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Safe Is Not Safe Anymore

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Historically, two sectors with consistently slow earnings growth have been utilities and consumer staples. Over the long-term, these two sectors have posted annualized earnings growth of 3% and 5% respectively, below the S&P 500's 7% earnings growth. Although earnings growth has been slower, and these two sectors have generally underperformed the S&P 500 over decades, there have been periods when investors were smart to allocate toward these sectors. When the economy and earnings growth are peaking, along with interest rates, these two sectors can be excellent hedges. Why?

First, the earnings growth of these two sectors, although slow, is relatively consistent. Over the last 15 years, through a major economic recession and two earnings recessions in the United States, the consumer staples sector's worst year-over-year earnings growth was 0%, while utilities' worst was only negative 2%. Second, their valuations are usually tame at market highs. For example, in 2007 both sectors traded at a slight discount to the S&P 500. Third, they both have long-term average dividend yields of about 3.7%. With these three facts in mind, it is easy to see how investors would be interested in the two sectors at economic peaks – overall equity valuations are usually high, earnings are inflecting negatively, and interest rates are likely to fall as demand for bonds increases and the Federal Reserve starts reducing Fed Funds interest rates. As interest rates fall, these higher yielding sectors are more appealing. However, today we do not believe the potential reward in these sectors outweighs the risk.

The consensus believes earnings growth is slowing, and that it may continue slowing through the end of the year. In reaction to this growth fear, investors have been (blindly) shifting assets into these two sectors. However, due to today's absolute and relative valuations, along with where the economy is in the economic cycle, plus the balance sheet leverage with these two sectors – safe is not safe anymore.

Regarding valuations, there are signs of slower earnings growth in the overall equity market. If earnings fall in the overall S&P 500, utilities and consumer staples should at least post flat growth. However, the P/E multiples for these two sectors both on an absolute and relative basis are high. First, utilities now trade at over 19x forward earnings, which is the highest in decades, and over 30% above their long-term average of 14.5x. Additionally, on a relative basis, utilities trade at a 12% premium to the overall S&P 500. In the following graph, we show the long-term relative P/E between utilities and the S&P 500.

