Let's Not Miss the Forest for the Trees; Macro Drives Ute Sector Appeal

Summary

Investors are focused on the possibility of a December 16 Fed rate hike and if rates will continue to rise. Not surprisingly, utility investors are on the sidelines. However, we think the broader macro issues should garner more attention and a further analysis suggests the macro environment is not robust as some might think. That would argue for a defensive bent. And with utes trading at reasonable valuations, we think there is still room for the sector to do well into year-end and beyond.

Key Points

The utility sector continues to look appealing, in our view, and the markets appear to have priced in a 25 bps hike. Following the Nov 6 market correction when several Fed Governors suggested a December hike was forthcoming, the utes have rallied, outperforming the S&P 500 by 200 basis points. Mizuho's Chief US Economist, Steve Ricchiuto, has been spot on over the course of the year with his call regarding Fed action. Importantly, he believes the data still doesn't support a Fed hike at this time.

Macro data suggests challenges ahead and investors should seek a defensive bias. On Dec 1, the Atlanta Fed slashed 4Q15 GDP growth to 1.4% from 1.8% (Consensus: 2.5% growth). S&P 500 estimates are beginning to roll over, operating margins are declining, and U.S. and global GDP expectations are falling. Further, durable goods and retail sales are stumbling, commodity prices falling, and industrial production hurting. And that's just the start . . .

All of this belies the popular notion that utilities may retreat in the near-term. With most companies in the broader utility sector projecting 4-6% earnings growth and paying a roughly 4.0% yield, total return potential of approximately 8-10% is attractive, especially since one does not need to go out on the risk curve to produce such returns.

We remain positively biased with Buy recommendations on AEP, NEE, PCG, and WEC and while there isn't enough upside to warrant a Buy recommendation, we think ED, EIX, and ES are worth a look. Mega-caps DUK and SO will be turned to given their liquidity, but caution that both have their various 'puts' and 'takes' that investors need to remain cognizant of.

Company	Symbol	Price (11/30)	Rating Prior	Rating Curr	PT
American Electric Power Company, Inc.	AEP	$56.01	–	Buy	$65.00
Consolidated Edison, Inc.	ED	$62.15	–	Neutral	$66.00
Duke Energy	DUK	$67.76	–	Neutral	$75.00
Edison International	EIX	$59.36	–	Neutral	$60.00
Entergy Corp	ETR	$66.63	–	Neutral	$67.50
Eversource Energy	ES	$50.95	–	Neutral	$52.00
NextEra Energy, Inc.	NEE	$99.86	–	Buy	$125.00
PG&E Corporation	PCG	$52.73	–	Buy	$56.00
Pinnacle West Capital Corporation	PNW	$63.36	–	Neutral	$60.00
SCANA Corporation	SCG	$59.14	–	Neutral	$56.00
TECO Energy, Inc.	TE	$26.32	–	Neutral	$27.50
The Southern Company	SO	$44.54	–	Neutral	$45.00
WEC Energy Group	WEC	$49.32	–	Buy	$54.00

Source: Bloomberg and Mizuho Securities USA

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Executive Summary

"When conventional wisdom no longer explains short- to medium-term financial market movements, the search for non-traditional explanations can roam very far from reality. This is exactly what is happening over the past few weeks as the domestic equity market has rallied despite disappointing earnings, weak economic numbers (outside the October jobs report), and the rising tensions in the Middle East. The search for a reason why markets are up appears to have found a completely convoluted rational one. The pundits are claiming that a Fed rate hike will be good for the markets. The logic suggests that if the Fed does hike rates, then the economy must be stronger than earnings or the GDP data imply and it is safe to increase exposure even more to stocks. This logic is completely upside down.

"A detailed look at the data strongly suggests that the Fed has no reason to hike rates at this juncture. In fact, we believe it is obvious the equity market is overvalued, and a rate hike would hurt the economy and, subsequently, stock prices. The data released in the last few days highlight the disconnect between the broader economy, the payroll data, and the markets Fed call…This sample of data points suggest the Fed should exercise real caution in hiking rates and a further spike in the currency could have destabilizing consequences"

Steven Ricchiuto, US Chief Economist, Mizuho Securities USA
Daily Briefing, November 30, 2015

Those are the words of MSUSA's house economist, Steven Ricchiuto, a man who has consistently and correctly predicted that there would be no rate hike through today. We at MSUSA firmly believe in collaboration between and across specialties and there is no more imperative collaboration than between the Utilities Analyst and the Chief Economist, especially when his insights are appropriate not only to the larger and more important issue of whether the Fed will hike rates, but also when his insight about conventional wisdom failing is so appropriate to the current state of conventional wisdom in the regulated Utilities sector.

Today, a Fed hike of approximately 25 basis points appears to be fully priced into the market, but there are significant signposts and macro factors that suggest the economy is not as robust as one might believe, and in this environment, it's best to be defensive.

All of this belies the popular notion that utilities may retreat in the near-term. With most companies in the broader utility sector projecting 4-6% earnings growth and paying a roughly 4.0% yield, total return potential of approximately 8-10% is attractive, especially since one does not need to go out on the risk curve to produce such returns. That said, absolute forward valuations may not mean this much where the total return potential for the utilities appears better on a risk-adjusted basis.

We're not macro analysts *per se*, but we do pay attention to what is happening around us. For, example a few macro highlights:

- **On December 1, the Atlanta Fed slashed its 4Q15 GDP forecast to 1.4% from 1.8% on November 18.** Street consensus growth is currently 2.5%;

- **The S&P estimates are beginning to roll over**. At some point, the S&P 'truth tellers' will have to realize that you can't exclude a particular subsector, just because results are poor, *e.g.*, excl. Energy, Financials et.al.;

- **Energy still doesn't look like it has hit bottom.** Given the lower for longer commodity price environment, there is rising concern about the E&P sector and its ability meet its debt service obligations on nearly $200 billion in high-yield debt. Price related impairments and asset write-downs appear to be right around the corner. Is some or all of this debt at risk and what omens would such write-downs have on the broader economy?

- **Companies across varying industries are flashing warning signs.** Some of the 3Q15 earnings highlights include: Schlumberger says to expect weak commodity prices through 2016; E&C companies are ratcheting back their capex expectations; Walmart, IBM all missed and warned; and, Financials, *e.g.*,, JP Morgan, Morgan Stanley aren't faring well, to name a few.

Goldman Sachs, Morgan Stanley and JP Morgan reported third quarter earnings below analyst estimates, attributing the miss to negative cyclical pressures, a weaker global economy and lower trading revenues. At the same time, Citi and Bank of America reported better-than-expected earnings based on lower expenses and cost control instead of higher revenues.

Corporate bellwethers such as Alcoa, IBM and Caterpillar missed top line or bottom line estimates for the third quarter. Third quarter earnings of Alcoa were 77% lower than a year ago after revenues declined due to lower aluminum prices, a stronger dollar and cheaper yuan and the ongoing slowdown in China.

IBM reported revenue below analyst expectations, blaming the miss on dollar strength and then followed up with lowering its earnings guidance for the year. Caterpillar's earnings and revenues were below analyst expectations and the company reduced its earnings outlook for the year. Unsurprisingly, Caterpillar cited weaker economic growth in the U.S., Europe, China and Brazil and the commodity downturn in lowering its outlook.

Meanwhile, the move by Walmart to raise the minimum wage of its employees has seen its SG&A expenses rise sharply in recent quarters. Indeed, during its annual investor day earlier this month, the company issued a profit warning for FY 2017 on account of higher wages and greater investment in e-commerce. However, around 75% of the decline in earnings is on account of higher wages. The company also cut its revenue forecast for the year as the strong dollar is reducing its international

revenues. The latest profit warning was in addition to cutting this year's profit guidance earlier in August.

So, of course, the conventional wisdom is that the utility sector will roll over in January 2016 with the start of a new year and investors chase beta as we start a new year. We wouldn't necessarily bet on it – and precisely for the reason that our colleague doesn't think rates will rise: the economy is weaker than the market thinks…and we can and do show that utilities outperform in precisely this kind of environment.

This report will look at the following:

1) Stock Ideas
2) Valuation in terms of historical context
3) Valuation – Defensives vs. Cyclicals
4) How Utilities Perform in Defensive Environments
5) High Yield Warning Signs
6) The Nine Macro Factors Leading to a More Defensive Environment
7) Deflationary Pressures Mandate Careful Monitoring
8) When the Fed Does Hike, What Happens?

Stock Ideas

Favorite large cap ideas (alphabetical):

1) **American Electric Power (AEP, Buy, Target: $65)**. AEPs new management team is moving forward with simplifying the business, i.e. selling non-core assets, and in so doing, gaining a valuation uplift akin to other simplified stories. The next key catalyst could come late this week, early next week when a settlement between AEP and key advocacy groups might be announced. That settlement will give insight whether AEP goes down the path of full or partial divestiture for its merchant generation fleet. Key Risk: retain all generation and hence, commodity exposure.

2) **NextEra Energy (NEE, Buy, Target: $125)** 14-year track record under current leadership speaks for itself, having delivered growth each year, including the period of the Great Recession. Investment thesis consists of 6-8% annual EPS growth and 12-14% DPS annual growth through 2018. This is best in calls in the Key Risk: Crowded Long; M&A interest

3) **PG&E Corp. (PCG, Buy, Target: $56).** One major regulatory proceeding remains outstanding in the very near term, but the PCG investment thesis is about dividend growth resumption and capital investment. A simple story, but the valuation is unlikely to rebase appreciably until PCG articulates its dividend growth outlook. Another key investment consideration is succession planning, and as we've stated previously, the easiest way to solve a succession issue is via M&A. Key Risk: regulatory uncertainty and disconnected regulatory decisions from the filings that were made

4) **WEC Energy (WEC, Buy, Target: $54)** While the conventional wisdom around the WEC premium is the "Klappa call," namely CEO Klappa continues to deliver on his promises and then some, the real thesis has been the cash flows, and earnings from the Power the Future program which has allowed the company to reinvest in Wisconsin without having to tap the equity markets. Meantime, investors are rewarded with DPS growth of 5-7%. Growing short position in a defensive tape may require some unwinding. Key Risk: executing the gas main replacement program, on time and on budget, remains the best defense of Illinois' seemingly continuous political interference and Monday morning quarterbacking.

