

Why a Coming Surge in Interest Rates Is 2017's Biggest Investment Story

Description

By ignoring the big economic picture, investors do so at their own peril. In 2014 and 2015, for example, many commodity-based companies may have looked fantastic individually, but ignoring the broader economic picture that resulted in a historic commodity rout cost many investors massive returns.

Similarly, in 2016 investors who caught on to the big-picture story of commodity prices being way too low to encourage enough production growth to meet steady demand (especially after nearly two years of underinvestment across the commodity complex) would have seen fantastic returns in 2016.

What is the big narrative for 2017? One of them will be rising interest rates. The main catalyst for rising interest rates has been the election of Donald Trump. Some, like billionaire Stan Druckenmiller, see this as being one of the only reasons. Trump is set to unleash a series of pro-growth economic policies, including widespread deregulation, a cut of corporate taxes from 35% to 15%, personal income tax cuts, the repatriation of overseas corporate profits, and a \$1 trillion infrastructure plan.

The result of these policies will be economic growth, and economic growth leads to increased inflation and interest rates. Druckenmiller sees the 10-year U.S. bond yield eventually surging to 6% (it is currently 2.44%—the highest level since July 2015 and up from 1.8% pre-election).

This has massive implications for stocks, some of which are positive and some of which are negative.

How rising rates affects your portfolio

Since Trump's election, interest rates have been rising and stocks have been rallying. For the first part of 2017, this pattern is likely to continue. A recent report by **Goldman Sachs** indicated that when bond yields are low (especially under 3%), rising bond yields are actually associated with rising stock prices.

What kind of stocks perform well in this environment? Cyclical stocks in particular (these include energy stocks, industrial stocks, and materials stocks) perform well. This is in contrast to defensive stocks (like utilities, which typically perform well regardless of the point in the economic cycle).

A recent report found that during the previous seven Federal Reserve rate-tightening cycles (periods of rising interest rates), energy stocks returned an average of eight percentage points more than the index, and materials beat the index by six percentage points. Defensive sectors underperformed.

Since rising rates are typically indicative of a strong economy, investors should be overweight in cyclical stocks that are in the energy or materials spaces, as these sectors will likely outperform.

Unfortunately, however, the effect of rising interest rates is not all positive. The same Goldman Sachs report stated that when interest rates rise close to the 3% level, rising interest rates are associated with falling equity prices. The current stock market is overvalued by historical standards, but this overvaluation is justified by interest rates being low (low bond yields send investors to stocks for yield). When interest rates normalize, this is bad news for stocks.

Goldman Sachs sees 10-year U.S. bond yields of 2.75% as the point in which stocks become overvalued, and a 10% correction would result if yields hit 3%. With this in mind, investors should also keep more cash in hand into 2017 to use any correction as an opportunity to add to more cyclical names.

What should Canadian investors buy?

While this has mostly focused on U.S. yields, Canadian yields typically track U.S. yields fairly closely, and what happens in the U.S. closely effects Canada. A diversified portfolio to take advantage of rising rates would include **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK) and **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE).

Teck gives investors exposure to metallurgical or steel-making coal, copper, and zinc. These commodities have performed well this year and will continue to do so on strong Chinese economic data (the main users of these commodities), as well as tightening supplies.

Baytex gives investors leveraged exposure to rising oil prices. Baytex has a relatively high debt load and produces heavy oil; both these factors mean that Baytex will rise significantly more than its peers per dollar increase in oil prices.

CATEGORY

1. Energy Stocks
2. Investing
3. Metals and Mining Stocks

TICKERS GLOBAL

1. NYSE:TECK (Teck Resources Limited)
2. TSX:BTE (Baytex Energy Corp.)
3. TSX:TECK.B (Teck Resources Limited)

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