Edward Jones
MAKING SENSE OF INVESTING

Canadian Utilities and Interest Rates

UTILITIES SECTOR REPORT

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Buy-rated Canadian utility companies mentioned in this report:

Emera (EMA.TO - $52.00)

Fortis Inc. (FTS.TO - $51.07)

Source: Reuters. Prices and opinion ratings as of market close on 04/01/20 and subject to change.

Individuals can obtain the full research report with full disclosures on any of the companies mentioned in this report by contacting a local Edward Jones financial advisor, or write to: Edward Jones, 90 Sussex Centre, 90 Burnhamthorpe, Mississauga, Ontario, Canada, L5B 3C3.

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Investment Overview

Utility stocks may continue to trade more based on interest rate changes than on fundamentals during times in the future. We continue to recommend that investors hold a portfolio of quality, dividend-paying stocks for the long term, and not try to move in and out of the market based on interest rate predictions.

In this report, we will discuss recent developments in both the utility industry and interest rate levels. We will summarize our current view on utilities' fundamentals, as well as discuss how valuation has changed over the past several years:

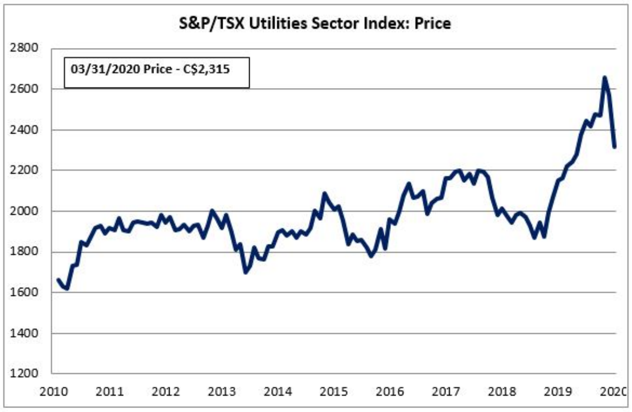
- While the inverse relationship between rates and stock prices that has existed historically may not hold perfectly all of the time, we believe it remains intact (see Figure 4).
- We believe utility industry fundamentals will remain healthy and supportive of solid earnings and dividend growth.
- We continue to recommend that investors remain focused on principles, not predictions, and invest in a diversified portfolio for the long term as opposed to trying to time the market.

We believe it is important to periodically review portfolios to ensure that they remain properly diversified, especially given the current changing interest rate environment and its potential impact on utility stocks.

Why have utility stocks done well over the long term?

Utility stocks have performed well since the financial crisis, with consistent dividend growth from many of those companies (Please see **Figure 1** on the next page). We believe a combination of industry fundamentals as well as macroeconomic issues contributed to this positive environment. Within the utility sector, companies have had significant opportunities for new investment in electric and gas infrastructure, renewables, and pipelines, which has led to strong earnings growth. This, combined with the relatively low-risk nature of utility stocks, has been attractive to investors.

Figure 1



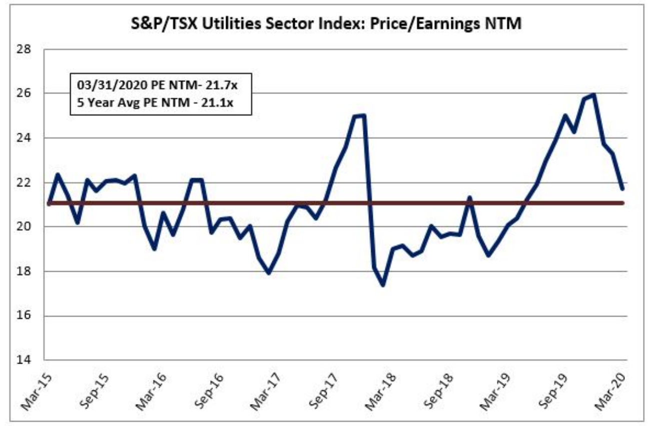
Source: Bloomberg. S&P/TSX Index is based on the average performance of around 250 widely held common stocks. S&P/TSX Utility Index consists of around 16 utility companies within the S&P/TSX Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

On a separate plane, macroeconomic factors, such as the ongoing historically low interest rate environment and a corresponding lack of options available to investors to generate current income, helped boost utilities. Many investors used utilities and other defensive sectors as substitutes for bonds, as equity dividend yields often exceeded bond coupon yields for the same company. This philosophy worked well in an ascending market for utility stocks, as investors have been happy and perhaps pleasantly surprised to realize significant capital appreciation, in some cases in addition to healthy and often rising dividend payments.

