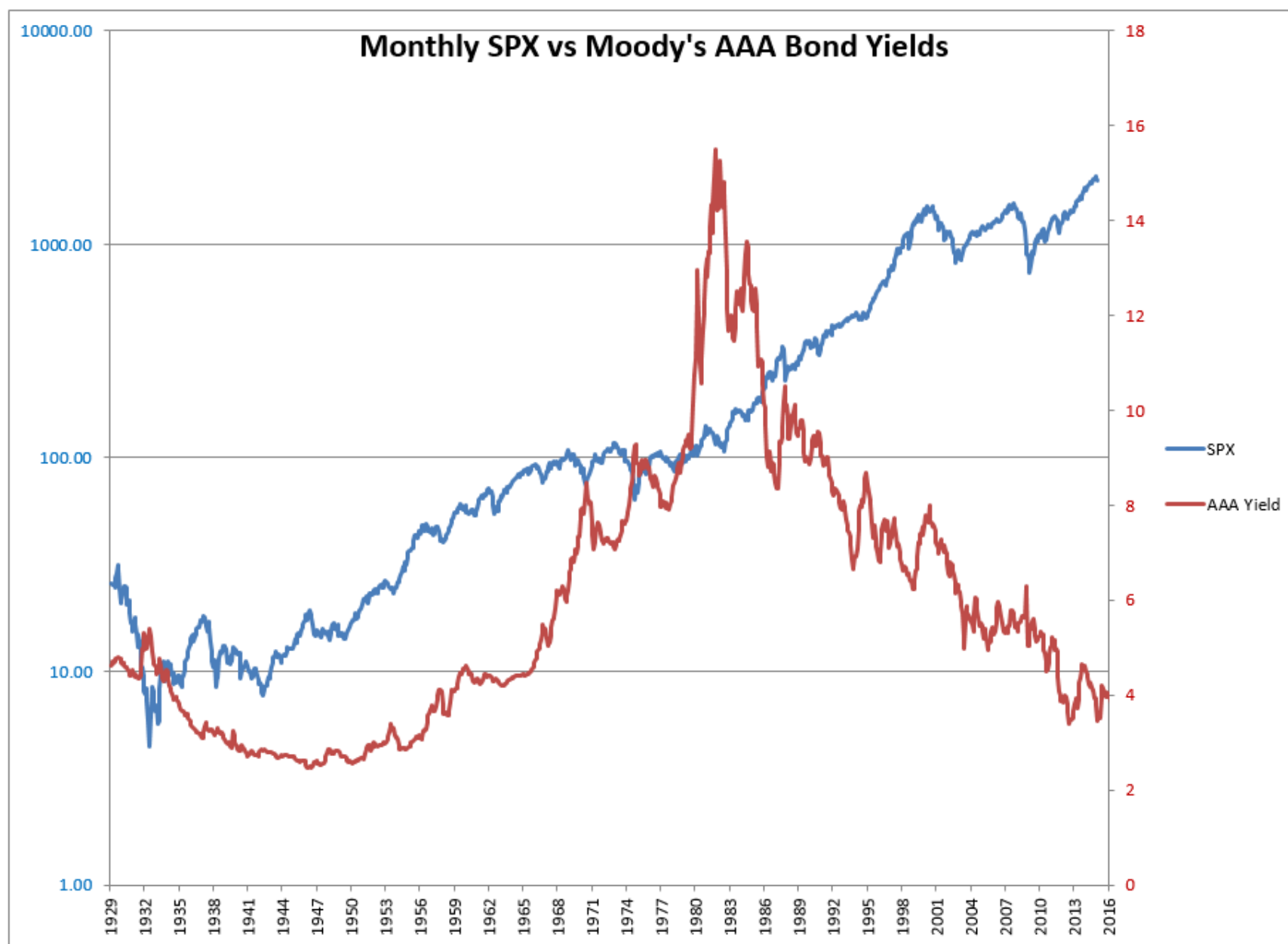
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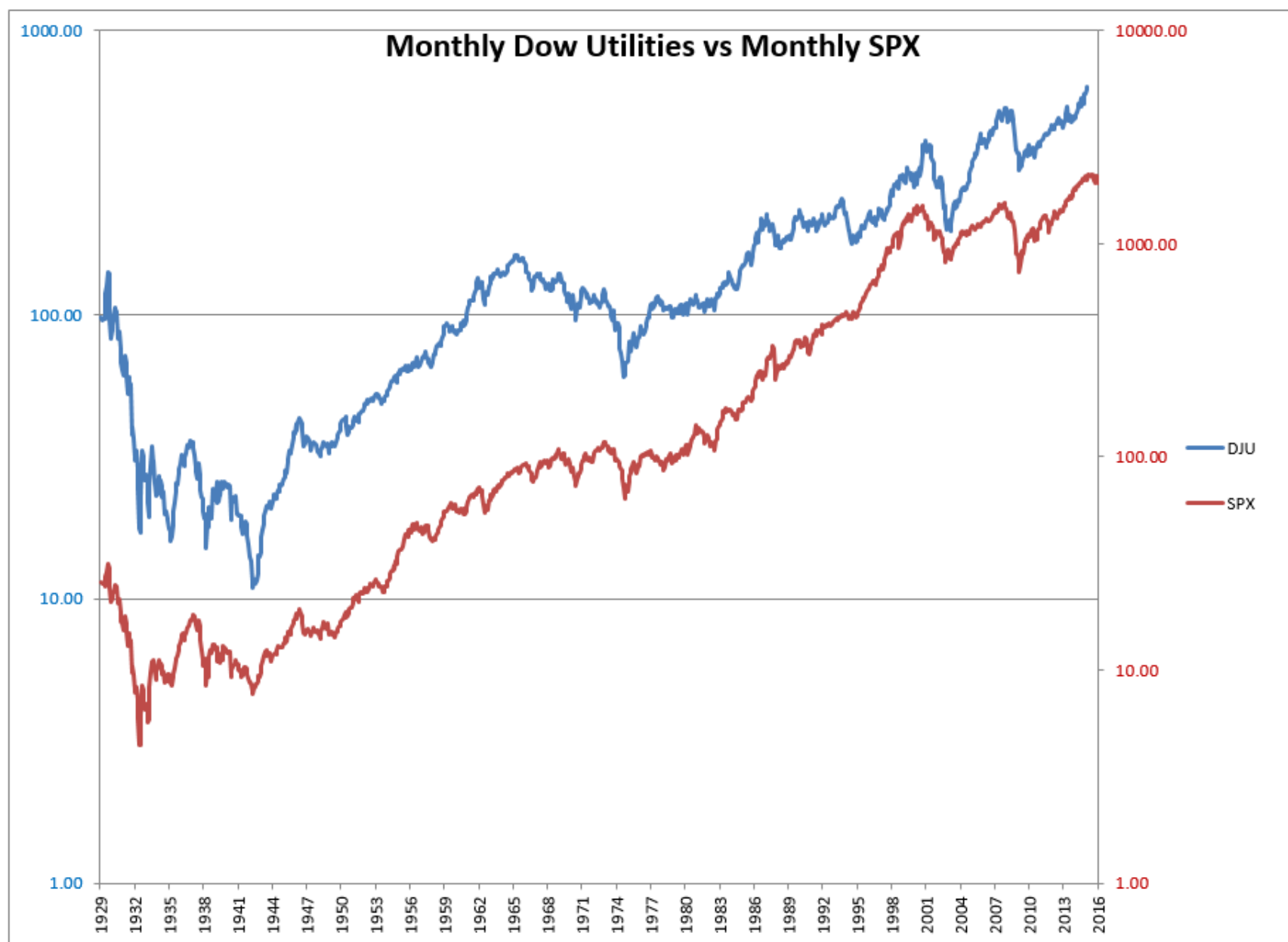
The FRED Report – Special Research Article

