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After A 'Good Run' For Utilities In 2022, Analyst Says 'Trade Is Over — For Now,' But Retains Bullish Bias On These Stocks

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Benzinga

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The utility sector is generally credited as an “all-weather” investment, given its defensive nature and the steady returns it generates in the form of dividends. Riding on these traits, utility stocks fared relatively better in a down year for equity markets.

The Dow Jones Utility Average was down merely 1.4% in 2022 compared to S&P 500's 19.4% slump. The **Utilities Select Sector SPDR Fund** (NYSE:XLU), an exchange-traded fund tracking the performance of utility stocks that are S&P 500 components, rose 1.4% last year.

An analyst at KeyBanc Capital Markets warned that the good times may not last.

The Utility Analyst: Analyst Sophie Karp downgraded both **Southern Company** (NYSE:SO) and **CenterPoint Energy, Inc.** (NYSE:CNP) from Overweight to Sector Weight.

The analyst sees Southern Company pressured by near-term headwinds and a not-so-attractive valuation, stemming from the shares trading above KeyBanc's price target.

CenterPoint's valuation is unattractive, and it is also at risk from the "Texas regulatory noise," she said.

The Utility Thesis: The utility sector's relative outperformance came on the back of the pre-recessionary environment in the U.S. in 2022, analyst Karp said. She noted that the sector now traded at a 2.8 times premium to

the S&P 500 Index, which is relatively wide by historical standards.

She said the utility sector is relatively overvalued and will see a mean reversion in 2023, adding that the last time such a premium over the S&P 500 Index happened was in 2004.

“We are therefore negative on the sector overall going into 2023 and our OW picks grow fewer,” Karp said.

See also: Best Utility Stocks Right Now

There has been a surprising deterioration of the regulatory environment across multiple jurisdictions, including the historically stronger ones, she noted. Some regulatory developments, according to the analyst, are driven by the regulator’s desire to moderate the impact on customer bills. “Given that power and commodity prices remain elevated, we expect to continue seeing regulators getting 'creative' with assumptions and rate mechanisms to achieve that goal,” she added.

Karp said she would focus on rate affordability, as inflationary pressures will likely be a factor for the foreseeable future.

"As we turn to 2023, we believe that the sector will find it difficult to defend this relative valuation position, particularly as macro headwinds persist and begin to take a toll on utility earnings," she added.

The analyst sees **Xcel Energy, Inc.** (NYSE:XEL) as standing out for having the most affordable and low-rate states in its territory.

KeyBanc's few Overweight stocks in the sector are:

- **FirstEnergy Corp.** (NYSE:FE)
- **NorthWestern Corp.** (NASDAQ:NEW)
- **Constellation Energy Corp.** (NASDAQ:CEG)
- Xcel
- **Duke Energy Corp.** (NYSE:DUK)
- **WEC Energy Group, Inc.** (NYSE:WEC)

KeyBanc singled out **Dominion Energy, Inc.** (NYSE:D) as the most interesting story to watch in 2023, as its shares have underperformed the sector by a wide margin in the fourth quarter. The firm expects the company to start asset sales and balance sheet repair this year due to the prospectively lower return on equity in Virginia.

Utility Price Action: The XLU ended Friday's session down 0.36% at $71.33, according to Benzinga Pro data.

Read next: Southern Company Needs To Examine Its Portfolio: Why This Analyst Is Bullish

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