BANK OF AMERICA

CHIEF INVESTMENT OFFICE

Equity Spotlight

The Difference Between Power & Energy

October 2023

All data, projections and opinions are as of the date of this report and subject to change.

SUMMARY

The current environment provides examples of market rotations that can occur in the late phase of the business cycle and when there is macroeconomic regime change—in this case higher interest rates and inflation. This regime change can also cause Equity rotations and rebalancing across all sizes and styles of portfolios. As such, we increased our Energy weighting to overweight and reduced our Utility weighting to neutral due to higher interest rates and higher cost of capital.

The continued electrification and digitalization of the U.S. and global economies requires key outputs from two sectors: Energy and Utilities. The supply of traditional energy and electric power is critical for the modern-day economy to function, grow and continue to evolve, yet the Energy and Utility sectors are two of the smallest sectors in the S&P 500 Index. Even after the recent rally in traditional energy stocks, the Energy sector is only a 4.5% weight in the S&P 500 Index, yet it accounts for around 7.2% of the S&P 500 Index profits. The Utility sector is even smaller at 2.4% of the index and accounts for around 2.9% of S&P 500 Index profits. These percentages seem very small for some of the most important inputs for the economy to run smoothly—electricity, oil, increasingly natural gas for electric power generation, and refined fuels. The old phrase "the lights don't turn on" is very appropriate because without these two critical sectors operating effectively, today's increasingly digital economy does not run as efficiently, and the phrase "the machines don't turn on" might be more appropriate.

People often interchange the terms energy and power; however, there can be significant differences between the two when it comes to the characteristics and performance of the Energy and Utility (power) sectors. Performance differences can depend on the stage in the business cycle and macroeconomic factors. Recently the Energy and Utility sectors exhibited opposite trends, with Energy the strongest trend in the equity market and Utilities the weakest trend over the last couple of months. The current momentum in each sector can be explained by two key macro factors: interest rates and oil prices. As a result, in the Chief Investment Office October Viewpoint report—*The Great Debate Continues*—we suggest adding exposure to the overweight Energy sector and reducing exposure back to neutral in the Utilities sector.

Utility companies, sometimes referred to as power companies, are under pressure this year as interest rates climbed higher and raised the cost of capital for the industry. Utilities and power generation companies are very capital-intensive businesses and use

CIO ASSET CLASS VIEWS

Asset Class	CIO View				
	Underweight		Neutral	Overweight	
Equities	•	•	●	•	•
U.S. Large-Cap	•	•	•	●	•
U.S. Mid-Cap	•	•	•	●	•
U.S. Small-Cap	•	•	●	•	•
International Developed	•	●	•	•	•
Emerging Markets	•	•	●	•	•

Source: Chief Investment Office as of Octber 3, 2023.
CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio.

CIO EQUITY SECTOR VIEWS

Sector	CIO View				
	Underweight		Neutral	Overweight	
Energy	•	•	•	▶	●
Healthcare	•	•	•	•	●
Utilities	•	•	●	◀	•
Consumer Staples	•	•	●	•	•
Information Technology	•	•	●	•	•
Communication Services	•	•	●	•	•
Industrials	•	•	●	•	•
Financials	•	•	●	•	•
Materials	•	●	•	•	•
Real Estate	•	●	•	•	•
Consumer Discretionary	●	•	•	•	•

Source: Chief Investment Office as of October 3, 2023 All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

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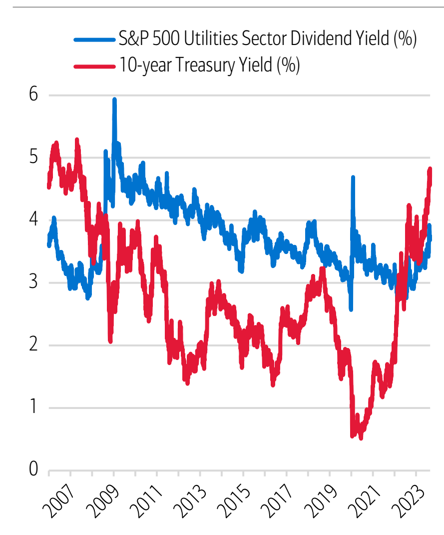
a combination of Equity, Fixed Income, project-specific financing and various loans to raise capital for new power investments. The capital is needed upfront until revenues and cash flows are recouped from paying customers to cover the costs of new power projects. Higher interest rates could delay or change plans for new electric power projects, specifically, new renewable power projects that could provide future earnings growth for utility companies. Project plans may change because the internal rates of return (IRR) and returns on capital (ROC) are lower after factoring in the higher costs on the capital for new power and infrastructure projects. Government legislation that includes subsidies can help offset the higher cost of capital to varying degrees but may not be enough to make a project economic, depending on the details of the projects.

Despite the higher cost of capital, the U.S. transportation industry and the entire U.S. economy is on a path for increased electrification that requires billions in capital investments to generate, distribute and store greater base load electric power on the U.S. grid. In addition, important investments and developments are also needed in power storage solutions for times of peak power demand and for efficient power storage. To increase the power generation on the U.S. grid, new and cleaner power generation is required at the state and regional levels, including major investments for transmission and distribution (T&D) infrastructure to connect new renewable power sources to the grid and for elective vehicles charging infrastructure. Utilities are well suited to manage and execute these large capital investments due to their experience with major capital investment projects and their electrical and engineering expertise. However, if new power projects are pushed out or delayed, the future earnings growth for Utilities also needs to be adjusted downward. The resetting of utility stock prices and earnings expectations accelerated in September coinciding with interest rates moving higher and a major infrastructure company lowering guidance.