Other 'favorite' names we like but not enough upside to warrant a Buy recommendation:

1) **Consolidated Edison** (ED, Neutral, Target: $66)**. "**Steady EDdie," and nothing fancy here as ED is largely a call on the broader bond market. ED consistently delivers, but that EPS and DPS growth is below the broader group median. Historically, ED has demonstrated an ability to outperform the S&P. Shareholder friendly CEO is better at articulating its investment thesis to the investment community than his predecessor.

2) **Edison International** (EIX, Neutral, Target: $60) An investor favorite given its above average longer-term EPS growth profile and above-average dividend growth potential. Regulatory interference seems to have slowed down and the California regulatory body is marshalling forward with the green goals supported by the state legislature and Governor Brown. And, with the SONGs and general rate case now behind them, there are probably few near-term catalysts to get the shares moving appreciably higher for now, unless the EIX Board raises the dividend above Street expectations (growth of 11%, we see 15%). The shares are trading at a group average P/E multiple and one could rightfully argue there is a longer-term argument for a higher P/E but that would likely occur over time, in our view.

3) **Eversource Energy** (ES, Neutral, Target: $52). 2.5% price upside from current levels. In the tale of the tape, ES and WEC are similar across all metrics – exceptionally strong balance sheets, no equity needs, above average EPS and DPS growth expectations, proven management teams – with the exception of one. That exception is the execution and construction

risk with its two large infrastructure projects: Northern Pass transmission and Access Northeast natural gas pipelines. The pending generation plant shutdowns in the Boston area make ES' projects all the more critical. Yet, with the construction risk, the timing and certainty of the cash flows are not known. It should be noted that every project ES has undertaken has made it over the finish line.

The following have their "puts" and "takes" fundamentally although they may be attractive investments from a 'defensive' perspective.

1) **Duke Energy (DUK, Neutral, Target: $75).** Largest company by market cap, but plagued by challenges at its International business. Its minority investment in National Methanol is tied to oil prices which remain weak are below the levels set by DUK in their formal guidance. The weak hydrology story in Latin America is well known, but the reality is it will rain. What's unclear is the tenuous political and economic situation in Brazil and the duration of the same, primarily the economy. Weak economic conditions don't lend itself to improved power production. Meantime, DUK owns 523MW in Argentina, and with the political party turnover, there is compelling reason to believe the Argentine peso will be devalued. If Argentina and Brazil stutter, will the rest of LatAm be far behind? And although LatAm is less than 10% of DUKs earnings power, it tends to become the tail that wags the dog.

2) **Southern Company (SO, Neutral, Target: $45).** Just when you thought it was perhaps safe to begin investing, and not trading, in SO again – given its pending deal with AGL Resources that raises and solidifies the underlying growth expectations – Mississippi and the ills of the IGCC Plant Ratcliffe at Kemper County continue to pop up. The latest is a consultant's report that places 70% odds that the plant will be fully operational by December 2016. At $30 million per month in owner's costs, that equates to $0.13-0.15 per share in shareholder funded expenses potentially. There's been enough uncertainty, *i.e.*, budget overruns, and timing delays regarding this facility that perhaps investors won't be convinced until the switch is flipped on and the regulators have opined (and no more state Supreme Court interference).

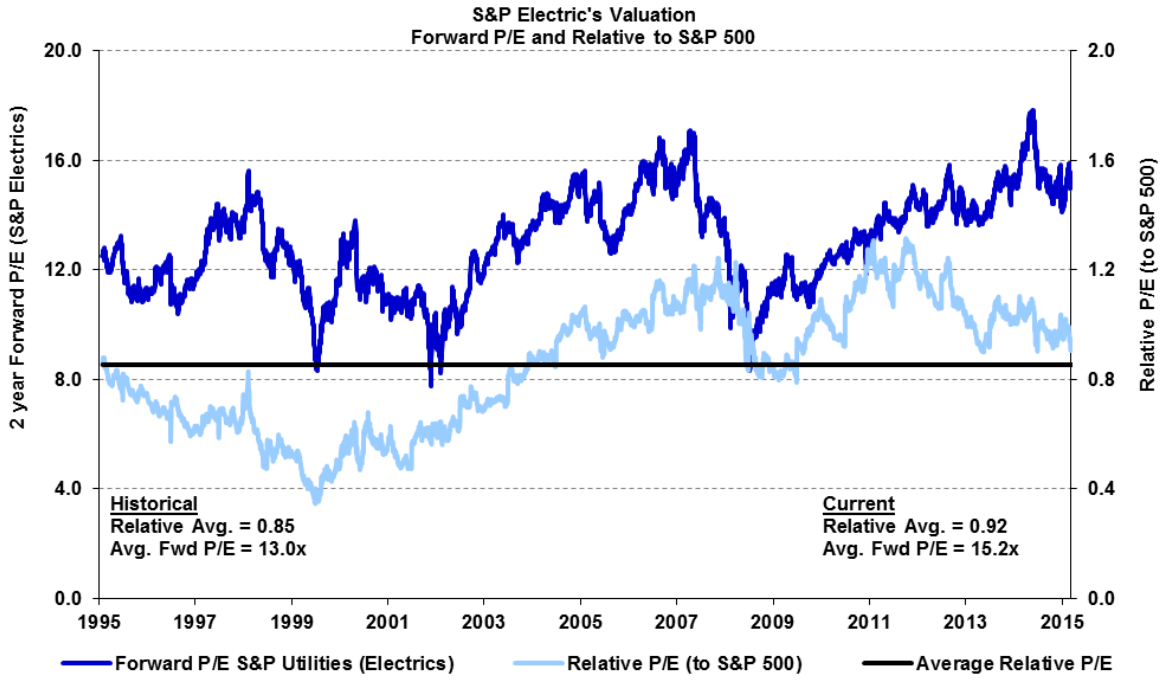
Valuation – Historical Context

The utility sector, based on an arithmetic average of the S&P Electric's Two Year forward P/E multiple at current prices (approximately at par relative to the SPX), is not out of line in terms of historical context.

That would argue that the group is neither "inexpensive" nor overvalued under these metrics. Importantly, it would argue the group has room to run if the poor macro environment, discussed herein, persists.

Exhibit 1 shows the valuation for the past 20 years.

Exhibit 1: Relative Valuation



Source: Bloomberg, Mizuho Securities USA Inc.

How Utilities Perform in Defensive Environments

Our work indicates that Utilities outperform leading into recessions beginning one year prior to the start of recession and underperform as the economy recovers. While we're not one to predict, nor will we, that a recession is forthcoming, there are enough signs that there will be hiccups along the way, which augurs well for the sector.

Exhibit 2: Utilities and Recessions

	Average of Past Three Recessions			Hypothetical Recession [1]		
	S&P Electrics	UTY Index	S&P 500	S&P Electrics	UTY Index	S&P 500
1-year prior	22.8%	18.3%	-5.4%	-8.5%	-8.6%	0.6%
6 months prior	2.7%	1.5%	-4.4%	-4.3%	-5.1%	-1.3%
3 months prior	3.3%	2.1%	-2.8%	1.0%	-0.5%	5.5%
1 month prior	1.1%	0.5%	-2.6%	-2.1%	-2.9%	0.1%
During	-15.0%	-13.9%	-11.3%			
1 month post	1.7%	2.5%	2.7%			
3 months post	-1.4%	0.5%	3.7%			
6 months post	5.6%	7.3%	6.1%			
1-year post	-6.4%	-5.0%	0.6%			

[1] Presumes recession began November 30, 2015

Source: Bloomberg, Mizuho Securities USA Inc.

Valuation: Utes and other Defensives vs. Cyclicals

The S&P Electric Utility index is trading at nearly 2.7x P/E multiple turns lower than other defensive sectors but is priced to yield about 80 bps lower. On a price to book basis, the electrics look inexpensive even to telcos and water companies.

Exhibit 3: Comparable Valuation Analysis: Cyclical vs. Defensive Sectors

		Price		3 Year	3 Year	Price/ Earnings				EV/EBITDA			P/Book	Trailing 52 Week Price		% Δ	
	Sector Name	11/30/2015	Yield	EPS CAGR	DPS CAGR	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	High	Low	High	Low
Cyclical	Materials	286.3	2.03%	8.2%	2.1%	18.8x	18.6x	16.7x	14.2x	10.6x	9.7x	8.8x	5.4x	327.3	244.0	-12.5%	17.3%
	Industrials	474.0	2.16%	6.6%	10.0%	18.5x	17.5x	16.6x	15.0x	10.2x	9.8x	9.1x	6.4x	498.9	420.8	-5.0%	12.6%
	Transports	523.0	1.86%	12.0%	13.3%	18.4x	15.7x	14.4x	13.0x	8.1x	7.6x	7.2x	5.4x	630.6	474.3	-17.1%	10.3%
	Capital Goods	512.5	2.16%	4.2%	9.5%	17.6x	17.5x	16.7x	15.1x	10.5x	10.2x	9.5x	7.2x	527.0	447.2	-2.8%	14.6%
	Consumer Discretionary	640.0	2.29%	10.1%	11.7%	25.3x	21.2x	18.3x	15.9x	12.6x	11.3x	9.8x	6.2x	649.4	541.0	-1.4%	18.3%
	Information Technology	738.7	2.36%	7.0%	7.5%	18.5x	16.9x	16.1x	14.6x	12.8x	12.2x	10.6x	5.6x	751.5	612.3	-1.7%	20.6%
	Financials	329.5	2.61%	7.8%	10.0%	15.6x	14.9x	13.5x	11.9x	16.8x	15.7x	14.5x	2.6x	344.9	296.1	-4.5%	11.3%
	Energy	498.3	2.81%	-21.1%	0.4%	12.8x	17.8x	21.7x	21.8x	9.0x	9.2x	7.8x	2.2x	610.8	432.0	-18.4%	15.3%
	Average		**2.28%**	**4.4%**	**8.0%**	**18.2x**	**17.5x**	**16.7x**	**15.2x**	**11.3x**	**10.7x**	**9.7x**	**5.1x**			**-7.9%**	**15.0%**
	Median		**2.23%**	**7.4%**	**9.7%**	**18.4x**	**17.5x**	**16.6x**	**14.8x**	**10.6x**	**10.0x**	**9.3x**	**5.5x**			**-4.7%**	**15.0%**
Defensive	Consumer Staples	505.7	5.57%	6.6%	10.6%	23.9x	22.9x	21.0x	19.2x	14.0x	13.0x	12.1x	13.0x	523.8	456.9	-3.5%	10.7%
	Food, Beverages & Tobacco	617.7	7.33%	6.6%	11.4%	24.1x	23.2x	21.1x	19.2x	14.9x	13.7x	12.7x	10.7x	640.8	547.4	-3.6%	12.8%
	Healthcare	820.0	1.55%	11.6%	6.5%	21.0x	19.3x	17.3x	15.2x	14.0x	12.7x	11.2x	5.5x	894.4	736.9	-8.3%	11.3%
	Telecoms	147.4	6.19%	7.1%	1.7%	18.9x	18.2x	14.3x	13.4x	7.4x	7.0x	6.7x	4.6x	161.5	135.9	-8.7%	8.5%
	REITs*	187.4	3.56%	9.6%	6.3%	41.0x	38.6x	33.9x	32.7x	20.0x	19.2x	17.9x	3.5x	206.7	168.5	-9.4%	11.2%
	Utilities (incl. electric, gas and IPPs)	216.0	3.94%	1.8%	5.2%	16.0x	15.8x	15.4x	14.7x	9.3x	8.8x	8.3x	1.6x	253.3	205.8	-14.7%	5.0%
	S&P Global Water Index	3,174.3	5.08%	10.5%	10.6%	22.3x	20.9x	18.2x	16.1x	11.3x	10.2x	9.4x	2.7x	3,348.2	2,856.3	-5.2%	11.1%
	Average*		**4.94%**	**7.4%**	**7.7%**	**21.0x**	**20.1x**	**17.9x**	**16.3x**	**11.8x**	**10.9x**	**10.1x**	**6.4x**			**-7.3%**	**9.9%**
	Median*		**5.32%**	**6.9%**	**8.5%**	**21.7x**	**20.1x**	**17.8x**	**15.7x**	**12.7x**	**11.4x**	**10.3x**	**5.1x**			**-6.8%**	**10.9%**
	Electric Utilities**	**240.3**	**4.10%**	**2.4%**	**4.4%**	**15.7x**	**15.6x**	**15.2x**	**14.5x**	**9.1x**	**8.7x**	**8.2x**	**1.5x**	**286.9**	**228.7**	**-16.3%**	**5.1%**
	S&P 500	2,080.4	2.10%	8.58%	8.22%	18.4x	17.6x	16.2x	14.4x	10.9x	10.2x	9.4x	2.7x	2,134.7	1,867.0	-2.5%	11.4%