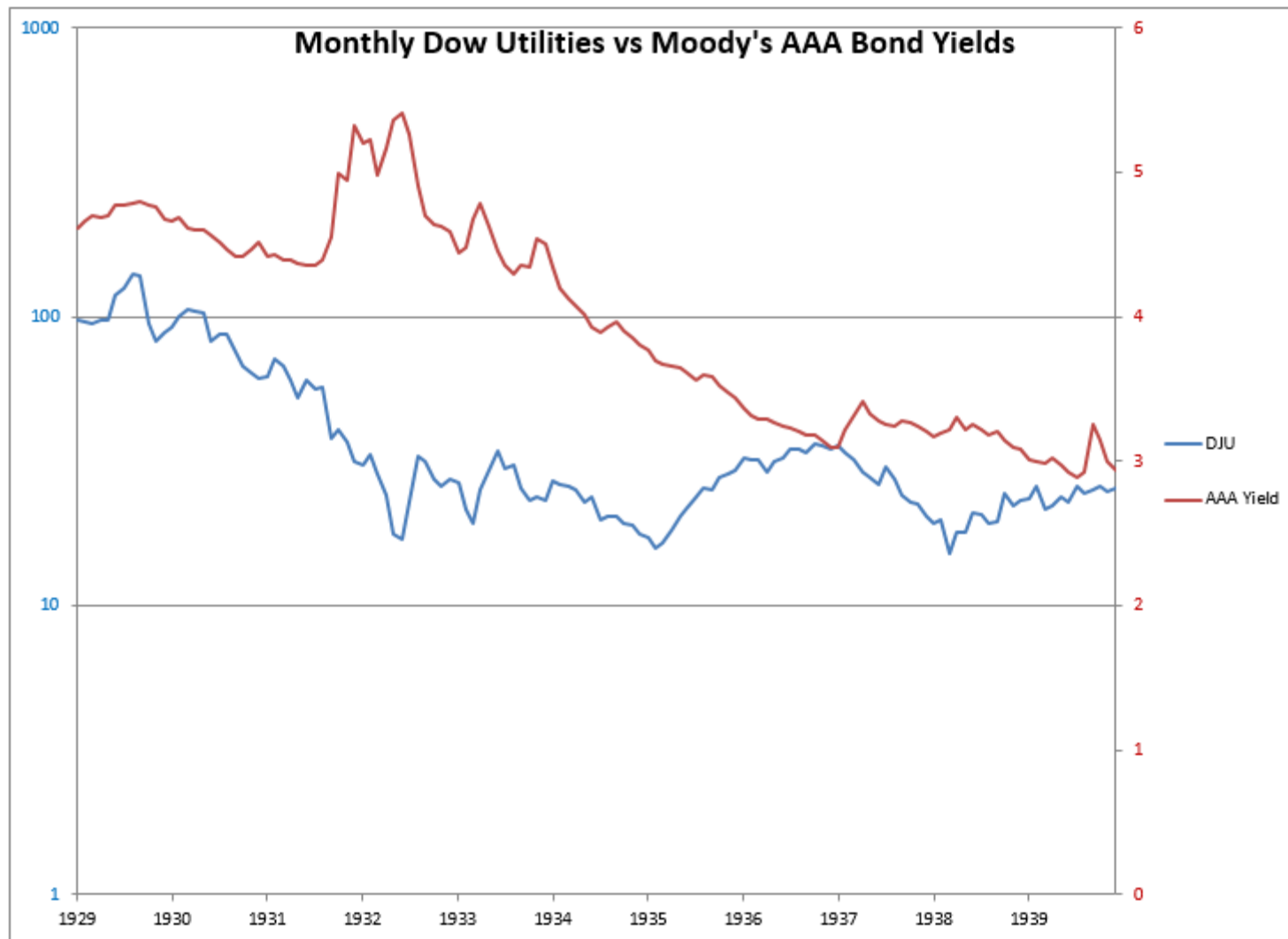
This month's research piece is about the relationship between Utilities and Bonds. We are using the Dow Utilities as a proxy for dividend paying stocks, as it is the longest data series of stocks used primarily as income vehicles available. We are using AAA bond yields, as they are one of the longest data series available for this comparison. Of course, we realize that there are other types of bonds, as well as dividend payers, but we feel this methodology is a good one to establish a baseline comparison. The questions we are trying to answer concern how utilities fare in a rising rate environment RELATIVE to bonds. Another way of putting this is, "Do Utilities preserve purchasing power and principal better than bonds do in a rising rate environment?" We show a number of charts in this article. First we show a long-term chart of the whole data set (we are using 1929 to 2015). Then we show charts of each decade and give some commentary on the performance of stocks and bonds during that decade.

