How Interest Rate Hikes Affect Dividend Stocks

Description

Interest rate hikes tend to negatively affect stocks in general because stocks are typically seen as high risk compared to other investments such as bonds or GICs.

When the interest rate increases, some investors would rotate out of stocks and into interest-producing investments that have lower risk.

The interest rate reported by the Bank of Canada has been in a downtrend for the past 25 years. During that time, it hit a high of 16% in 1991 and a low of 0.25% in 2009.

With a potential rate hike from the Fed coming, Canadian investors maybe fearing that Canada will follow soon after, especially since the interest rate is at the low end of historical levels.

Which dividend stocks will be most affected?

Real estate investment trusts

Real estate investment trusts (REITs) like **Dream Office Real Estate Investment Trst** (TSX:D.UN) and **NorthWest Health Prop Real Est Inv Trust** (TSX:NWH.UN) own, operate, and rent out office properties.

When the interest rate rises, it'll be more expensive for them to borrow money. I believe the potential rate hike from the Fed has pushed REIT prices down in the past few days.

Thanks to the price decline, however, investors can now get yields of 11.2% and 9.6%, respectively, from these REITs.

Debt-laden companies

As mentioned before, higher interest rates would imply higher borrowing costs. So, businesses that are heavier in debt than peers would likely be penalized by the market.

For example, **Enbridge Inc.** (TSX:ENB)(NYSE:ENB) and **TransCanada Corporation** (TSX:TRP)(NYSE:TRP

) are both pipeline leaders, but Enbridge has higher debt levels than TransCanada. Enbridge's higher financial leverage may be seen as a negative as rates increase.

Slow growers

Stocks that grow profitability slowly or don't grow at all may be the first stocks to be let go. Again, stocks are generally viewed as risky investments. If it's not growing and interest rates increase, company performance is dragged down and the stock is likely to do worse.

For example, Dream Office's funds from operations per share declined 6.2% from 2008's $3.06 to 2014's $2.87. So, it seems the REIT hasn't recovered from the financial crisis. At the same time, the REIT has come down so much that it's priced at 40% discount to its book value.

Investors will need to decide whether a growing business is essential for their buy candidates or if a high income and a cheap stock, in Dream Office's case, suffice as an investment.

In conclusion

Investors should be clear on why they're buying a stock. They could be buying it for income or growth or because the stock is cheap. With a clear reason to buy a stock, investors can make more informed decisions for their own portfolios when external factors, such as interest rates, occur.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:ENB (Enbridge Inc.)
2. NYSE:TRP (Tc Energy)
3. TSX:D.UN (Dream Office Real Estate Investment Trust)
4. TSX:ENB (Enbridge Inc.)
5. TSX:NWH.UN (NorthWest Healthcare Properties Real Estate Investment Trust)
6. TSX:TRP (TC Energy Corporation)

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