Source: Bloomberg, Mizuho Securities USA Inc.

Utility Share Performance – Fourth Quarter

A cursory look suggests that the Power & Utility sector performs poorly relative to the S&P during the fourth quarter. However, during periods of economic sluggishness, evidenced by the Great Recession in 2007/08, utility shares outperformed the S&P 500. This can be seen in Exhibit 4 below.

Exhibit 4: Fourth Quarter Utility Performance (2005 - 2014)

	Performance				Performance (relative to S&P 500)		
Period	S&P 500	UTY Index	S&P Electrics	Utilities ETF	UTY Index	S&P Electrics	Utilities ETF
4Q 2005	1.6%	-6.0%	-5.2%	-6.6%	-7.5%	-6.8%	-8.2%
4Q 2006	6.2%	7.8%	10.0%	8.0%	1.7%	3.8%	1.9%
4Q 2007	-3.8%	6.7%	8.4%	6.4%	10.5%	12.2%	10.2%
4Q 2008	-22.6%	-10.6%	-11.0%	-12.6%	11.9%	11.5%	9.9%
4Q 2009	5.5%	5.5%	3.3%	5.8%	0.0%	-2.1%	0.3%
4Q 2010	10.2%	-0.1%	-0.7%	-0.1%	-10.3%	-10.9%	-10.3%
4Q 2011	11.2%	6.7%	7.2%	7.0%	-4.5%	-3.9%	-4.1%
4Q 2012	-1.0%	-4.8%	-4.6%	-4.0%	-3.8%	-3.6%	-3.0%
4Q 2013	9.9%	1.1%	1.0%	1.6%	-8.9%	-9.0%	-8.3%
4Q 2014	4.4%	12.9%	13.4%	12.2%	8.5%	9.0%	7.8%
Average	**2.2%**	**1.9%**	**2.2%**	**1.8%**	**-0.2%**	**0.0%**	**-0.4%**
Median	**4.9%**	**3.3%**	**2.2%**	**3.7%**	**-1.9%**	**-2.9%**	**-1.4%**

Source: Bloomberg, Mizuho Securities USA Inc.

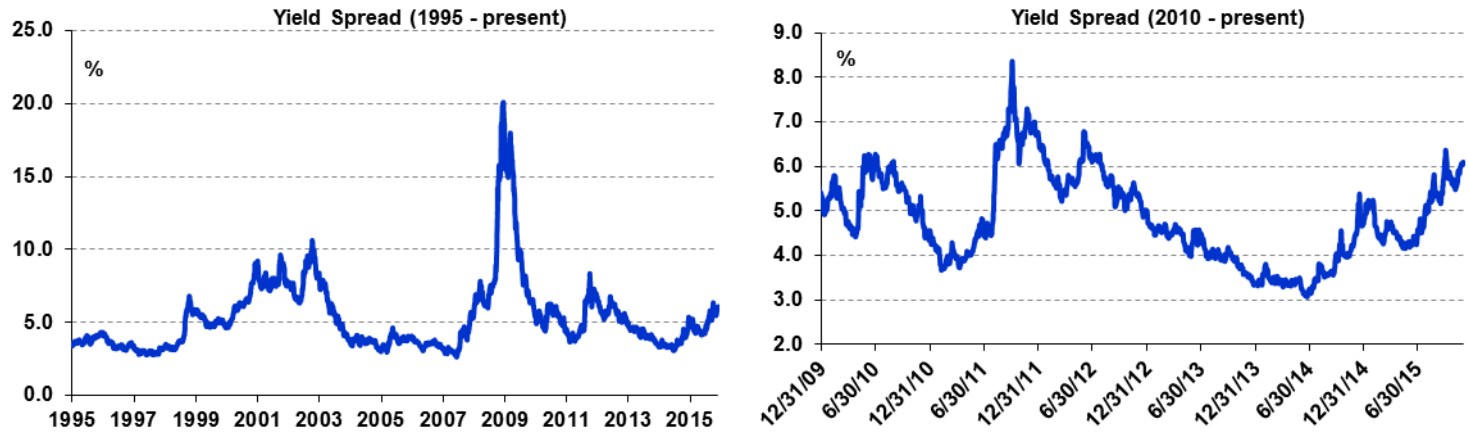
The less than spectacular performance by the utility sector in 4Q15 thus far (down 2.4%) vs. the SPX uptick of 8.4% suggests to us that something is terribly amiss.

As Mizuho's US Chief Economist stated on November 30…"Specifically, the existing home sales report unexpectedly dipped 3.4% in October while the Street was expecting a small increase. The weekly retail data suggest that the consumer remains stretched, as the year ago increase is still below 2%. The revised Q3 real GDP report was revised higher, but largely as a result of a greater accumulation in inventories, suggesting a larger drag on the economy in the final three months of the year. Finally, the unexpected decline in the jobs plentiful minus jobs hard to get measure contributed to the big decline in consumer confidence in November. The headline confidence report fell to 90.4 from 99.1 as the key jobs measure dipped to -6.3 from -1.9 in October. The October data on durable goods shipments and orders suggest that companies remain cautious in their investment spending decisions. In, fact the modest decline in shipments of non-defense, non-aircraft capital good suggest that corporate investment will be a small drag on the economy in the final three months. The personal income and spending data suggest the consumer will add a full 1% less to Q4 GDP than to Q3. **This sample of data points suggest the Fed should exercise real caution in hiking rates and a further spike in the currency could have destabilizing consequences.** *(emphasis added)*"

High Yield Warning Signs

High Yield credit, 10 year Treasury yields, and WTI crude, among others – have s/tumbled since early 2015**.** Meantime, the dollar remains strong and the S&P 500 goes even higher. Credit markets are flashing warning signs. The yield spread between 10 year Treasuries and High Yield debt has been widening since June 2014 when it troughed at 347 basis points. The yield spread had narrowed from around 500 basis points in January this year to just above 400 basis points in May before rising to reach the highest level since June 2012 at 637 basis points recently. It is currently hovering around 600 basis points. The widening of the yield spread indicates that we are probably in the latter half of the credit cycle when investors start becoming more wary about the financial and business prospects of companies. The uptick in spreads, in turn, leads to higher borrowing suggesting additional downside risk to the current economic recovery. There is a major disconnect between the credit and equity markets, in our view.

Exhibit 5: Yield Spread (BAML High Yield Index/10-year Treasury)



Source: FactSet, Mizuho Securities USA Inc.

In Exhibit 6 below, we show how the High Yield Indices have trended and are trending.

Exhibit 6: High Yield Spreads and Recessions

	Average of Past Two Recessions			Hypothetical Recession [1]		
	BofAML High Yield Index	10-year Treasury	Spread (bps)	BofAML High Yield Index	10-year Treasury	Spread (bps)
1-year prior	9.9%	5.4%	445	6.3%	2.3%	394
6 months prior	10.4%	5.5%	490	6.1%	2.2%	394
3 months prior	11.5%	4.9%	660	7.3%	2.2%	517
1 month prior	11.0%	4.6%	634	7.5%	2.1%	543
Beginning	11.3%	4.5%	677	8.1%	2.3%	587
End	12.9%	4.2%	868			
1 month post	12.3%	4.3%	795			
3 months post	11.4%	4.2%	722			
6 months post	10.4%	4.4%	605			
1-year post	10.7%	3.6%	703			

[1] Presumes recession began November 30, 2015

Source: Bloomberg, Mizuho Securities USA Inc.