The long-term chart of this data shows that these questions are not answerable due to facets in the relationship between bonds and dividend paying stocks. Rather, the secular trend of stocks vs. the secular trend of bonds is what is most important. Because of this we can state that **utilities have, overall, been a better bet than bonds**. Look at the chart below, and then look at the charts of the various decades.

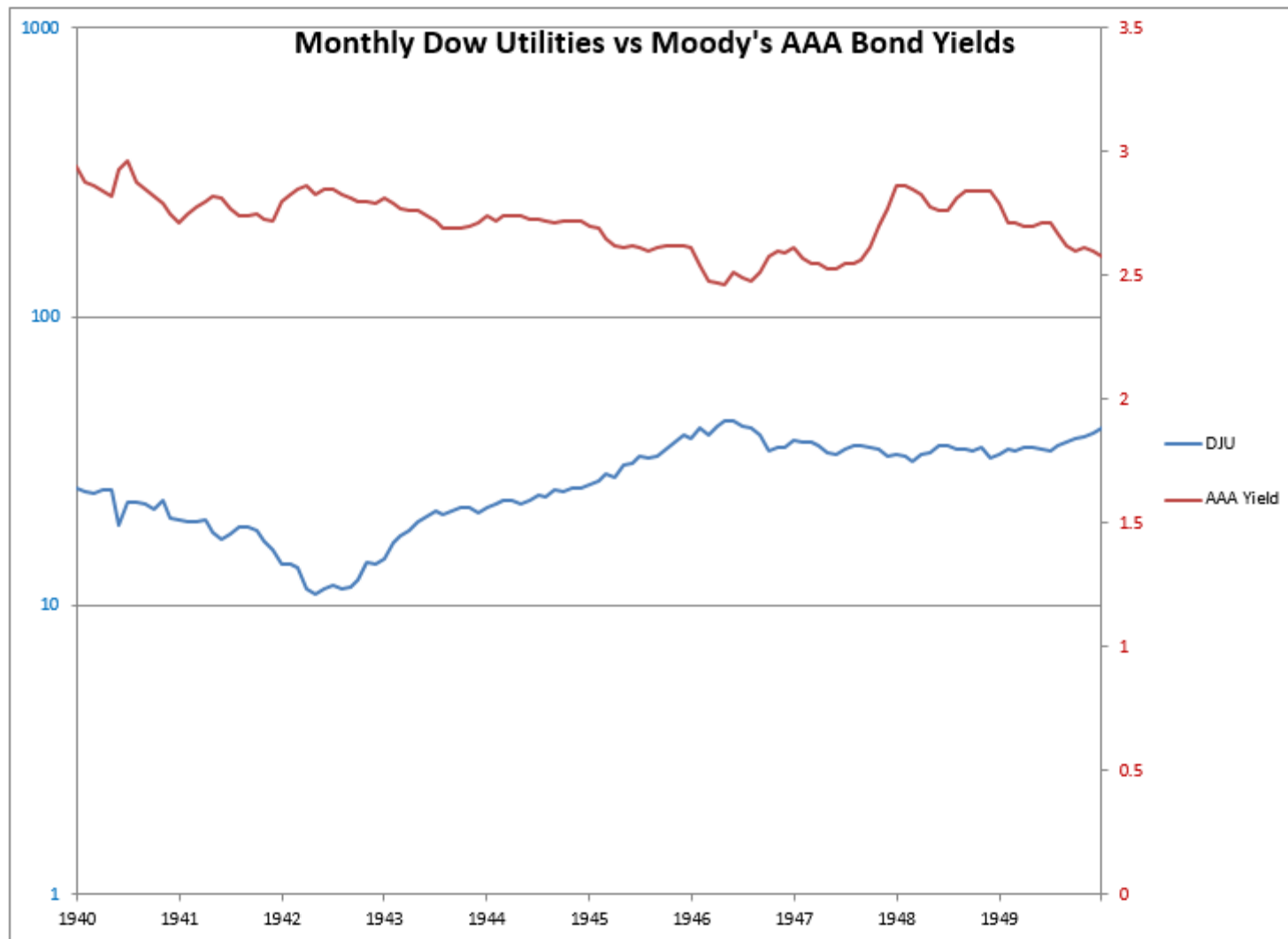




