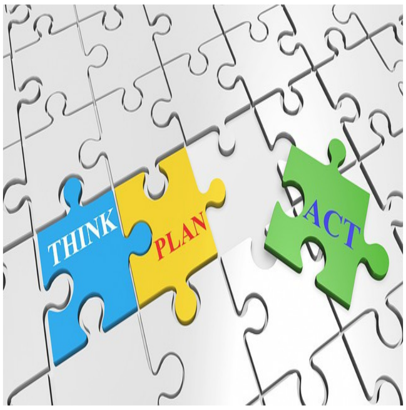


# Which Stocks Should You Avoid in a Rising Interest Rate Environment?

## Description

On July 12, 2017, the Bank of Canada raised its overnight interest rate to 0.75%. The interest rate had been at 0.50% for seven years before this hike. There is a great chance that the Bank of Canada will raise its interest rate again this fall, since the Canadian economy is showing signs of recovery.



When interest rates rise, bonds prices fall. Although stocks are affected by a rise in interest rates, the impact is not as clear as it is for bonds. In fact, some stocks will see their performance improve after an interest hike, while other sectors will see their prices drop.

We will look at sectors that you should underweight during periods of rising interest rates, since there is a high chance they won't perform well.

**Stay away from utilities and telecoms**

You should stay away from bond proxies such as utility and telecommunications stocks, because there is an inverse relationship between their prices and interest rates. That is, when interest rates rise, utility and telecoms stocks prices drop, and vice versa.

This means utility stocks such as **Fortis Inc.** (TSX:FTS)(NYSE:FTS) and **Hydro One Ltd.** (TSX:H), as well as telecoms stocks such as **BCE Inc.** (TSX:BCE)(NYSE:BCE) and **Telus Corporation** (TSX:T)( NYSE:TU) will be hurt by interest rates hikes.

One reason why utilities and telecoms stock prices drop after an interest rate hike is because higher interest rates mean higher borrowing costs. This increase in borrowing costs will negatively affect a utility company like Fortis, since it has a high level of debt.

Utilities and telecoms are capital intensive and need to have a continuous inflow of funds to maintain organic growth and upgrade their infrastructure projects.

A part of the funds these companies generate from operations is used to meet capital requirements, but most of these funds are used to pay dividends. Therefore, they need external sources of financing to meet their capital requirements. As a result, they have high levels of debt. Rising interest rates will increase the cost of their debt and thus restrain their ability to pay a consistent dividend.

Another reason why utilities and telecoms stocks prices may drop during a period of rising interest rates is that utility and telecoms stocks are in competition with bonds when interest rates rise.

Those stocks pay a high dividend. When interest rates rise, risk-averse investors may be tempted to buy bonds instead of utility and telecoms stocks, because bonds offer higher yields.

**REITs are negatively impacted, too**

REITs exist so that the companies that own the properties can avoid paying corporate taxes as long as they distribute 90% of taxable income as dividends. This means that REITs only retain a small amount of their earnings.

Thus, in order to grow, REITs need to raise external debt and equity capital from investors. As a result, higher interest rates increase a REIT's borrowing costs, which in turn impacts its profitability and ability to make acquisitions.

**Cominar REIT** (TSX:CUF.UN) has a high level of debt and is already impacted by the last interest hike. It has cut its distribution from $0.1225 a share to $0.095 a share a month. Cominar had a payout ratio of 116% before the cut, which was hardly sustainable.



Rising interest rates offer many other investment options to investors than REITs, such as bonds, savings accounts, money market funds, and certificate of deposits. Investors who own REITs can thus be tempted to sell their shares, because they can get similar but less risky yields with other investments.

**CATEGORY**

1. Dividend Stocks
2. Investing
3. Tech Stocks

**TICKERS GLOBAL**

1. NYSE:BCE (BCE Inc.)
2. NYSE:FTS (Fortis Inc.)
3. NYSE:TU (TELUS)
4. TSX:BCE (BCE Inc.)
5. TSX:FTS (Fortis Inc.)
6. TSX:H (Hydro One Limited)
7. TSX:T (TELUS)

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