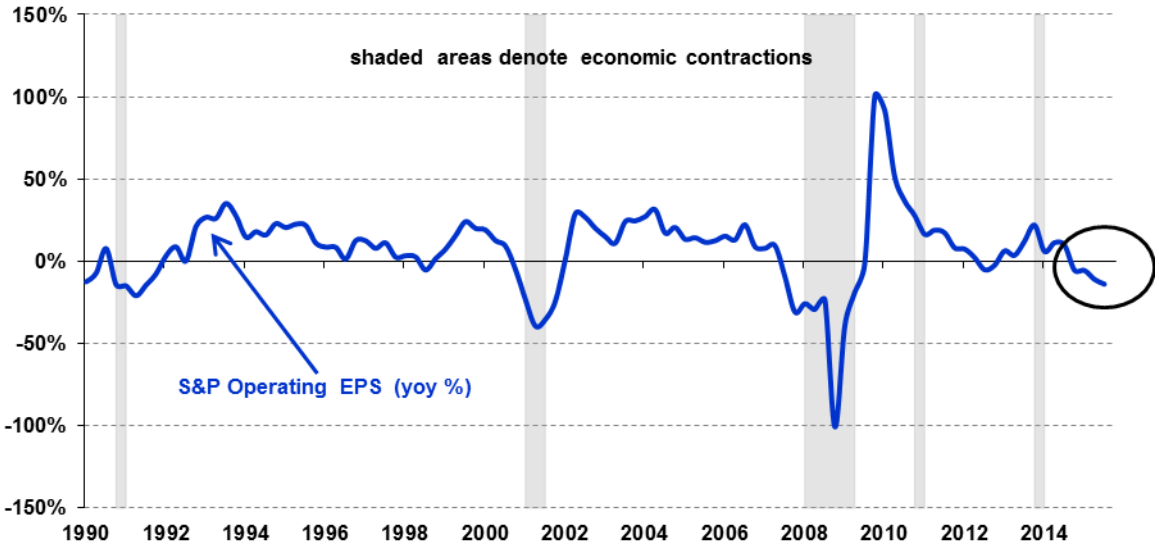
The Nine Macro Factors Leading to a More Defensive Environment

In our view, nine key macro factors are likely to affect utility shares over the balance of the year.

Earnings Expectations for the S&P 500 are Slowing

- **Ongoing earnings recession.** We are in the midst of an earnings and revenue recession. According to data from S&P, operating EPS (bottom up) of S&P 500 companies are on track to fall 13.9% in the third quarter following declines of 5.3%, 5.5% and 10.9% in 4Q14, 1Q15 and 2Q15, respectively.
- **A sharp contraction in earnings of energy and materials companies** has driven the deterioration in overall S&P 500 earnings. These sectors have been disproportionately affected by the plunge in commodity prices over the last year, the strength of the U.S. dollar and slowing economic growth overseas.
- **Lower S&P 500 targets and earnings estimates.** Against the backdrop of low commodity prices and an uncertain global and U.S. economic outlook, strategists at the big banks have been reducing their year-end targets and earnings estimates for the S&P 500 for some time now. Their year-end target for the S&P 500 stands at 2103 currently, down from 2200 in July ago while their 2015 EPS estimate is at $119.35 compared to $122.37 previously. According to Bloomberg consensus estimates, strategists expect S&P earnings to grow 2.5% in 2016 after 5.8% this year.

Exhibit 7: S&P Operating EPS

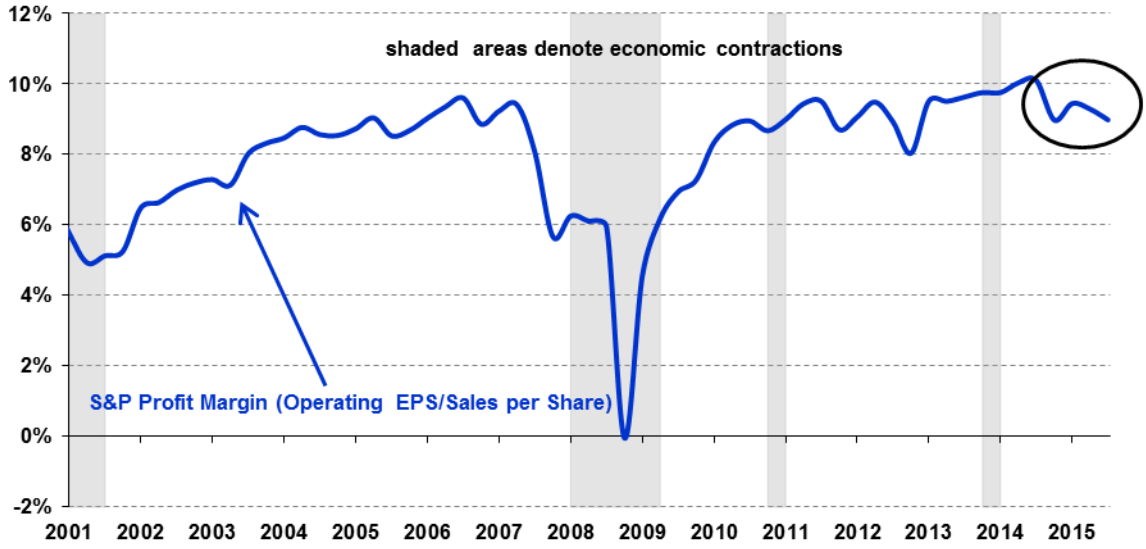


Source: S&P, Mizuho Securities USA Inc.

Falling S&P Operating Margins

- **Lower margins.** Operating margins of S&P 500 companies peaked at 10.1% in 3Q14. They have come under pressure since then and have hovered in the 9.0-9.4% range in the subsequent quarters.
- Lower commodity prices and overseas economic weakness have adversely affected revenues and profits at commodity and internationally-focussed companies, respectively, in addition to lower translation of profits due to the strength of the dollar. With the overhang of potential policy tightening by the Fed this year, the scope for lower borrowing costs has been limited. Meanwhile, in the retail sector, Walmart and Gap have both raised wages over the past year, which in turn has pressurized other companies to set a similar example. Target has followed their example and other companies are expected to follow suit.
- Profit margins are unlikely to start increasing from current levels without a recovery in commodity prices and stabilization of economic growth prospects overseas.

Exhibit 8: S&P Operating Margins

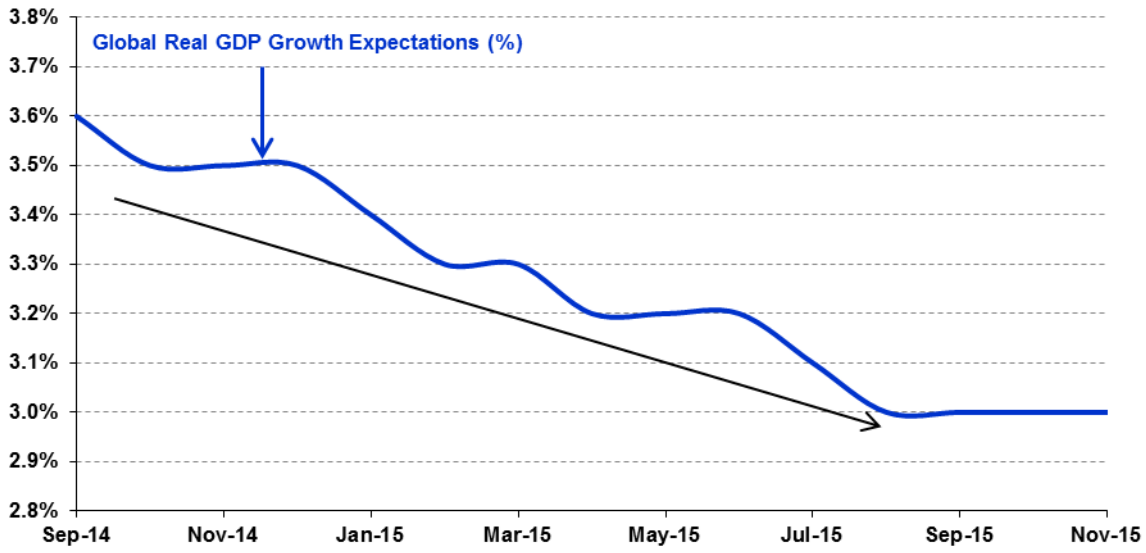


Source: S&P, Mizuho Securities USA Inc.

GDP Expectations are Falling

- **Global GDP expectations continue to be ratcheted back.** Even if the US may be somewhat resilient to global concerns, it won't be immune to any geo-financial shocks. If these occur, money flows are likely to move towards stocks with a defensive bias. Consensus global real GDP growth expectations for 2015 stand at 3.0% currently, down from 3.6% a year ago.
- **In terms of the U.S.,** expectations for this year's economic growth have deteriorated over the course of the year. Economists currently expect the U.S. economy to expand at 2.5% this year vs. 3.2% at the beginning of this year. Indeed, the downgrades in the U.S. economic outlook are continuing - Bank of America Merrill Lynch, Barclays, Deutsche Bank, Goldman Sachs, JPMorgan and RBC have all reduced their estimates for 2015 U.S. real GDP growth over the past few months.

Exhibit 9: Global Growth Expectations

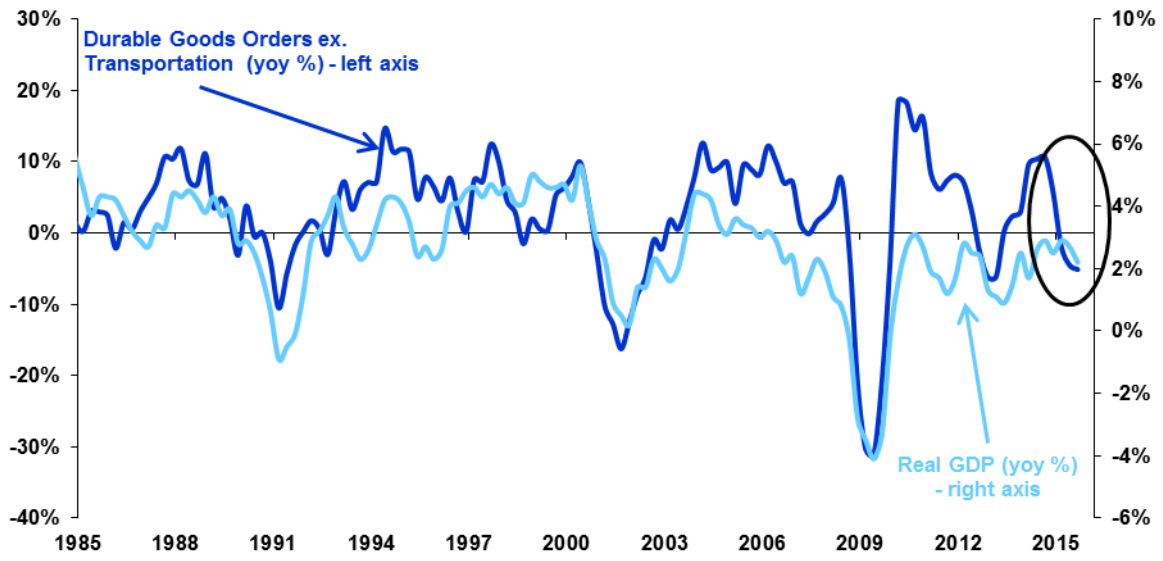


Source: Bloomberg, Mizuho Securities USA Inc.