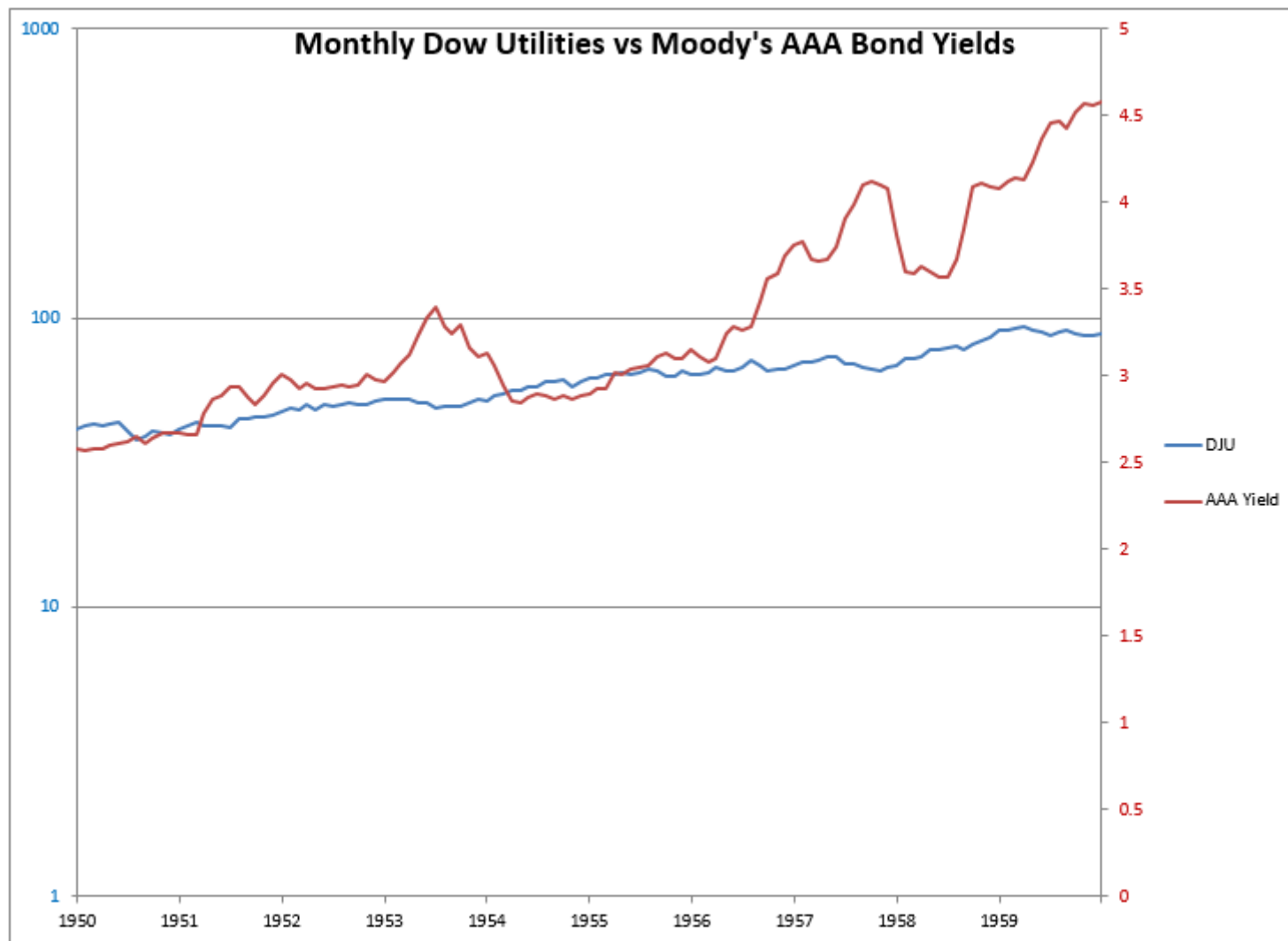




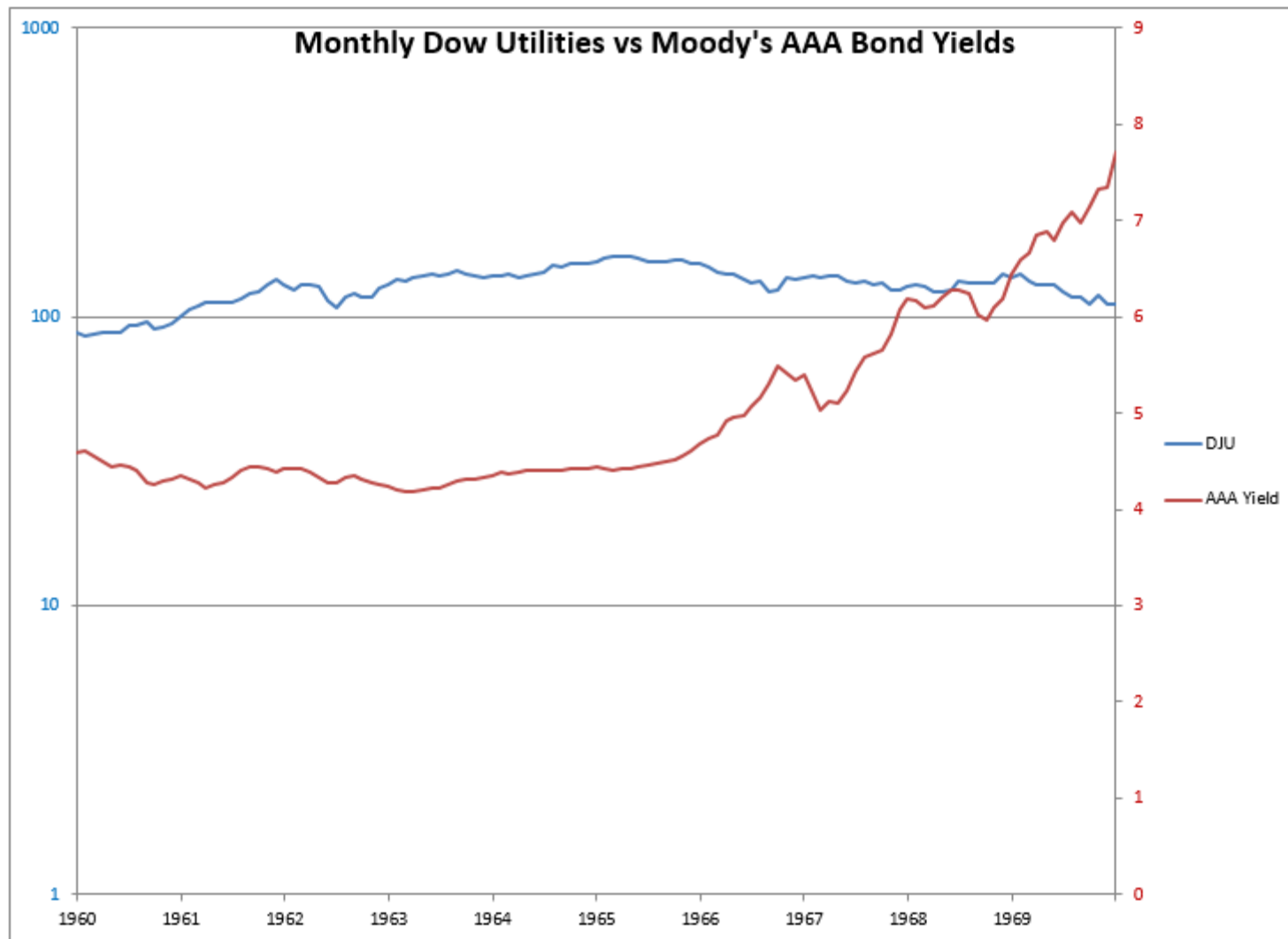
From 1929 through 1940, we had a deflationary bear market in stocks with the bottom being widely acknowledged as 1932. Part of this was a debt liquidation, with a large number of bonds defaulting. This is the reason for the spike in yields in 1931 – 1933. Bonds were not safe. Stocks had another major decline in 1937, and as we will see in the next chart the real advance did not start until 1942.