Utility company fundamentals remain solid -- In our view, utility industry fundamentals remain healthy and supportive of continued strong growth in earnings and dividends for the next several years. Regulated utilities hold virtual monopolies in their service territories, and they earn an allowed return on approved investments, of which there are tens of billions of dollars' worth needed in Canada, according to independent sources. The national average for allowed returns for both electric and gas utilities remains at roughly 9%, a level that we believe will enable utility companies to sustain profit growth.

Absolute valuation slightly above the longer-term average -- Currently, on an absolute valuation basis, price-to-earnings ratios (P/E) in the industry are slightly above their historical average. (Please see **Figure 2**). We believe today's prices reflect the outlook for stable and predominantly regulated earnings growth, along with lower for longer interest rates. Additionally, regulated utilities have historically traded at a premium to less regulated utility peers due to the highly visible nature of their generally more regulated business models.

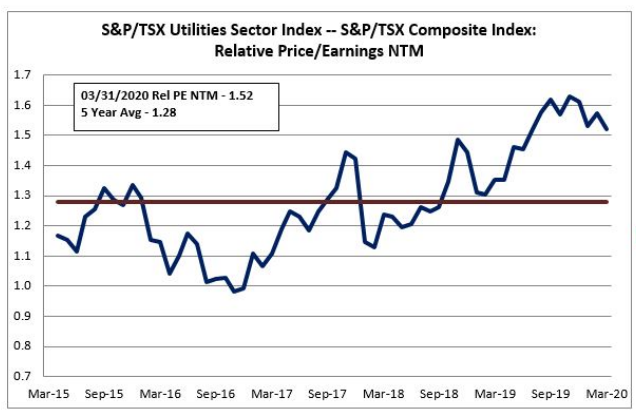
Figure 2



Source: Bloomberg. Absolute Valuation = P/E of the S&P/TSX Utility Index. S&P/TSX Index is based on the average performance of around 250 widely held common stocks. S&P/TSX Utility Index consists of around 16 utility companies within the S&P/TSX Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

Utilities trading at a premium to market valuations -- Having addressed absolute valuation, we believe it is also important to examine relative valuation. In other words, it is necessary to evaluate how utilities have performed relative to other investments and how expensive they are relative to alternatives. With the market as a whole up significantly since its low point in March 2009, other sectors have appreciated as well. So how have utilities fared compared with the market?

Figure 3



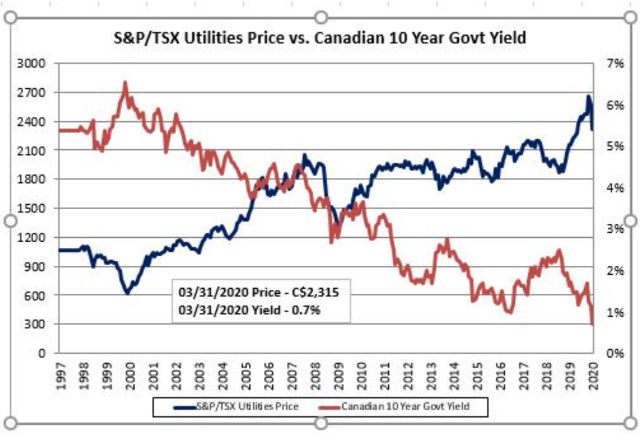
Source: Bloomberg. Relative Valuation = the S&P/TSX 500 Utility Index P/E divided by the S&P/TSX Composite Index P/E. S&P/TSX Index is based on the average performance of around 250 widely held common stocks. S&P/TSX Utility Index consists of around 16 utility companies within the S&P/TSX Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

On average, utilities have tended to trade at a premium to the market as a whole. After touching near historical highs relative to the market in late 2019, utility valuations relative to the market have come down. However, compared to the market as a while utilities trade well above their average premium.

In an environment in which higher-growth stocks outperform, we certainly believe utilities could lag, given their relative inability to accelerate earnings growth compared with high-growth companies in a growth-favoured market environment. Overall, we do think certain quality utilities are positioned to continue to provide competitive total returns; however, we also believe utility relative returns are narrowed by utilities' more limited growth potential versus faster-growing sectors.