Durable Goods Orders

- **Weak durable goods orders.** Durable goods orders (excluding transportation) have declined on a year-over-year basis every month from February this year following robust growth at the end of last year. The recent trajectory of durable goods orders suggests that investment is unlikely to see a strong pick up this year.
- The **strong dollar and overseas weakness** appear to have restrained foreign demand and **low commodity prices** have led to cutbacks in domestic investment on part of energy and metals and mining companies.

Exhibit 10: Durable Goods Orders ex. Transportation and Real GDP

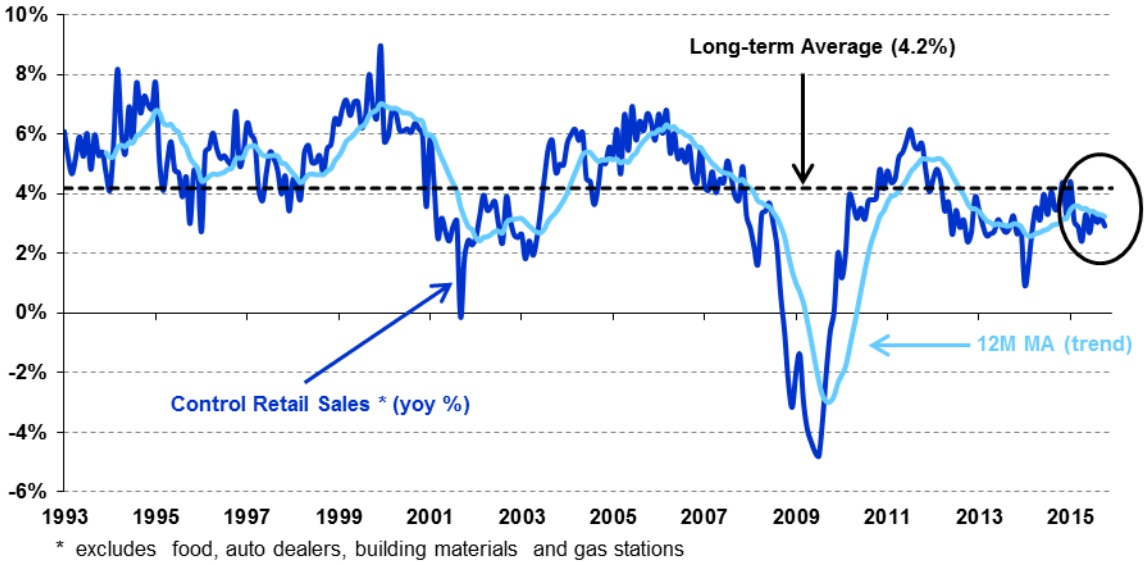


Source: Bloomberg, Mizuho Securities USA Inc.

Retail Sales

- **Retail sales have lost momentum over the last two quarters.** Average retail sales growth (year-over-year) has slowed to an average of 3.0% during the second and third quarter of this year from 3.8% and 3.5% in 4Q14 and 1Q15, respectively. Recent readings have registered well below its long-term average and its 12-month trend has been one of decline.
- Our retail analyst Betty Chen believes that retail sales have been pressured by **weak consumer spending power, unseasonal weather, and continued rotation into autos**. The lack of substantial wage growth coupled with inflation in food prices, education, health care and other costs could continue to dampen retail sales growth.
- In a consumption-driven economy such as the U.S., the weakness in retail sales bodes ill for real GDP growth going forward.

Exhibit 11: Retail Sales

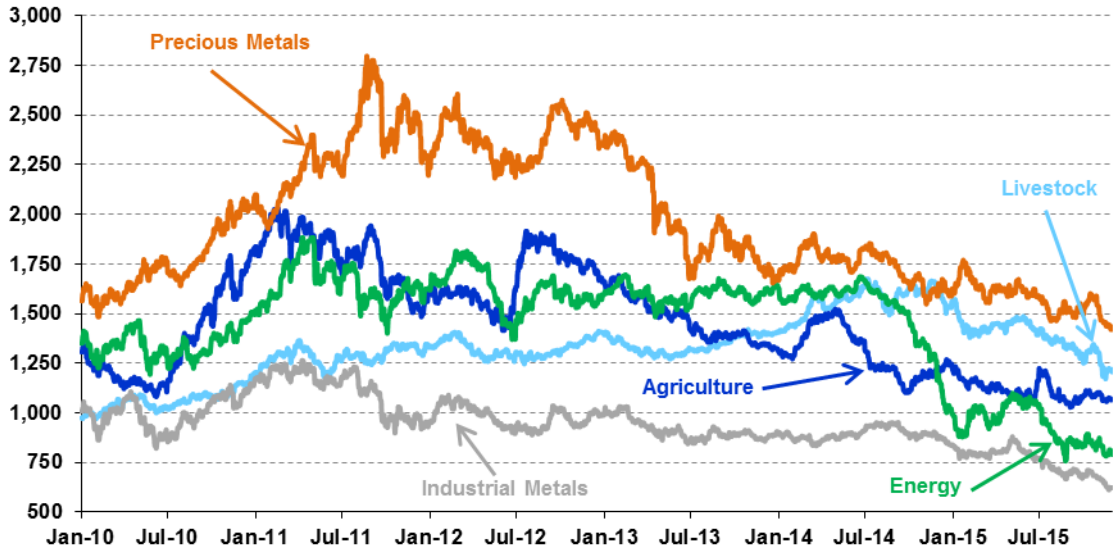


Source: Bloomberg, Mizuho Securities USA Inc.

Commodity Prices

- **Continued weakness in commodity prices.** Commodities have recently witnessed some consolidation but signs of a sustained recovery remain far and few. Indeed, with a weaker economic outlook for China, emerging markets and the world at large, ongoing strength of the U.S. dollar and persistent doubts regarding the sustainability of the U.S. and European economic recoveries, analysts expect do not expect further gains in commodity prices. Corporate profitability and investment should remain under pressure until supply and demand balances adjust and commodity prices recover.

Exhibit 12: Commodity Prices (UBS SPGSCI Constant Maturity Indices)

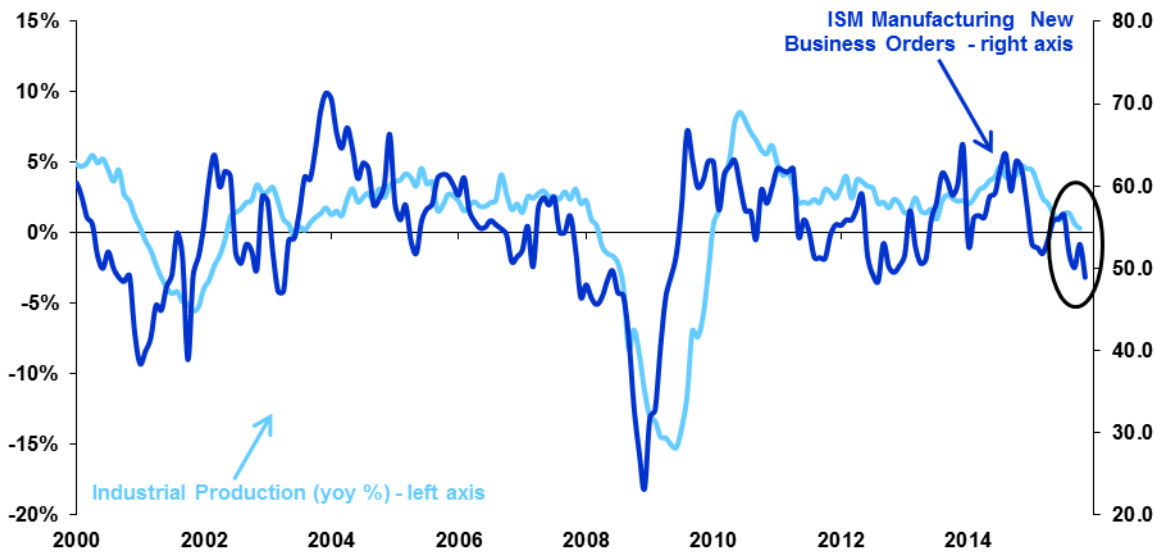


Source: Bloomberg, Mizuho Securities USA Inc.

Industrial Production

- **Sluggish manufacturing.** Industrial production stagnated in October, barely growing at 0.3% from a year ago. It was also the slowest rate of expansion recorded during the current recovery. A strong dollar and overseas weakness are curbing foreign demand while the oil patch has forced energy companies to cut back on drilling and exploration activities. Meanwhile, capacity utilization, which never recovered to pre-recession levels, reached its post-recession peak at the end of last year and has been on a declining trend since. The manufacturing sector is struggling and current low levels of the ISM Manufacturing New Business Orders suggest that the weakness is yet to run its full course.

Exhibit 13: Industrial Production and ISM Manufacturing New Business Orders

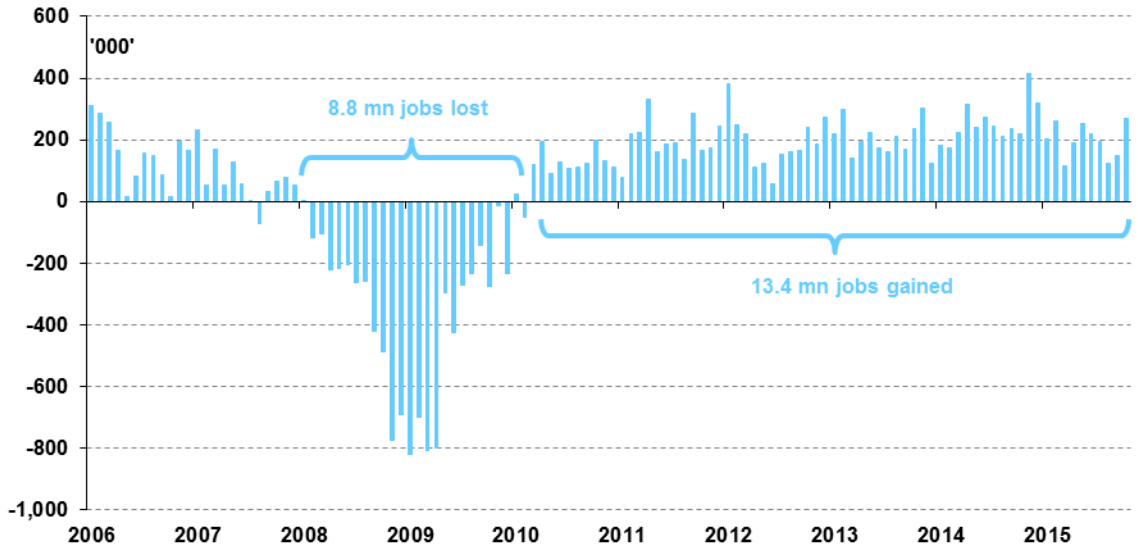


Source: Bloomberg, Mizuho Securities USA Inc.

