Compelling Opportunities for Contrarian Investors

Rate anxiety means utilities and high yield bonds offer value.

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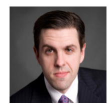

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KEY INSIGHTS

- The market consensus that the Federal Reserve will need to keep rates higher for longer creates opportunities for contrarian investors.
- The relative value in parts of the high yield market looks attractive. Selectivity is critical for separating the potential jewels from the junk.
- Select utilities can offer a combination of dividend yield and potential earnings growth that looks attractive relative to the broader equity market.

Many investors, even professionals, are so fixated on present market conditions that they often miss the longer-term trends that could have a more meaningful impact on their portfolios.

This bias can create opportunity for those willing to lean against the crowd.

Interest Rates: Higher for How Much Longer?

Lately, the market consensus seems to be that the Federal Reserve will need to keep rates higher for longer as it seeks to bring inflation to heel.

Inflation tends to pressure bond prices because it erodes the purchasing power of the fixed coupon payments received by bondholders.

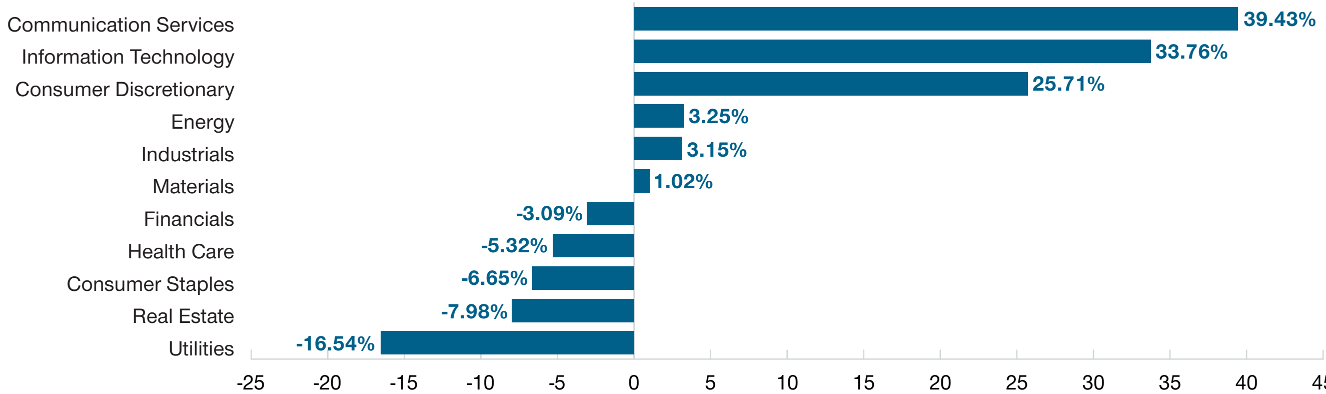
But some of the key drivers of higher inflation, many stemming from pandemic-related dislocations, appear to be in the process of normalizing:

- After an extended period of near-zero rates, the Fed has tightened monetary policy aggressively.
- Supply chain problems stemming from disruptions to manufacturing and shipping have eased.
- The massive fiscal stimulus of recent years has largely worked its way through the system. Direct payments to households and businesses boosted demand for goods when output was constrained, contributing to inflationary pressures.
- Apartment rents appear to be moderating. Plus, more supply will enter the market in 2024 and 2025.

Over a longer time frame—say, 2025 to 2030—productivity gains related to artificial intelligence (AI) could be a deflationary force.

Utilities Lagged During First Three Quarters of 2023

(Fig. 1) Sector price returns for S&P 500 Index



Nine months ended September 30, 2023.

Past performance is not a reliable indicator of future performance.

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Structural inefficiencies make BB rated credits and leveraged loans[1] attractive hunting grounds....

A fast-food restaurant in Ohio, for example, has already tested an AI ordering system at its drive-through lane. Generative AI models have also emerged that meaningfully increase computer programmers' efficiency.

Bottom Line: *The bond market doesn't appear to be pricing in the possibility that the Fed may not need to keep rates higher for an extended period to bring inflation closer to its stated target of 2%.*

The yields on 10-year U.S. Treasuries strike me as relatively attractive when you consider the asset class's historical resilience in difficult markets.

But the relative value in high yield bonds looks even more compelling.

High Yield Offers Good Value

Structural inefficiencies make BB rated credits and leveraged loans[1] attractive hunting grounds for securities offering the prospect of strong risk-adjusted returns.

Here's why:

- Insurance companies and other institutions that are big players in the investment-grade market don't hunt much in these areas because they would need to increase their capital reserves.
- Fewer natural buyers in these parts of the fixed income market may lead to more dislocations that savvy investors can exploit.

Rigorous research and a deep understanding of individual companies are critical to finding the jewels amid the junk.

Insurance brokerages are a good example:

- Elevated debt levels mean that some of these companies have lower credit ratings and offer big yields.
- We view the default risk as limited because these business models historically have not exhibited much volatility.

[1] The credit ratings are provided by Moody's Investors Service, Standard & Poor's, and Fitch Ratings. A bond is considered non-investment grade (or high yield) if it has a rating of BB+ or below from Standard & Poor's and Fitch or Ba1 or below from Moody's. Leveraged loans typically feature floating rates that go higher when the Fed raises the benchmark interest rate.

Why Utility Stocks Look Attractive

The stock market's valuation does not appear especially attractive.

However, pockets of opportunity exist for those who are willing to zig when the market is zagging.

Utility stocks are one area where we see opportunity.

The market does not appreciate the rate at which some utilities could increase their cash flows and dividends in the coming years:

- Electricity infrastructure in the U.S. will change significantly over the coming decade, as the industry seeks to reduce carbon emissions and reinforce the grid against disruptions.
- As regulated utilities replace and upgrade critical infrastructure, they grow their rate base—that's the net value of the plants, property, and equipment on which they can earn a return.
- Select utilities can offer a combination of dividend yield and potential earnings growth that looks attractive relative to the broader equity market.

As for valuation, utilities were the worst-performing sector in the S&P 500 Index over the first nine months of 2023 (Figure 1):

- Higher rates typically pressure utilities because they reduce the present value of future dividends. Bond yields also become more competitive with the dividend yields offered by the stocks.
- The sector trades at a discount to its median valuation over the past two decades.[2]

U.S. utilities also have minimal exposure to exchange rates. And some have exhibited lower volatility relative to the market.

Even if interest rates remain elevated, select utilities should be able to compound value through earnings and dividend growth.

A Deep Understanding of Industries and Companies

Our process focuses intensely on company analysis and valuations.

Working with our research analysts, who are well versed in the industries they cover, helps to give us the conviction and selectivity needed to be contrarian when opportunities arise.

[2] As of September 30, 2023, the S&P 500 Utilities Index traded at about 15x 12-month forward earnings, compared with a median valuation of 15.5x forward earnings for the trailing 20 years. Actual outcomes may differ materially from estimates. Source: Financial data and analytics provider FactSet. Data analysis by T. Rowe Price. Copyright 2023 FactSet. All Rights Reserved. See Additional Disclosure.

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