Why Now May Be the Time to Load Up on Utilities

Description

The utilities sector has risen sharply over the past five years, only recently retreating slightly after speculation surrounding impending rate hikes from the Bank of Canada and the Fed in the coming weeks.

Utilities, REITs, and other sectors that typically carry higher-than-average yields tend to fall alongside rising interest rates, acting in a similar way to bonds. Income-focused investors choosing between a stock or a bond with the same yield and different risk profiles will, assuming the investor is rational, choose the security with the lowest amount of risk.

The sell-off of most Canadian utilities has reflected market sentiment that rates are about to rise in Canada and the U.S. with many utilities such as **Algonquin Power & Utilities Corp.** (TSX:AQN)(NYSE:AQN) experiencing a drop of nearly 9% from its peak just two weeks ago.

On Friday, as positive news surrounding Canada's job market surfaced, the rout continued. The country is estimated to have created a significantly higher number of jobs than the previously estimated for the period, lowering the country's overall unemployment rate by 0.1%, suggesting an interest rate hike is even more likely after comments from the Bank of Canada governor Stephen Poloz, which were largely taken as an early indication that a rate hike would be in order as the Canadian economy continues to stabilize. Raising rates seems to be the only prudent option on the table for Mr. Poloz.

There are two things I would like to point out here.

First of all, the Bank of Canada has taken an overly accommodating policy of late, contrasting with the monetary policy platform of its bigger brother the United States. In general, the interest rate policy of the Bank of Canada has closely mirrored that of the U.S. for decades; typically, when the Fed moves in one direction, the Bank of Canada follows suit.

Mr. Poloz has proven he is willing to do things his own way; he's previously shocked markets by cutting rates unexpectedly in the past. While the likelihood that Mr. Poloz will hold rates steady appears to be slimmer every day, the inclination for the Bank of Canada to act alone remains strong.

Second, the long-term ability of the Bank of Canada to raise interest rates *substantially* in a manner quick enough to cause a massive exodus of investment from utilities is going to be tested by the heightened consumer debt profile of most Canadians. With a debt-to-disposable-income ratio among the highest in the world (and much higher than the U.S. ratio during the last recession), economists are warning that dramatic interest rate increases are more likely to cause a recession than a soft landing (as shown by the 2007/2008 crisis following rapid interest rate increases in the U.S.). The Bank of Canada will need to maneuver raising rates very slowly and carefully, so as not to tip the housing market into recession, while not allowing the housing sector to get too out of control for average working-class Canadians.

Algonquin has been beat up on expectations of continued rate hikes. My take on this situation is that the Bank of Canada is being forced into a corner where it must raise rates because the markets expect such an action. Moving forward from rock-bottom interest rates is one thing; however, my opinion is that it remains less likely that the Bank of Canada can continue to raise rates over the medium to long term in any meaningful way due to the increasingly prescient consumption model and debt-laden makeup of the Canadian economy.

Stay Foolish, my friends.

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