Payrolls and Unemployment

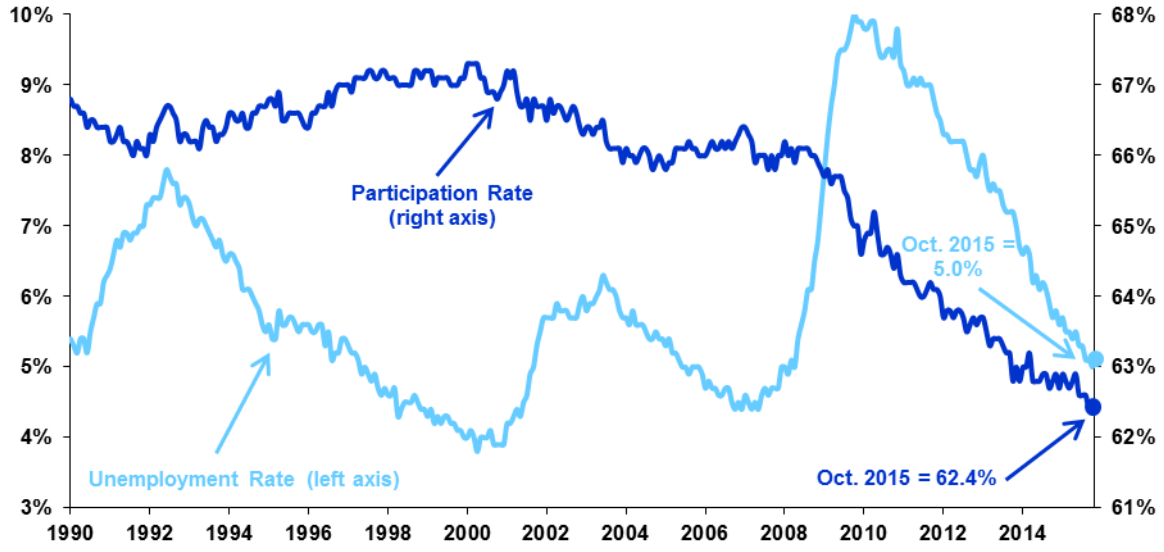
- **Slowdown in the labor market.** The U.S. economy has recovered all the private sector jobs it lost during the recession, having regained 13.4 million jobs since March 2010 after having lost 8.8 million jobs during the recession. The recovery has somewhat slowed in the second half of the year with monthly private payroll growth decelerating to 184k from 207k in the first half of the year. The headline unemployment rate has declined to 5.0% on the back of labor participation dropping to levels not seen since 1977. At the same time, the U-6 rate, a broader measure of unemployment, which includes the total unemployed, the marginally attached and part time employed for economic reasons, shows that the labor market has not recovered to pre-recession levels.

Exhibit 14: Change in Private Payrolls (monthly)



Source: Bloomberg, Mizuho Securities USA Inc.

Exhibit 15: Headline Unemployment Rate and Labor Participation Rate



Source: Bloomberg, Mizuho Securities USA Inc.

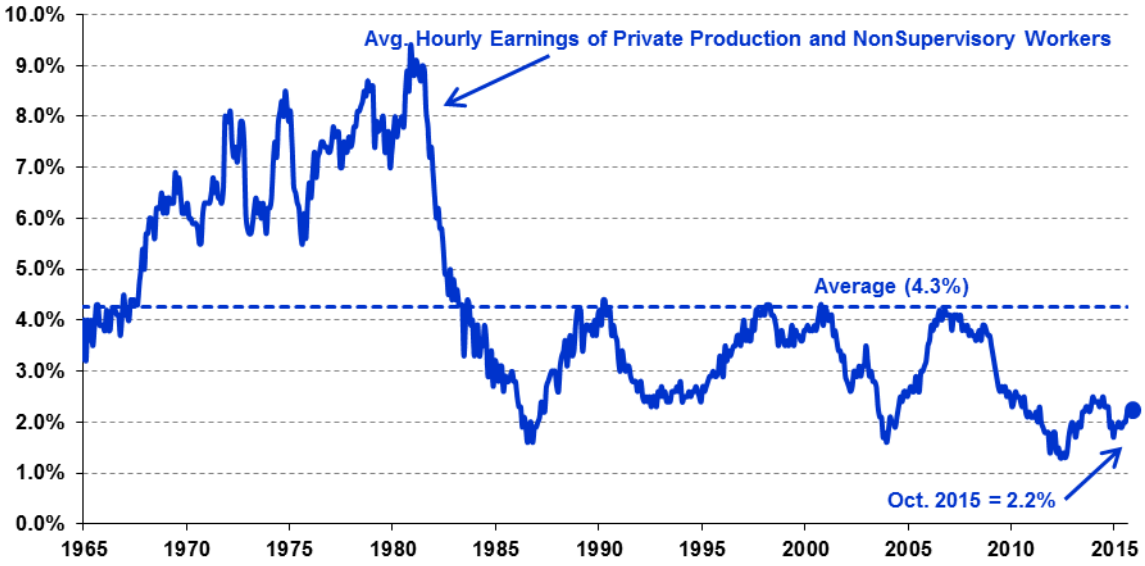
Exhibit 16: U-6 Unemployment Rate

Source: Bloomberg, Mizuho Securities USA Inc.

Wage Growth and Inflation

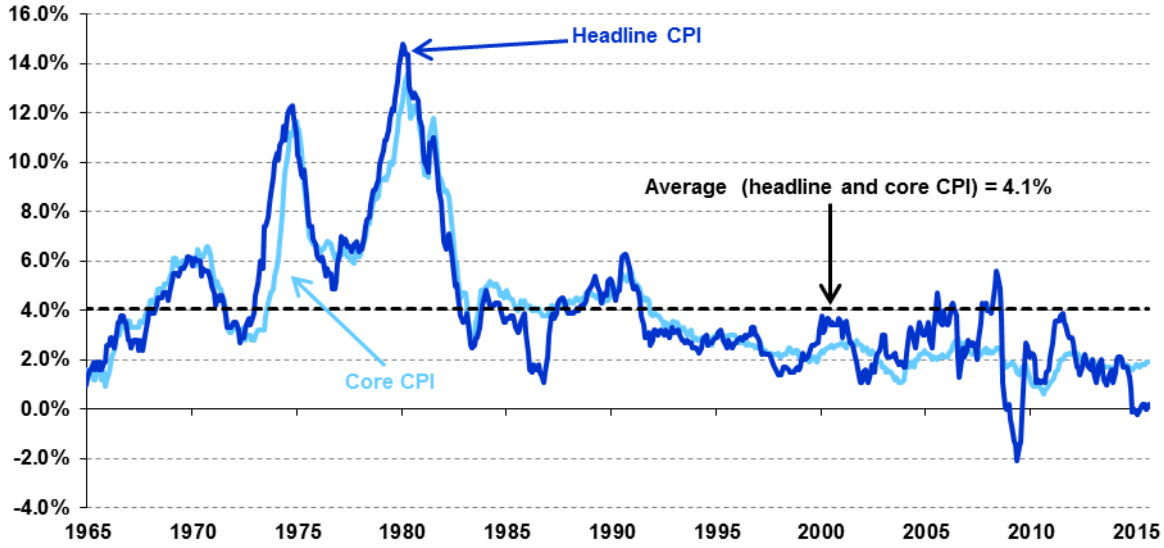
- **Low wage growth.** Notwithstanding the improvement in the labor market, wage growth has been dismal. Wage growth has averaged 2% year-over-year over the last five years and stood at 2.2% in October. Many of the jobs that have been created since the recession are low wage in nature. Almost a third of the 13.4 million jobs gained since March 2010 is in the retail trade and leisure sectors, which are characterized by low wages.
- **Lack of inflationary pressures.** Neither do such subdued levels of wage growth suggest an impending burst of inflation nor are market participants anticipating a climb in inflation anytime soon. On the contrary, ten- and five-year breakeven rates (difference between the Treasury bond and the equivalent maturity Treasury Inflation-Protected Security yields) indicate that inflation expectations of market participants have dropped below the Fed's inflation target of 2%.

Exhibit 17: Wage Growth



Source: Bloomberg, Mizuho Securities USA Inc.

Exhibit 18: Core and Headline Inflation



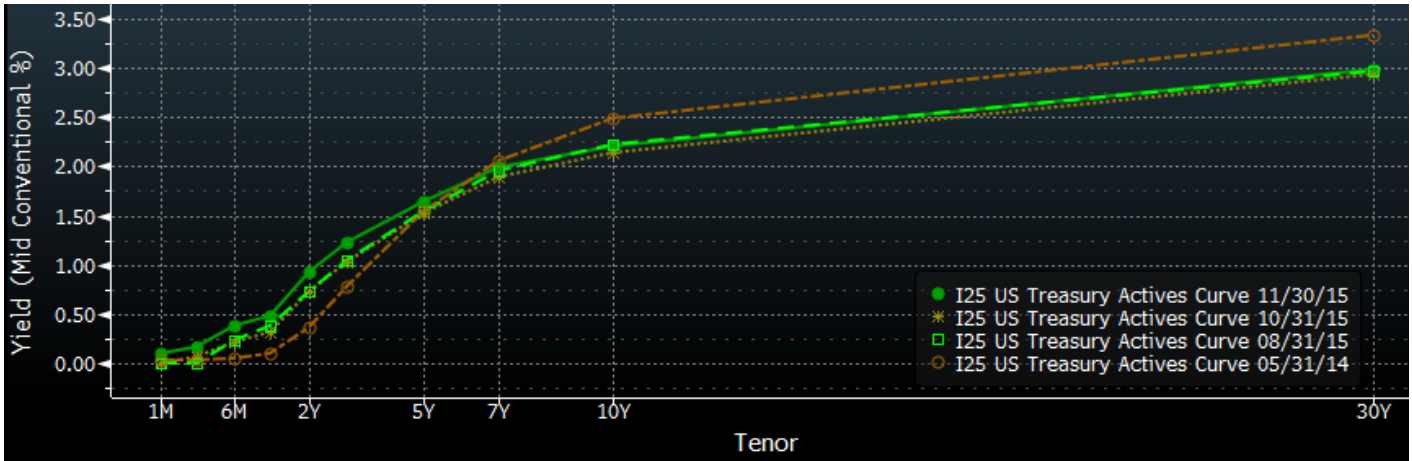
Source: Bloomberg, Mizuho Securities USA Inc.