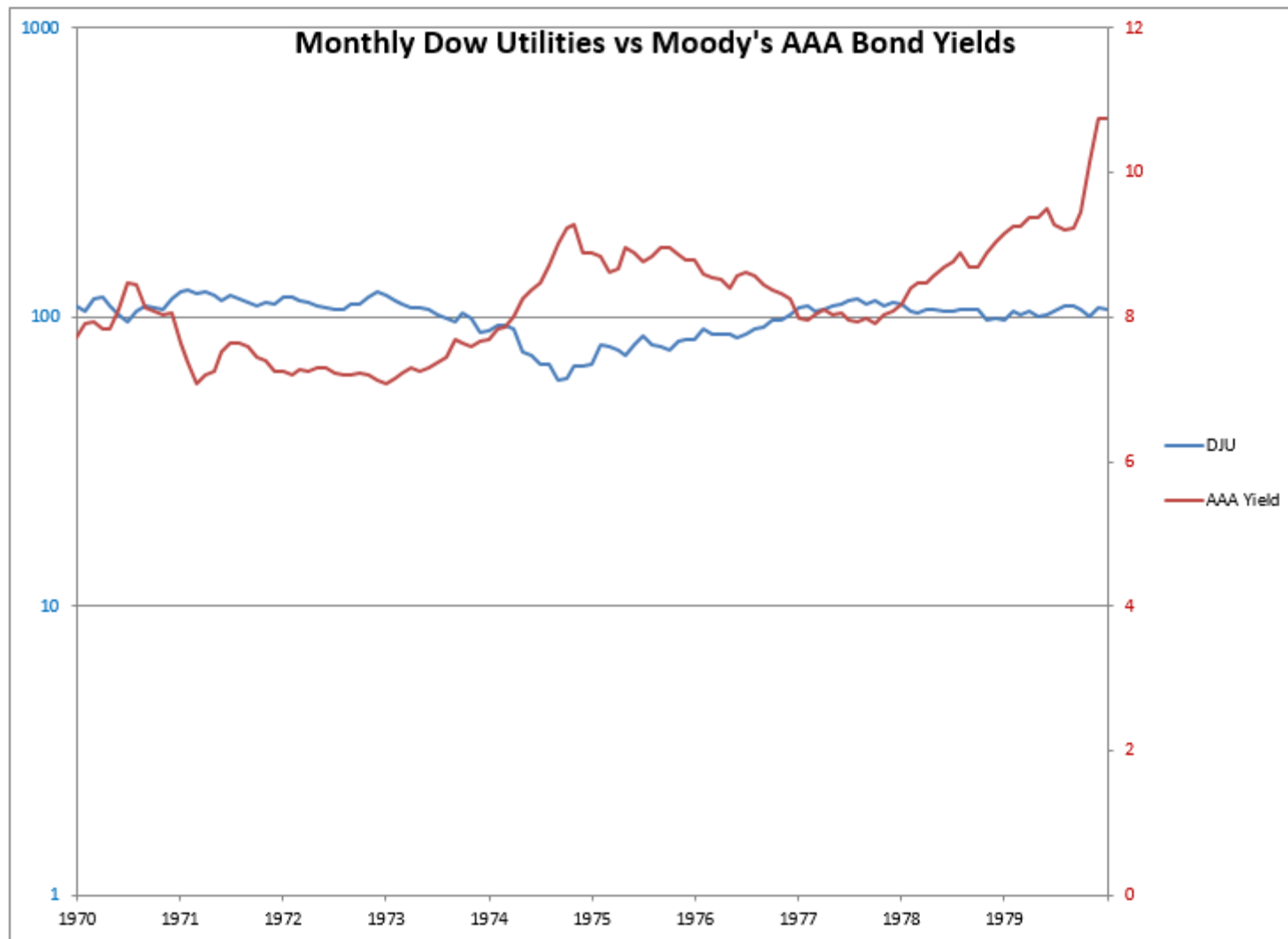
Stocks continued their bear market, while yields stabilized, in the 1940 – 1942 period, then bottomed in 1942 in the middle of WW2. The rest of the decade saw an advance in Utilities (as well as stocks in general), and a slow decline in yields. Utilities peaked in 1946 and went sideways to slightly up. There was concern that as hostilities ended the world would slip back into an economic slowdown as demand from the war machine evaporated. Consumer spending and the GI bill took up the slack, however.



