Why TSX Utility Stocks Are Underperforming

Description

It's interesting to see how tables have turned for equities during the pandemic. TSX utility stocks were some of the "go-to" areas last March amid the beginning of the market volatility. However, these days, those are some of the overlooked sectors across the markets.

Notably, safe-haven utilities have significantly underperformed in the last 12 months amid stellar economic growth and rising bond yields. TSX utility index has risen by just 5% since last year, while the **TSX Composite Index** has risen by 21%.

Utility stocks might continue to disappoint…

It is quite evident that as markets are flush with liquidity, it will go to high-growth areas like tech. Tech stocks once again became the preferred stocks and have returned almost 25% in the last 12 months.

Fortis (TSX:FTS)(NYSE:FTS), Canada's top utility stock, has gained 10% since last year. Stocks like FTS are low-risk, low-return stocks and generally underperform during bull markets. Their lower correlation with broader markets makes them well placed to outperform in bear markets. For example, when markets tumbled more than 25% last March amid the pandemic, FTS stood relatively strong and lost a mere 6%.

More importantly, Fortis continued to increase shareholder dividends during the pandemic when companies were trimming or suspending payouts. It has increased dividends for the last 48 consecutive years, even during the financial meltdown. FTS stock has returned 12% compounded annually since 2000, more than double the TSX Index.

So, what should investors do?

Utilities may not give the best returns during rallying markets, but they do act as a hedge when uncertainties arise. Also, their stable dividends could create a passive-income stream in sunset years. So, yield-seeking investors can consider allocating a small portion of their portfolio to utilities. Also, a few specific names with exposure to natural gas and renewables could outperform in the future.

Moreover, utilities notably outperformed in the post-2008 financial crisis period amid near-zero interest rates. Interest rates and utilities generally trade inversely to each other. Utility stocks are perceived as "bond-proxies," and higher rates make them less attractive to bonds. That's why we see investors fleeing from utilities to bonds to earn higher yields when rates increase.

Another negative of higher rates is associated with a pile of debt. Utilities tend to carry large amounts to debts. So, when rates rise, their debt-servicing costs rise, negatively affecting their profitability.

Many global central banks reduced their rates to near zero last year. The low cost of capital fueled economic growth amid the pandemic, and now, inflation seems to be peaking again. So, market participants are expecting a tightening of monetary policy starting in 2022. Higher rates will likely be detrimental to utility stocks.

Top utility stock for 2022

One utility stock that seems poised to grow next year is **AltaGas** (TSX:ALA). It is a healthy combination of utility and energy infrastructure operations. It has $20 billion in assets and serves 1.6 million customers in the U.S.

ALA stock yields a decent 4% and has risen 35% in the last 12 months. Even if rates increase in the future, AltaGas offers a decent yield premium to investors.

All in all, utility stocks could continue to underperform as economic growth pick up steam post-pandemic. However, if you are a very long-term investor and prefer stable regular income, these "widow-and-orphan" stocks are for you.

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