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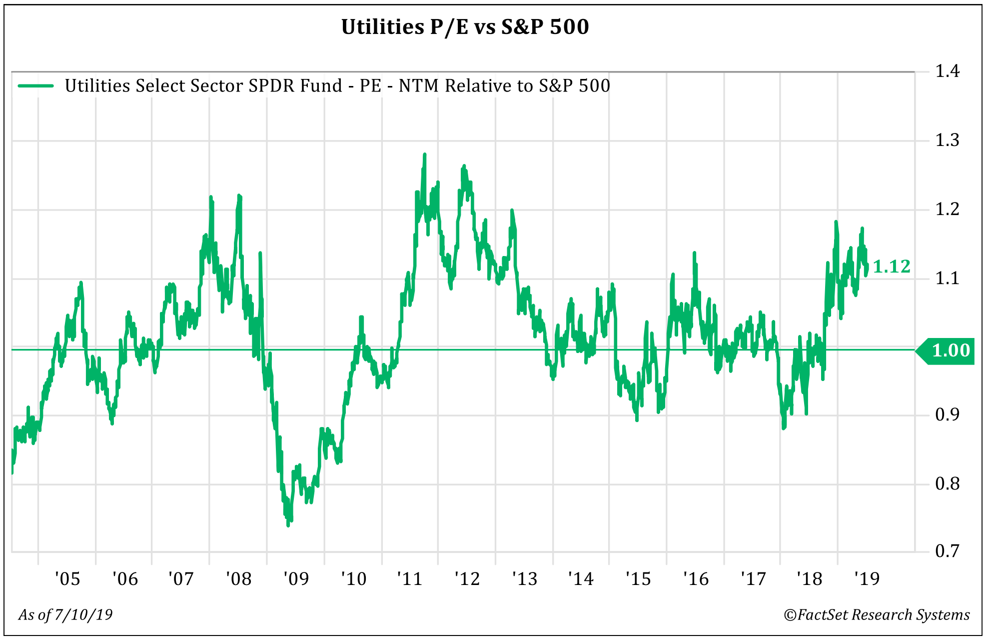
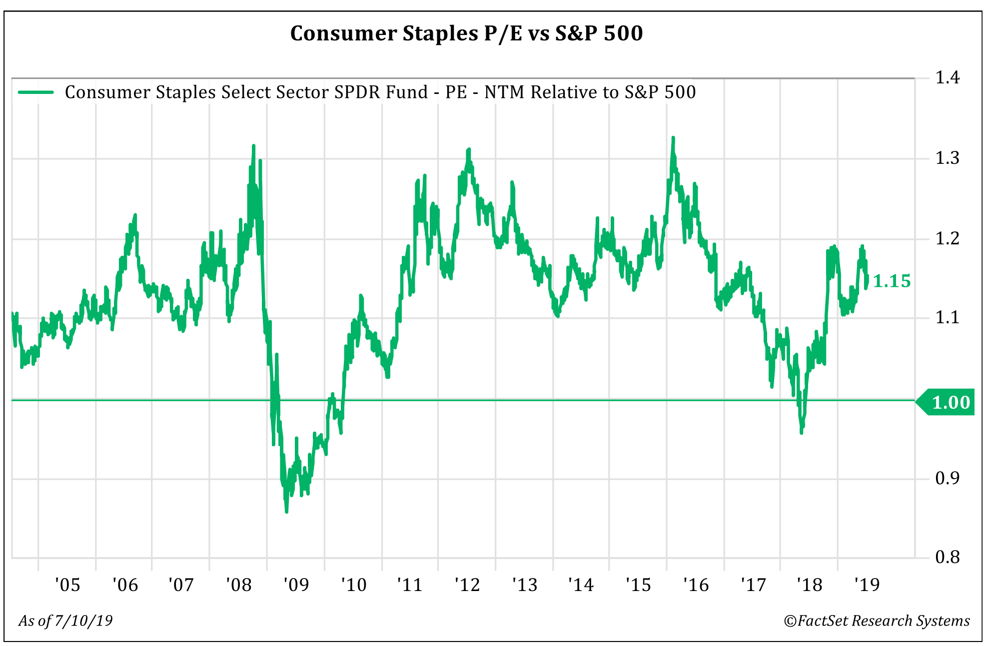
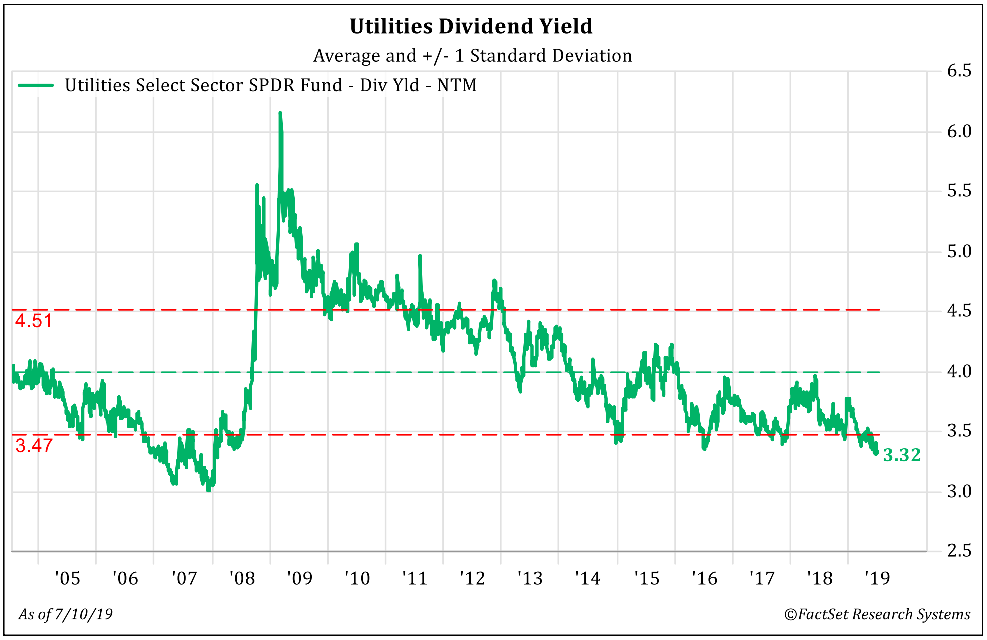


Consumer staples are a similar story, trading at a forward P/E of 20x or 25% above their long-term average of 16x. On a relative basis, consumer staples recently traded at a 20% premium to the overall S&P 500. For that premium, you are purchasing 5% earnings growth and a strong dollar headwind. The strong dollar increases the price of exports, and weighs on the profit picture for multinationals, many of which are in the consumer staples sector. Below is the long-term relative P/E between consumer staples and the S&P 500.



Next in examining dividend yields, investors are actually paying much higher valuations…for lower dividend yields. With the rise in valuation, the utilities index is now only yielding 3.3%. While this yield is higher than the 2% yield of the S&P 500 and 2.1% yield available from U.S. Treasuries, it is near a decade low. With the recent rise in price for consumer staples, the yield is even worse at less than 2.7%. Below, we show a ten-year history of the utilities sector dividend yield.



On top of high valuations, slow earnings growth, and low dividend yields, there is a material risk in the inherent balance sheet leverage found in both of these sectors, especially utilities. High leverage, which we define as the ratio of net debt (total debt less cash) to EBITDA (earnings before interest, taxes, depreciation and amortization) of greater than 3-4 times, can be palatable when the economy is strong and interest rates are low. When both reverse, the environment is not enjoyable for highly leveraged companies. Today, the leverage of the utilities sector has risen from 3x (net debt is three times as much as EBITDA) to 5x – the highest level since the 1990's. As a comparison, the overall net debt to EBTIDA ratio for the S&P 500 is a more modest 1.8x. Although a more manageable 2.3x, leverage for consumer staples is at an over 20-year high. Safe is not safe anymore.

To own the consumer staples sector, investors are paying 20 times earnings, for almost zero earnings growth, and a 2.7% dividend yield. Meanwhile the utilities sector is not any better, except an investor owns a sector with debt leverage at a multi-decade high and nearly 3x the level of the S&P 500 – not a good idea when/if interest rates rise or the economy weakens even moderately.