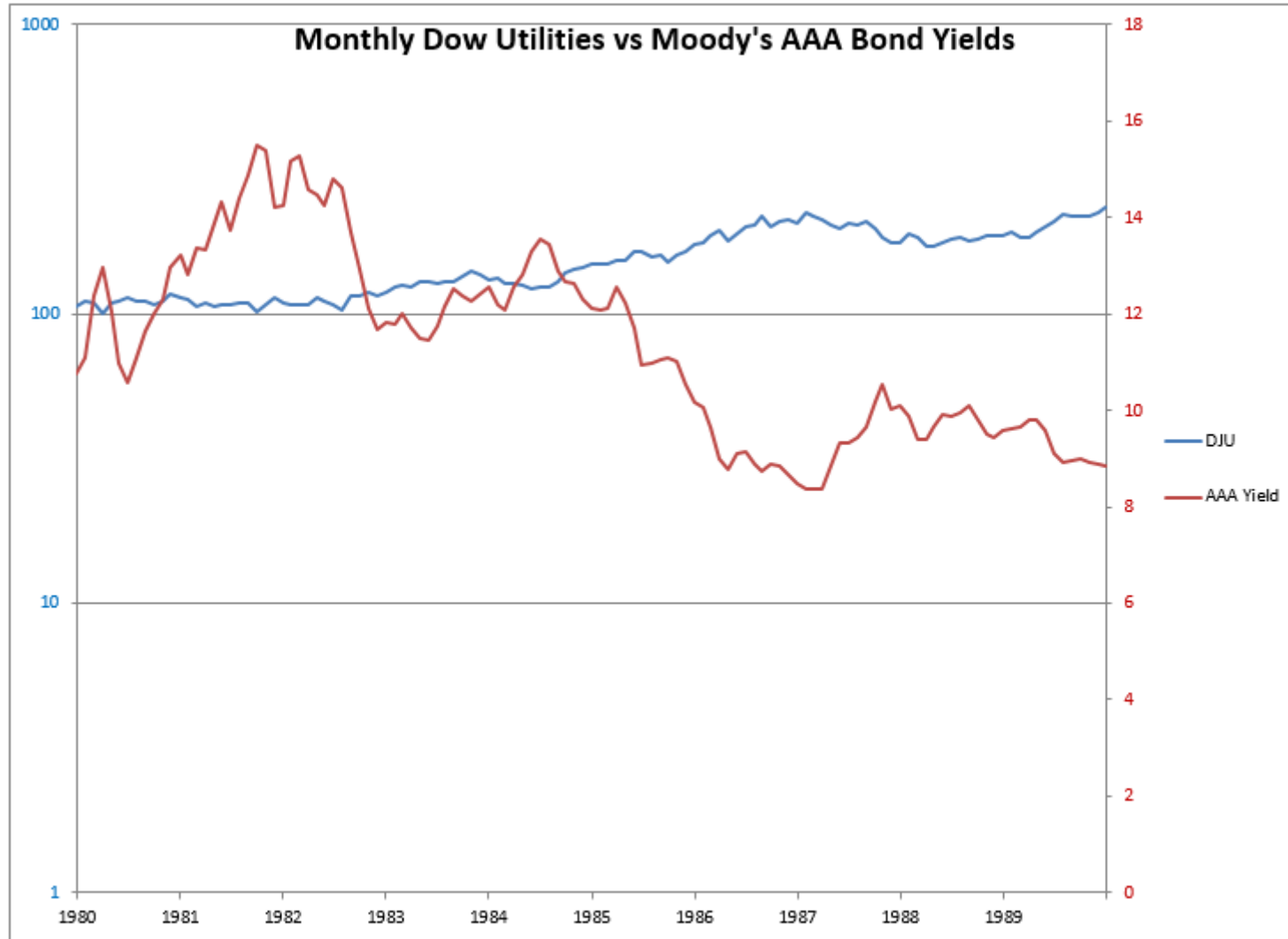
The mid-50's saw a sharp rise in yields while utilities stayed flat. This lasted through the end of the 1950's and was due at least in part of the end of a sharp mini recession in 1957. There were some issues regarding the Suez Canal that created market turmoil as well.



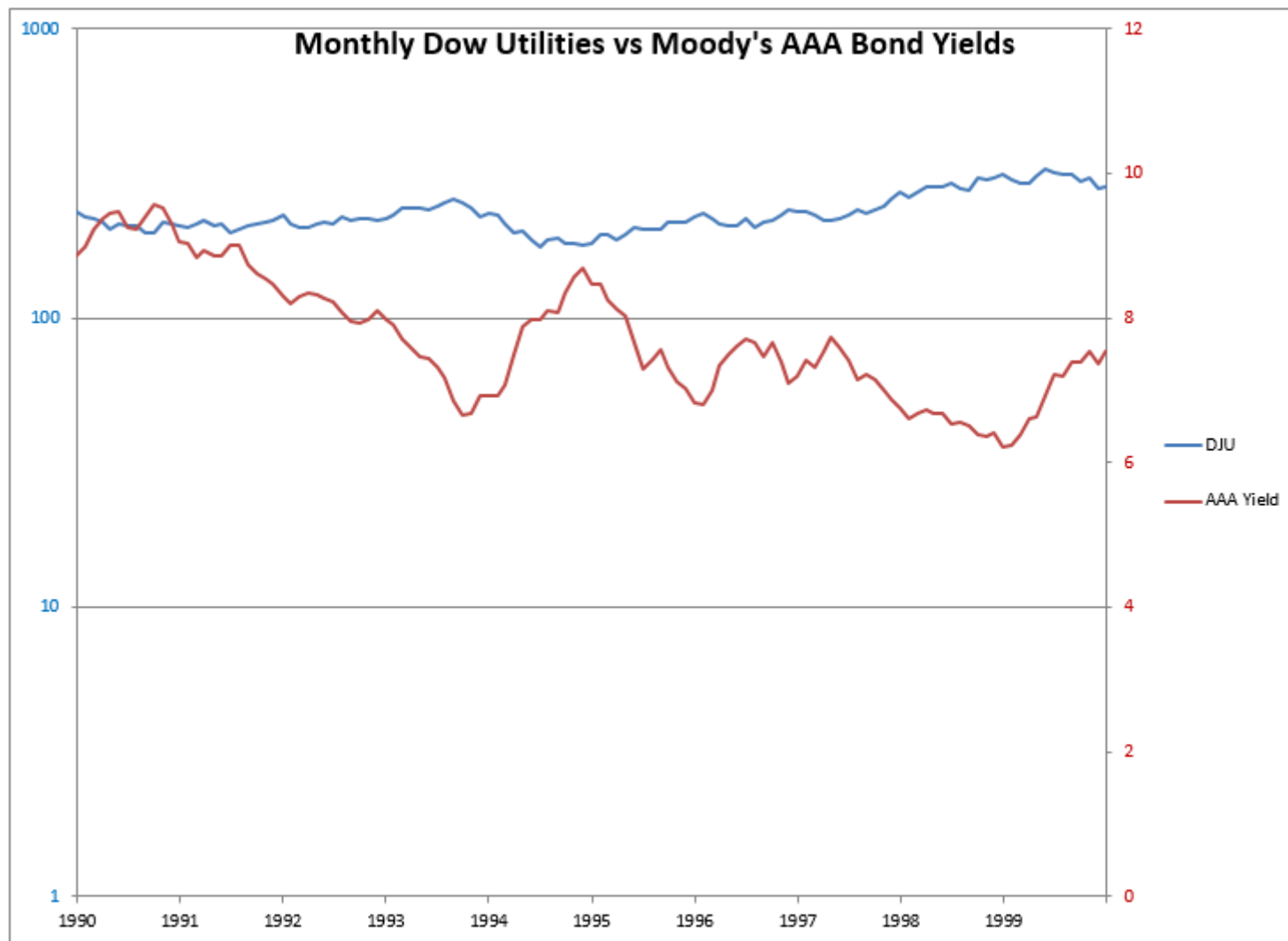
There was a sharp drop in stocks in 1962 as Kennedy had disputes with the Steel Industry, but these resolved and the “guns or butter” bull market of the Johnson years ran up a substantial amount of debt and inflation that led to the stagflation of the 1970’s. As you can see on that charts the orthodox high of the bull market starting in 1942 was 1966, and utilities went sideways along with stocks while rates went up. There was a “nifty fifty” rally in certain stocks, and narrowing breadth into 1968 that does not show up on this chart. Both market suffered but bonds suffered more.