Deflationary Pressures Mandate Careful Monitoring

The Central Banks have been trying to avoid asset price deflation and debt reduction as a way of preserving valuation, but waffling commodity prices (we're being polite here), inconsistent signals in the U.S. housing market, weak wage growth, and higher structural unemployment seem to point towards an accelerating deflationary trend. Central Banks – that when there is a dramatic change or shift in policy, the valuation swing can be dramatic. Said differently, the markets move towards where they are supposed to be whether it is commodities, currencies, stock, bonds, or otherwise.

1. **The broader commodity downturn capped by the recent 50% oil price decline will heighten growing concern about underlying economic health and demand for goods and services, in our judgment.** The commodity price collapse – with key industrial and agricultural prices having fallen precipitously – tells us that it is more than a supply issue. Rather, it's about growing concerns regarding the underlying economic health for the demand for goods and services. None of the commodities, with the exception of silver, has regained more than 10% of its respective price declines.
2. **Other major signposts** – High Yield credit, 10 year Treasury yields, and WTI crude, among others – have s/tumbled since early 2014**.** Meantime, the dollar remains strong and the S&P 500 goes even higher. Credit markets are flashing warning signs. The yield spread between 10 year Treasuries and High Yield debt has been widening since June 2014 when it troughed at 347 basis points. Today it stands at around 520 basis points. There is a major disconnect between the equity and credit markets, in our view.
3. **Careful attention must be paid to the flattening yield curve and where it heads thereafter.** An inverted yield curve has always predicted a recession. The spread between Treasuries and their corporate brethren (high grade and high yield). <u>On the latter, the empirical evidence shows that utilities typically outperform the S&P beginning a year prior to the start of a recession and don't consistently underperform until after six months out of a recession</u>. These factors are displayed in Exhibit 19 below.

Exhibit 19: Yield Curve Changes – Three Month History



	Curve Id	3M	1Y	2Y	3Y	5Y	10Y	30Y
11)	I25 11/30/15	0.170	0.482	0.932	1.222	1.645	2.207	2.973
12)	I25 10/31/15	0.074	0.324	0.726	1.025	1.519	2.143	2.923
13)	I25 08/31/15	0.003	0.380	0.739	1.052	1.549	2.219	2.962
14)	I25 05/31/14	0.033	0.094	0.375	0.774	1.540	2.477	3.328

Source: Bloomberg

Conventional wisdom suggests that we cannot have a market correction without an inverted yield curve but the correction of 1987 proved otherwise.

When the Fed Hikes, What Happens?

The stock market usually posts strong gains during the stage of the business cycle when interest rates start rising. We have identified 14 monetary tightening episodes dating back to the mid-1950s, defined as a continual advance in the federal funds rate over an extended period. Excluding the anomalous inflation era, the S&P 500 rallied an average of 9.2% over the twelve months following the onset of the tightening episode, advancing on eight out of ten occasions, or 80% of the time.

Exhibit 20: Fed Tightening Cycles and Stock Market Performance

Prior Change in S&P 500		Fed Tightening Cycle	Post-Cycle Change in S&P 500		
12M	6M		6M	12M	18M
40.6%	23.2%	Mar 55 - Oct 57	17.5%	23.3%	29.2%
-7.0%	5.7%	Jun 58 - Nov 59	19.0%	33.1%	32.2%
6.9%	4.4%	Oct 65 - Nov 66	-0.8%	-14.9%	0.3%
17.1%	-0.1%	Nov 67 - Aug 69	3.9%	10.1%	10.4%
11.9%	19.1%	Apr 71 - Aug 71	-2.0%	6.9%	10.2%
10.1%	7.6%	Mar 72 - Sep 73	4.2%	4.8%	-2.2%
-13.8%	-7.7%	Mar 74 - Jul 74	-25.0%	-15.2%	-9.7%
1.2%	-1.4%	Feb 77 - Apr 80	-3.1%	-12.5%	-1.3%
17.2%	6.6%	Aug 80 - Jun 81	6.5%	7.6%	-1.0%
30.9%	23.9%	Mar 83 - Aug 84	11.0%	6.1%	12.6%
-11.2%	-19.6%	Apr 88 - Mar 89	5.0%	13.9%	34.9%
7.1%	3.5%	Jan 94 - Apr 95	-4.8%	-1.5%	16.8%
19.3%	11.9%	Jun 99 - Jul 00	6.7%	9.1%	1.0%
16.3%	5.9%	Jun 04 - Sep 07	4.7%	6.3%	11.5%
10.5%	**5.9%**	**Average (All Cycles)**	**3.1%**	**5.5%**	**10.3%**
79%	71%	% of times up	64%	71%	71%
3.7%	**1.3%**	**Average (Inflation)**	**-4.4%**	**-3.8%**	**-3.6%**
75%	50%	% of times up	50%	50%	0%
Inflation era cycles are from 1972 to 1981					
13.2%	**7.8%**	**Average (Non-Inflation)**	**6.0%**	**9.2%**	**15.9%**
80%	80%	% of times up	70%	80%	100%

Source: Bloomberg, Mizuho Securities USA Inc.

The current economic expansion bears a greater similarity to the periods of gradually rising inflation than to the boom–bust cycles of the inflation era. Outside of the inflation era, the cyclical acceleration in inflation was mild and gradual, and so was the Fed's approach toward policy, raising rates in small, slow steps. Consequently, interest rates rose slowly and bull markets lasted longer than usual.

In contrast, the inflation era, the decade between the early 1970s and early 1980s, was an unusual time, characterized by a rapid acceleration in inflation, and abrupt and aggressive shifts in monetary policy. Once inflation gathered momentum, an extremely restrictive monetary policy and a recession were necessary to subdue it. During this ten-year stretch, there were four tightening cycles, the highest of any ten-year period included in the analysis and three economic recessions. The stock market experienced four bear markets, while remaining largely in a trading range for a decade.

Accelerating economic momentum has always been the key influence behind policymakers' decisions to hike rates and carry out a tightening cycle. Using all fourteen tightening episodes, nominal gross domestic product (GDP) expanded, on average, to 9.4% during the twelve months after the tightening cycle began compared to 6.8% for the previous year, an increase of 2.6 percentage points. Only twice has the economic growth rate failed to rise; namely, GDP growth fell by 0.9 percentage points in the episode beginning in March 1955 and 0.6 percentage points in the June 2004 episode.

The most important point of our historical review is that accelerating profits growth is the principal reason behind the favorable stock performance at a time when the monetary policy and the interest environment turned hostile. For the average non-inflation episodes, operating profits accelerated to 18.2% during the twelve months after the onset of a tightening cycle from 6.7% for the previous year, representing an acceleration of 11.5 percentage points.

Remarkably, despite the impressive profit surge, the market P/E multiple fell sharply, dropping an average of 1.3 points over the year following the onset of a tightening cycle. Explicitly, in the first year of a tightening cycle, the average 9.2% stock market gain was less than the 18.2% jump in operating profits, resulting in shrinkage of the market multiple of more than a point. P/E multiples fell in eight out of ten tightening episodes. Contracting P/E multiples at a time of rising interest rates is consistent with market history and the theory of valuation.

One thing seems rather clear from our review of history: the impact of Fed tightening on the stock market depends on profit trends. According to FactSet, analysts are projecting a decline of 4.4% in third quarter earnings of S&P 500 companies, which if reported, would be the first time since 2009 that earnings fell in consecutive quarters. Current global economies do not appear strong enough to produce sufficient profit expansion to offset the negative consequences of rising rates. In short, the stock market is unlikely to be in a position to withstand a Fed tightening cycle, in this analyst's judgement.

Exhibit 21: Utility Performance during Fed Tightening Cycles

Fed Rate Hike Cycles*			Fed Funds Rate			Performance				Performance (relative to S&P 500)		
Cycle	Start	End Date	Starting Low (prior month)	Ending Peak	Change (bps)	S&P 500	UTY Index	S&P Electrics	Utilities SPDR	UTY Index	S&P Electrics	Utilities SPDR
1988 - 1989	April-88	March-89	6.58%	9.85%	327	12.8%	NA	8.6%	NA	NA	-4.3%	NA
1994 - 1995	January-94	April-95	2.96%	6.05%	309	6.9%	-11.2%	-12.3%	NA	-18.1%	-19.2%	NA
1999 - 2000	June-99	July-00	4.74%	6.54%	180	4.2%	-7.4%	-4.4%	-9.7%	-11.6%	-8.6%	-13.9%
2004 - 2007	June-04	September-07	1.00%	5.25%	425	33.8%	69.5%	75.7%	67.5%	35.7%	41.9%	33.7%
		Average	**3.82%**	**6.92%**	**310**	**14.4%**	**16.9%**	**16.9%**	**28.9%**	**2.0%**	**2.5%**	**9.9%**

* We do not include the Fed rate hike of 25 bps in March 1997 in our analysis.

Source: Bloomberg, Mizuho Securities USA Inc.

Exhibit 22: Utility Performance Three Months prior to Fed Tightening Cycles

			Fed Funds Rate			Performance				Performance (relative to S&P 500)		
Cycle	3 Months Prior	Cycle Start	Starting Low (prior month)	Ending Peak	Change (bps)	S&P 500	UTY Index	S&P Electrics	Utilities SPDR	UTY Index	S&P Electrics	Utilities SPDR
1988 - 1989	January-88	April-88	6.58%	9.85%	327	1.7%	NA	-11.4%	NA	NA	-13.0%	NA
1994 - 1995	October-93	January-94	2.96%	6.05%	309	2.9%	-7.3%	-6.9%	NA	-10.2%	-9.8%	NA
1999 - 2000	March-99	June-99	4.74%	6.54%	180	6.7%	5.5%	8.0%	14.8%	-1.3%	1.2%	8.1%
2004 - 2007	March-04	June-04	1.00%	5.25%	425	1.3%	-2.6%	-1.5%	-2.3%	-3.9%	-2.8%	-3.6%
		Average	**3.82%**	**6.92%**	**310**	**3.2%**	**-1.5%**	**-2.9%**	**6.3%**	**-5.1%**	**-6.1%**	**2.2%**

Source: Bloomberg, Mizuho Securities USA Inc.

