



3 Stocks to Avoid When Interest Rates Are Rising

Description

In a long-awaited move, Bank of Canada increased the benchmark overnight rate by 25 basis points to 0.75% last month in response to improving economic growth. This was the first rate hike in seven years, and there are signs that further increases are on the way. The central bank indicated that there are signs that the gathering economic momentum will last and inflation will reach the targeted 2%.

To put it simply, higher rates cause the cost of capital to rise. This makes it less attractive for businesses to borrow to expand their operations and increases the cost of existing debt, particularly where a company must refinance. That not only impacts earnings but also slows growth, reducing a company's ability to unlock value for investors and boost dividend payments.

Companies operating in capital-intensive industries are the most vulnerable.

Now what?

The two sectors with the highest degree of leverage, because of the need to borrow heavily to build as well as maintain significant amounts of necessary and costly infrastructure, are utilities and telecommunications.

One electric utility that appears vulnerable is **TransAlta Corporation** ([TSX:TA](#))([NYSE:TAC](#)). It has been battling a range of headwinds for some time — key being the costly process of modifying or decommissioning its coal-fired power plants to meet Alberta's stringent emission regulations. The utility has amassed a mountain of debt totaling \$2.9 billion, which is seven times its EBITDA. This indicates that it is heavily levered and susceptible to the additional costs created by higher rates, making it an unattractive investment.

Meanwhile, Canada's largest telecom **BCE Inc.** ([TSX:BCE](#))([NYSE:BCE](#)) has over \$17 billion of debt, which is costing the company \$238 million every quarter in interest expenses. While that debt is only a mere 2.4 times its EBITDA, indicating that it is not overly leveraged, higher financing costs will impact its ability to raise capital.

BCE operates in a mature industry and what can only be characterized as a saturated market,

meaning BCE has limited growth opportunities. This makes it an unappealing investment relative to companies operating in industries that are less capital intensive and that possess better growth prospects.

REITs are another unattractive sector in which to invest when rates are rising.

You see, they are required to pay out all their net taxable income to shareholders in the form of dividends. That means they cannot retain earnings to invest in growing their businesses. To grow, they must raise external debt and equity capital from investors. Higher rates increase a REIT's cost of debt, making it incrementally more difficult to achieve profitable growth.

One of the most vulnerable is **Boardwalk REIT** ([TSX:BEI.UN](#)) because its earnings are heavily reliant on the fortunes of the oil industry with its properties in Alberta being its largest operating segment.

Weaker-than-forecast oil prices are weighing heavily on activity in the energy patch, and this is impacting Boardwalk's business as are higher electricity costs in Alberta. For the second quarter 2017, net operating income plummeted by 18% compared to a year earlier, and that trend will continue for as long oil prices remain weak. Now that rates have risen, with further increases on the horizon, it is difficult for Boardwalk to acquire cost-effective capital to further diversify its operations outside of the energy patch.

So what?

The latest rate hike, along with signs of more on the way, makes it important for investors to consider how interest rate hikes affect various stocks. While higher rates are indicative of a stronger economy, which is beneficial for consumer discretionary stocks, banks, and insurance companies, they can have a marked impact on those companies reliant on raising capital to expand their operations. That makes capital-intensive utilities, telecommunications, and REIT stocks unattractive.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:BCE (BCE Inc.)
2. NYSE:TAC (TransAlta Corporation)
3. TSX:BCE (BCE Inc.)
4. TSX:BEI.UN (Boardwalk Real Estate Investment Trust)
5. TSX:TA (TransAlta Corporation)

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