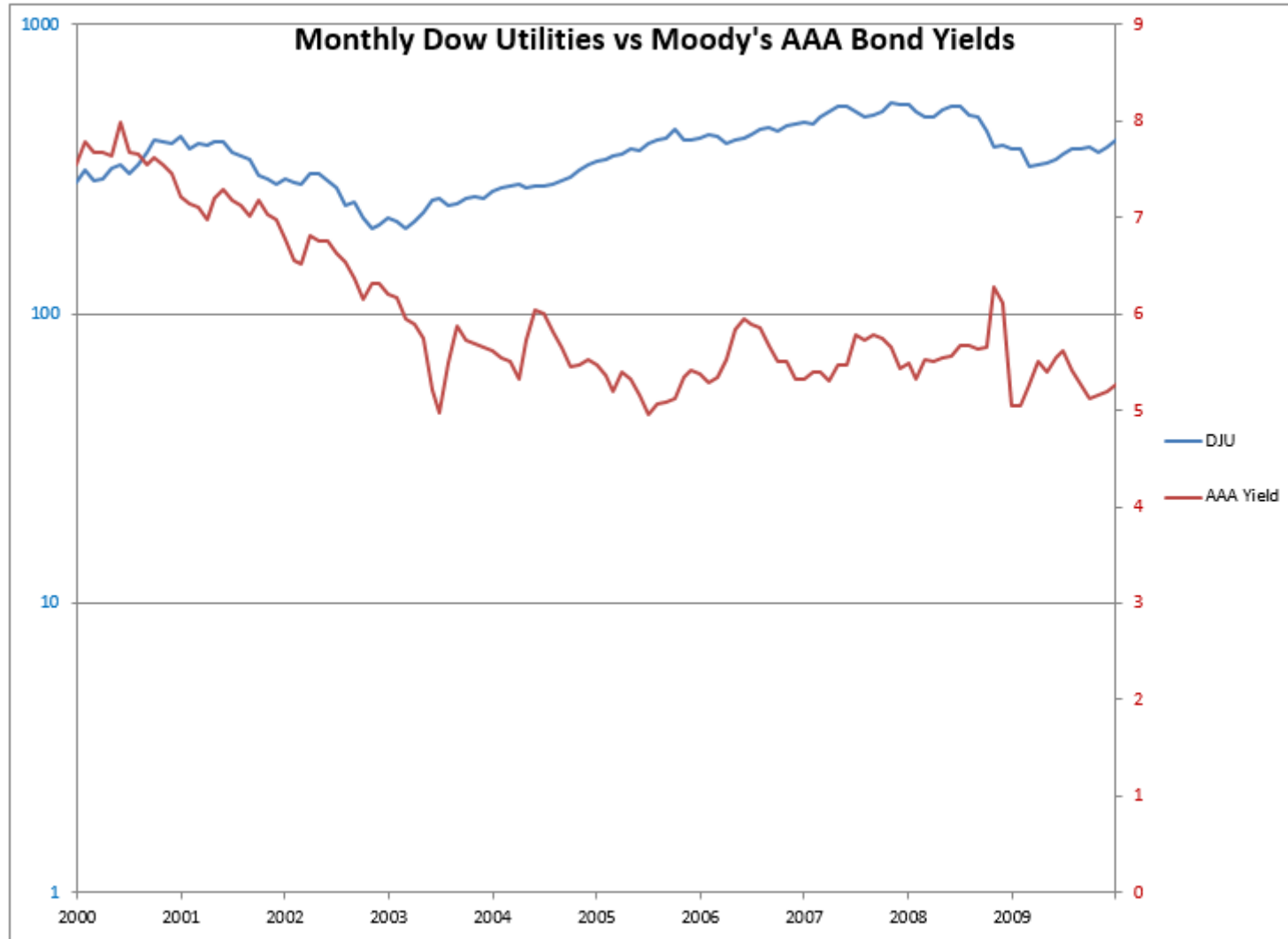
The market went into the biggest bear market since 1929 in the early 1970's and bottomed in 1974. There were several fundamental negatives – Watergate, the Vietnam war, etc. Bonds and stocks both performed badly in the first part of the 1970's then utilities went flat while rates continued up. The Iran hostage crisis did not help either, and prices stagnated. This contributed to the election of Ronald Reagan and his and Volker's fight against inflation via raising rates.