A yield play of the past decade

For over a decade, the dividend yield on the Utility sector provided a more attractive yield compared to the entire U.S. Treasury curve and compared to the benchmark 10-year U.S. Treasury bond (Exhibit 1). During this period, investors hunting for yield—and with cash to invest—often found themselves looking at utility stocks and other "bond proxies" in the equity market due to their relative and absolute dividend yields. Fixed Income was not offering as attractive yields during the Federal Reserve's (Fed) low-to-zero interest rate (ZIRP) monetary policy period; therefore, Utilities received inflows for years in the hunt for yield. This also drove the valuations and price-to-earnings (P/E) multiples for utility stocks higher and above longer-term averages. However, the recent rise in interest rates reversed this trend, and now U.S. Treasury bonds are yielding higher than the Utility sector for the first time in years which is resulting in fund outflows for Utilities. This trend is also true for other bond proxies in the equity market like Real Estate Investment Trusts (REITs) and some Consumer Staples. While interest rates are higher and provide investors with additional options for income at attractive yields, flows and valuations in Utility stocks could be muted in the short term. Unlike the past decade, today there are alternatives for adding higher yielding investments to portfolios outside of high-dividend yield stocks.

Exhibit 1: Utility Dividend Yield vs. 10-year Treasury Yield.



Source: Bloomberg. Data as of October 17, 2023. **Past performance is no guarantee of future results. Please refer to index definitions and important disclosures at the end of this report. It is not possible to invest directly in an index.**

Utilities are arguably more susceptible to higher interest rates this cycle because expectations for future earnings growth were elevated and above trend due to the Inflation Reduction Act of 2022 legislation that supports renewable project growth. Renewable power development is not going away, and the energy transition will continue forward, but likely at a slower and more measured pace than previously expected as long as the cost of capital is elevated compared to recent years. Helping offset this dynamic should be individual state legislation—30 states currently have legal mandates to purchase renewable power—that should help drive demand for renewable power sources despite the rising cost of capital. Furthermore, many future renewable power projects were already discounted into utility stock prices that resulted in above-average utility valuations. As a result, utility stock valuations are resetting to lower levels to account for lower earnings growth than previously expected. This could be a short-term issue until

interest rates move lower in the future, but the long-term thesis for greater investment in electric power generation, renewable power projects and T&D infrastructure remains intact, though the pace of development could be affected by the level of interest rates.

On the other hand, Energy stocks outperformed this summer and early fall as oil prices moved higher and as geopolitical tensions added some risk premium to oil prices and energy stocks. It is important to note that coming into this summer, sentiment for the Energy sector was negative, and positioning in energy stocks was reduced during the first half of this year. This setup helped serve as a catalyst for a rally in energy stocks as oil moved higher and investors added energy exposure in Equity portfolios. Why did oil prices rally? Supply cuts from Organization of the Petroleum Exporting Countries+ (OPEC+) combined with better-than-expected global demand drove oil prices higher over the summer months. This resulted in oil prices shifting higher from a $65 to $75 range earlier in the year up to the $80 to $90 range. Current oil prices should raise estimates for revenues, operating cash flow, free cash flow (FCF), and earnings for energy stocks. In addition, energy companies maintained their capital discipline over the last two years and did not meaningfully increase investments (capital expenditures) in traditional fossil fuel development. Therefore, there is little supply growth from the U.S., and the lack of readily available spare capacity is supporting oil prices at higher levels. This will likely result in higher FCF from energy companies that can be returned to shareholders in the form of dividends and stock buybacks. With oil prices moving sharply higher and refining margins elevated over the summer months, we expect Q3 earnings and FCF estimates to move higher. Refining margins are moving lower in recent weeks as we move past the peak travel season and transition to “shoulder season” where refineries do maintenance work and run at lower utilization rates; however, a lack of new refining investments in the U.S. could keep inventories low and prices elevated for specific refined fuels like diesel. Energy stocks remain the cheapest sector in the equity market with some of the highest FCF yields and best returns of capital to shareholders that drives higher total returns.

An economy can not function without energy and electric power and even though these two sectors may sound similar, they have different investment characteristics, performance driven by different factors and depending on the phase of the business cycle. The Energy sector and Energy stocks remain very cyclical but are dependent on commodity prices, and have offered attractive valuation, dividends and FCF. Utilities may struggle to outperform near-term with higher interest rates, but the sector could still provide defensive characteristics for portfolios, specifically regulated Utilities where earnings are very predictable and stable. In conclusion, macro factors like oil prices, geopolitical risks, regulatory pressures and interest rates influence the performance of the Energy and Utility sectors; however, both sectors are critical to a healthy and functioning economy.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

Equities/S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

S&P 500 Sector Index constitute a method of sorting publicly traded companies into 11 sectors-Information Technology, Health Care, Financials, Consumer Discretionary, Communication Services, Industrials, Consumer Staples, Energy, Utilities, Real Estate (REITs), and Materials. Also known as the Global Industry Classification Standard (GICS) sorts companies into sectors based on their primary business activity.

Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 7-9.9999 years to maturity.

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