What about interest rates? Let us turn our attention to the relationship between utility stocks and interest rates (the 10-year Canadian Government yield). We believe that investors should be aware that historically utility stock prices and the 10-year Canadian Government yield have tended to have an inverse relationship. This means when interest rates rise, utility stock prices tend to drop, and vice versa. We saw a weakening of this relationship during the 2008 financial crisis (see **Figure 4**) when all equities dropped; however, we do believe this relationship generally still holds.

Figure 4



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Over the last few years, there have been fits and starts in longer-term interest rates. Moves up have spurred declines in utility stocks, while retreats in interest rates have driven utilities higher. We reiterate that trying to time entry and exit points for stocks based on interest rate predictions is a risky endeavour. Instead, we recommend that investors focus on the long term, and, with utility stock valuations relatively near their historical averages, we believe this could produce future returns that roughly approximate the earnings growth rate of the industry plus the dividend yield.

Should I adjust my portfolio as interest rates move? We think it is appropriate to periodically review portfolios and rebalance sector weightings. Certain life events or macroeconomic changes can demand timely examination of portfolios. We are aware that many of our clients have a weighting far in excess of 4% in utilities, and we understand that there may be individual reasons why this is appropriate.

Importantly, we recommend investing based on principles, not predictions. We preach diversification and quality, and we advocate owning a portfolio of dividend-paying stocks for the long run, through the ups and downs of the interest rate cycle. Investors can be burned if they try to move in and out of stocks based on predictions, whether for the economy, the stock market as a whole, or interest rates in particular.

Coming out of the Great Recession, most people thought interest rates had nowhere to go but up. The main point to remember is that even professionals find it very difficult to predict the direction and magnitude of interest rate changes, so we would not recommend making major changes to client portfolios based on predictions. We continue to believe utility stocks have attractive characteristics, and we believe they should be part of a diversified portfolio, regardless of short-term movements in interest rates.

While utilities offer a number of positives for investors, we would also note the risk of having too heavy a weighting in any one sector. In contrast, if investors need to boost current income or are underweight in utilities, and are seeking exposure to the group, we believe valuations now appear more reasonable. We think fundamentals remain solid, and we maintain the philosophy that a well-diversified portfolio should also include utilities. We maintain Buy recommendations on a number of the utility stocks covered by Research.

Risks besides valuation -- Despite their generally regulated nature, utility stocks carry various risks that investors should consider. Risks to the relative performance of utility stocks would include better-than-expected or faster overall economic growth, evolving or new legislation concerning environmental guidelines, unplanned operational outages, unfavourable regulatory changes, an overbuild of generation capacity resulting in downward pressure on contract prices, and the significant slowdown in the Canadian Oil Sands. Also, utility companies with large unregulated businesses are more susceptible to risks like evolving environmental regulations and low wholesale power prices. We recommend investors focus more on utility stocks with predominately regulated operations. Two Buy-rated Canadian utility stocks that have mostly regulated operations include Emera (EMA.TO) and Fortis Inc. (FTS.TO).

Required Research Disclosures

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report. Andy Pusateri, CFA and Mike Doyle, CFA

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Buy (B) - We believe the valuation is attractive and total return potential is above average over the next 3-5 years compared with industry peers. Hold (H) - We believe the stock is fairly valued and total return potential is about average over the next 3-5 years compared with industry peers or a special situation exists, such as a merger, that warrants no action. Sell (S) - We believe the stock is overvalued and total return potential is below average over the next 3-5 years compared with industry peers. In some cases we expect fundamentals to deteriorate considerably and/ or a recovery is highly uncertain. FYI - For informational purposes only; factual, no opinion.

The table below lists the percent of stocks we follow globally in each of our rating categories. Investment banking services indicate the percentage of those companies that have been investment banking clients within the past 12 months. As of: April 02, 2020

	BUY	HOLD	SELL
Stocks	**51%**	**45%**	**4%**
Investment Banking Services	**4%**	**0%**	**0%**

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Diversification does not guarantee a profit or protect against loss in declining markets.

Special risks are inherent to international investing including those related to currency fluctuations, foreign political and economic events.

Dividends can be increased, decreased or eliminated at any time without notice.

An index is not managed and is unavailable for direct investment.

Member - Canadian Investor Protection Fund

3-Year Rating and Price History for: Emera (EMA.TO) as of 04/01/2020

Source: Reuters

3-Year Rating and Price History for: Fortis Inc. (FTS.TO) as of 04/01/2020

Source: Reuters