Danger: 3 Types of Stocks to Avoid in a Rising Interest Rate Environment

Description

The Bank of Canada affects short-term interest rates by hiking or reducing the overnight rate target. In turn, large banks borrow and lend overnight funds to one another at the overnight rate.

You can imagine that the higher the rate that the large banks borrow and lend to each other, the higher the rate of other loans such as commercial loans, consumer loans, and mortgages will be.

In the last 10 years, the target for the overnight rate had been as low as 0.25% and as high as 4.5%. In July, the Bank of Canada hiked the overnight rate target by 0.25% to 0.75%, which is still a long way off from the high. So, it doesn't hurt to be extra cautious.

Investors shouldn't fear interest rate hikes too much, though. Generally, the Bank of Canada won't increase the rate unless the economy is improving. And each time, it tends to only tweak it marginally to ensure it doesn't throw off the economy, the businesses, and the people.

That said, higher interest rates could spell trouble for companies with one or more of the following characteristics, so investors should be more careful around such companies.

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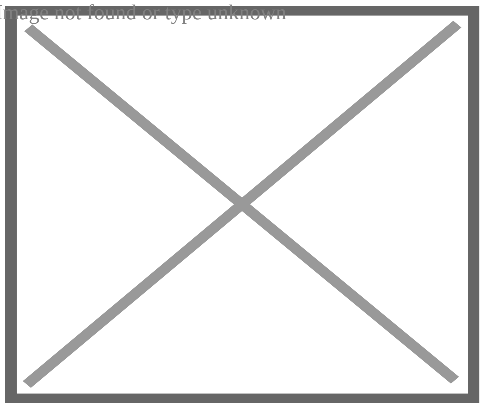

High debt levels

In a decreasing rate environment, companies could refinance at a lower rate and benefit from lower interest expense. However, they can’t do that in a higher rate environment.

Companies will tend to pay more interest for their liabilities in a rising-rate environment, and the ones with a higher debt level will receive a bigger blow.

For example, **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) has a debt-to-cap ratio of ~86%. It has about US$813 million of short-term debt (due within a year) and ~US$27.6 billion of long-term debt. So, even a slight raise in the interest rate can increase its interest expense by a lot.

Investors can see if a company’s debt levels align with those of its peers to determine if it’s overburdened with debt.

Low credit ratings

Borrowing costs are higher for businesses with low credit ratings. Valeant has a low S&P credit rating of B-. Its net interest expense for the first half of the year was US$927 million, and its interest rate is estimated to be ~6.5%.

Comparatively, **Fortis Inc.** (TSX:FTS)(NYSE:FTS), a high-quality utility with a high S&P credit rating of A-, has a debt-to-cap ratio of ~51%, and its interest rate is estimated to be ~4%.

If interest rates rise, Fortis’s higher credit rating will put it in a better position to keep its borrowing costs low than Valeant.

Variable rate

Companies with fixed-rate debt have a better cushion against a rising rate environment.

Investor takeaway

If you’re concerned about rising interest rates, avoid companies with high debt levels and low credit ratings. At a milder level, you should also act prudently around companies with a large portion of variable-rate debt.

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