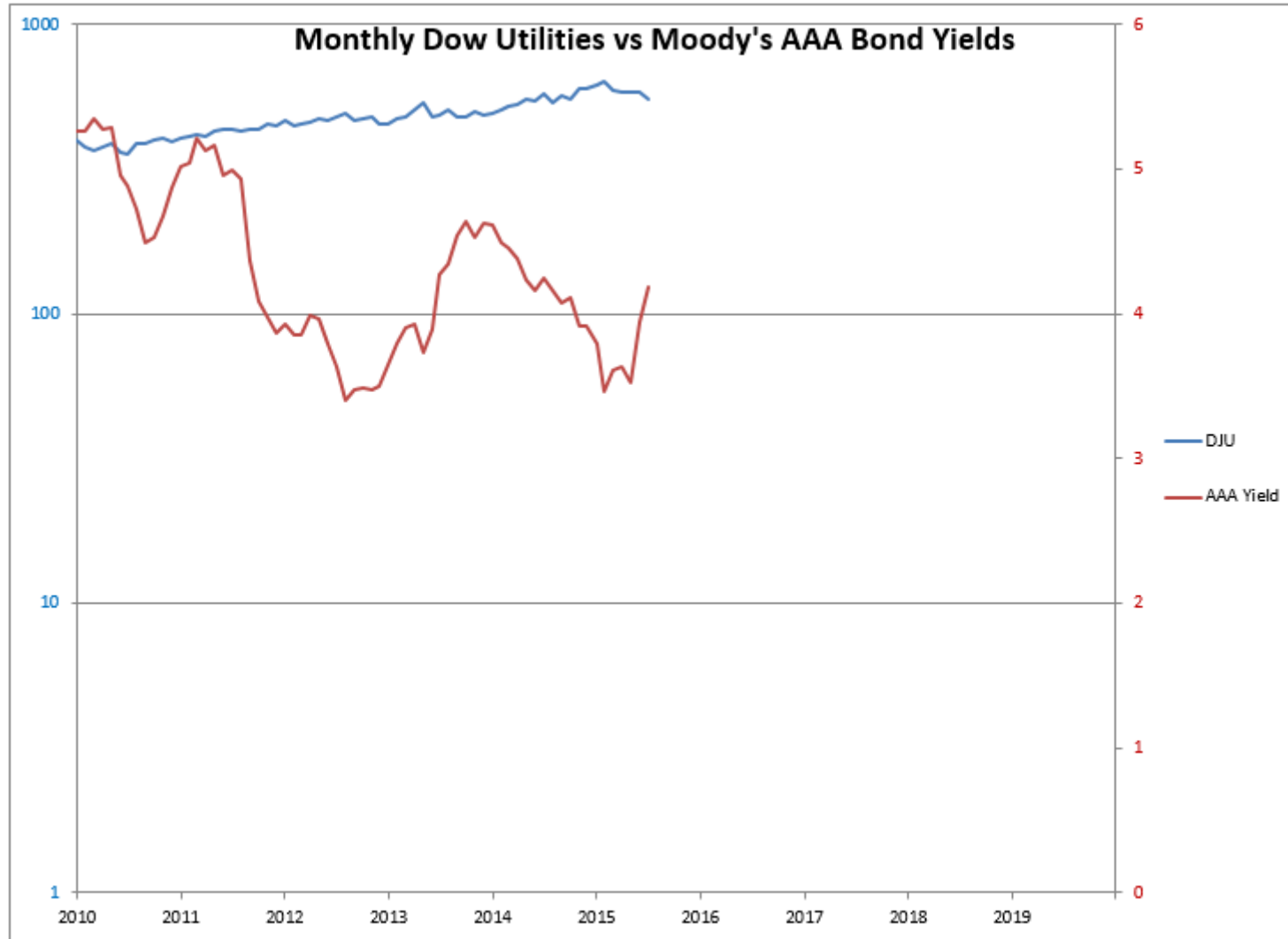
The market started to rally after the recession of the 1980 – 1981 period as Paul Volker broke the back of inflation through a rate rise that ended in 1982 - 1983. This led to a bull market in stocks, and the beginning of a drop in rates that continued to this day.



In the 1990's rates fell with a brief interlude in 1996, and stocks had a mini bear market. While the Dow and S&P did not correct more than 10% other indexes and some stock corrected much more. Rates continued down. The psychology of the times was that any uptick in rates meant inflation was returning, and hurt stocks. Unlike today, when rates went up, stocks fell due to this fear.



Stocks entered the Tech Bubble in the late 1990's, and a bear market struck in the 2000 – 2002 period. The fed lowered rates in an attempt to stimulate economic growth and this finally worked. Stocks outperformed bonds for much of the 2000's after 2002 – rates were flat with a slight rise in 2007 – 2008 before the start of QE.



As QE started in the 2011 period, rates fell dramatically and stocks underperformed bonds for much of that period. Today finds a market with weak internals, and weak Utilities as rates have started up.

To conclude, we had hoped to find some rules to use that would suggest when it was better to be in utilities, and dividend stocks, but instead we found that Utilities followed the secular trend of stocks in general as did bonds. Therefore, there is nothing unique about utilities or dividend stocks, and no rules are possible to derive. We will continue to look for some indicators and rates to measure this phenomenon, but are not certain we will find anything useful. There are some indicators we can use to determine whether growth and less dividends are better than value and dividends, but these also suggest being out of bonds as well, not the desired result. We will revisit this topic in a future letter.

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