Exhibit 23: Utility Performance in the Three Months following Fed Tightening Cycles

			Fed Funds Rate			Performance				Performance (relative to S&P 500)		
Cycle	Cycle End	Post 3 Months	Starting Low (prior month)	Ending Peak	Change (bps)	S&P 500	UTY Index	S&P Electrics	Utilities SPDR	UTY Index	S&P Electrics	Utilities SPDR
1988 - 1989	March-89	June-89	6.58%	9.85%	327	7.8%	NA	11.3%	NA	NA	3.5%	NA
1994 - 1995	April-95	July-95	2.96%	6.05%	309	9.2%	4.9%	4.9%	NA	-4.3%	-4.3%	NA
1999 - 2000	July-00	October-00	4.74%	6.54%	180	-0.1%	24.3%	22.3%	23.4%	24.4%	22.4%	23.5%
2004 - 2007	September-07	December-07	1.00%	5.25%	425	-3.8%	6.7%	8.4%	6.4%	10.5%	12.2%	10.2%
		Average	**3.82%**	**6.92%**	**310**	**3.3%**	**12.0%**	**11.7%**	**14.9%**	**10.2%**	**8.5%**	**16.9%**

Source: Bloomberg, Mizuho Securities USA Inc.

Price Target Calculation and Key Risks

American Electric Power Company, Inc.

We value AEP using several methodologies, including P/E, DDM and price to book value. We avoid using Sum of the Parts given the high likelihood (>70%) that the company sells its merchant generation fleet. DCF valuations are difficult given the capital intensive nature of the Power & Utility sector, especially regulated companies, and the lack of free cash flow generation, net of dividends. For triangulation purposes, we look at dividend discount models to see where the imputed price lies based on underlying dividend growth assumptions. We look principally towards a relative P/E approach. Our $65 per share 12-month target assumes a 15.5x P/E multiple rolled forward on our 2018 EPS estimate of $4.20 per share.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new construction, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

Consolidated Edison, Inc.

Our 12-month $64 per share price target for ED utilizes relative P/E multiples and we utilize a 7.5% premium to the underlying large cap P/E multiple on our 2017E. Our DDM methodology includes single stage and two stage approaches with the single stage under a baseline DPS growth rate. The two-stage uses various three year DPS growth expectations followed by a static long-term growth DPS growth rate. DCF methodologies are difficult given the limited free cash flow generation characteristics found in regulated companies. All underlying figures use constant betas, equity risk premiums, and risk-free rates.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

Duke Energy

We value DUK based on the arithmetic averages of P/E, P/Book, Single Stage DDM, and Yield support methodologies to arrive at our $75 target. The relative P/E basis method is consistent with the valuation methodologies of its large-cap (>$10.0 billion) peers. Premium valuations are ascribed for regulatory and better transparency when predicting earnings, while discounted valuations include heightened regulatory, construction, and operational/execution risks. Typically, businesses outside the core, in this case DUK's International unit, will tend to weigh more on the shares when trouble arises. This is known as the "dog wagging the tail' issue and DUK's International businesses consume a disproportionate amount of investor interest. We look at Yield support and Price to Book as indicators of future stock potential. DDM methodologies are highly dependent on underlying risk premiums, and DPS growth projections, which can swing valuations considerably.

The key risks for DUK include regulatory risk in six states, from rate regulation to operation of coal and nuclear units. Environmental regulation remains omnipresent and DUK's February 2014 coal ash spill at the Dan River facility has heightened regulatory risk around the company. DUK is active in building a renewables business and has done a good job doing so – nearly 2,000MW of owned and/or equity interest in both wind and

solar. building regulatory General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

Edison International

Our 12-month $60 per share price target for EIX is primarily based on a relative P/E basis and we adjust our multiples accordingly based on the inherent growth and risk profile. We look at single-stage and two-stage dividend discount models for valuation triangulation purposes. A two-stage model may be a tough argument given the call by TURN. A sum of the parts analysis is problematic given the integrated model and lack of desire to spin out the FERC-regulated transmission business.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

Entergy Corp

We value ETR using four valuation methodologies but rely primarily on P/E, and dividend discount models. We use sum of the parts, but the complicated tax structures and allocation among units makes its difficult to use with any sense of comfort. For triangulation purposes, we also look at price to book value. Our target is the arithmetic average of these methodologies.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

Eversource Energy

We value Eversource on a P/E multiple based on a t+2 forward year analysis, consistent with valuation methodologies for regulated names. For triangulation purposes, we turn to dividend discount models (single- and two-stage) as well as price/book methodologies. Our $52 per share, 12 month price target represents a 10% premium to the regulated group average P/E of 14.5x on our 2017E. ES is, in our view, one of the three premier companies in the space. Given the simplistic nature of its story, its proven track record, financial strength and integrity, coupled with its growth and dividend aspirations, ES has earned the right to trade at a premium. But, there isn’t enough upside from current levels to warrant the Buy recommendation, hence our Neutral rating on the shares.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new transmission and pipeline builds, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

NextEra Energy, Inc.

We value NEE utilizing five valuation methodologies but rely primarily on Sum of the Parts given its various businesses, all of which have scale. Our $125 target price is the arithmetic average of the P/E, Sum of the Parts, and DDM valuation methodologies.

We utilize group average multiples as the baseline and adjust up or down based on the specific business unit. This is key in SOP analysis. For example, the regulated business operates in one of the better jurisdictions, thus it receives a premium valuation, the highly contracted cash flows also receive a modest premium. We also assign small valuations on a $/KW basis for the development pipeline. The Sum of the Parts methodology also captures pipeline development and the benefits of the company's considerable tax attributes. All valuation metrics are on 2017.

The key risks for NEE include potential changes at the state and/or Federal level related to environmental policy; potential changes in state regulation or assigning more punitive allowed returns than previously authorized; tax policy, especially at the Federal level as it relates to renewables; operational risk; M&A; and, weather, especially since weather influences renewable generation. Broader macro concerns regarding economic outlook, changes in underlying Treasury securities or expectations of the same are other key concerns and can influence the investment appeal of utilities in general, and NEE, in particular.

Our NEP price target is $47 per unit and reflects a 3% targeted yield, which is the 2015 current yield applied to our year-end 2016 DPU level.

Key risks to the NEP story include: significant investor concentration and limited daily trading volumes; the tax status for renewables could change under Congressional directive; capital markets need to remain friendly in order to fund transactions at a low cost of capital. NEPs Genesis project produces 40-45% of the EBITDA from the initial portfolio.

PG&E Corporation

We examine PCG on a relative P/E basis and adjust our multiples accordingly based on the inherent growth and risk profile. A sum of the parts analysis is tough given the integrated operational profile of its core utility and gas transmission. We look at single-stage and two-stage dividend discount models for triangulation purposes only, and see where value could go in the event the Board moves to reinstate dividend growth We've looked at P/Book over the prior five years and derived a reasonable range of multiples. A DCF is problematic given the negative free cash flow throughout the forecast period. Combined, our 12-month per share price target for PCG is $56, equating to a 14.8x multiple on our 2017E, representing a modest, 7% premium to the large cap regulated peer universe.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

Pinnacle West Capital Corporation

Our 12-month $60 per share price target is based on four valuation methodologies – P/E, DDM, DCF and Price to Book – but rely primarily on P/E given that its EPS stream is derived entirely from regulated activities. Our Neutral recommendation is premised on two factors: outstanding considerations with rate design and underlying customer growth, while still up, is not materializing in the manner PNW anticipates. The P/E methodology utilizes group average multiples as a Base Case and adjusts the multiples +/- 7% from the base. The DDM utilizes current 10 Year Treasury as the risk free rate and a 7% equity risk premium and utilizes either near-term dividend growth

objectives (5%, in the single-stage approach) or a combination of N/T growth and long-term industry average DPS outlook for the two-stage approach. The DCF valuations are highly sensitive to underlying cost of capital expectations and presumed growth rates. The Price to Book methodology uses historical P/Book as a reasonable range of expectations.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with ongoing business operations, construction risk (both transmission build and generation plant upgrades), nuclear plant operations, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance outlook.

SCANA Corporation

Our 12-month $56 per share price target is based on the arithmetic average of P/E and DDM valuation. We utilize a 14,5x P/E multiple on our 2017E and use current 10 year Treasury notes when calculating DDM. Key risks include execution risk with the nuclear project; the cost of building the two new nuclear units is roughly equivalent to SCGs market cap today and once complete, will represent nearly one-half the earnings power and two-thirds of the cash flow. General risks include economic conditions, a changing regulatory environment, and changes in interest rates.

TECO Energy, Inc.

Our price target and investment recommendation reflects TECO acknowledging that it is "in play" and average of precedent transaction multiples to arrive at our $24 PT. Key risks include regulatory changes at both the Federal and State level, execution risk associated with new plant build, general economic conditions. Additionally, utilities tend to have a high correlation with interest rate moves and any material upward move in underlying Treasuries could impact valuations for TE and the broader utility group. In addition, TECO may not be able to find an acceptable buyer at an acceptable price.

The Southern Company

Our $45 price target is calculated as the arithmetic average of P/E and sum of the parts on our 2017 financial estimates. We utilize group multiples for the various components. Execution risk with the development of two large generating facilities is a key risk, as are potential changes in environmental compliance and regulation both the Federal and state levels. The moves in underlying Treasury securities is statistically significant with movement in utility share prices.

WEC Energy Group

Our $50 per share 12 month price target utilizes relative P/E and DDM as the basis for our valuation methodology although we look at DCF and yield support for triangulation purposes. WEC shares are currently trading at 15.5x our 2017 EPS estimates and are priced to yield 3.6% (full year 2015 dividend expectations) compared with group averages of 13.7x and 4.1%, respectively.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with merger integration, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

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NR:	No Rating - not covered, and therefore not assigned a rating.

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(As of 11/30)	% of coverage	IB service past 12 mo
Buy (Buy)	47.72%	38.30%
Hold (Neutral)	50.76%	25.00%
Sell (Underperform)	1.52%	0.00%

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