Why Rising Interest Rates Are Good News for Insurance Stocks

Description

The Bank of Canada’s overnight interest rate had been at 0.50% for seven years before it was finally hiked at 0.75% on July 12. This rise has an impact not only on bonds, but also on stocks. Some sectors will benefit from this rise, while others will suffer from it.

One of the stock sectors that will greatly benefit from this interest rate hike and the others to come is the insurance stocks sector.

Rising interest rates boost investment income

There is a linear relationship between interest rates and insurance stocks prices, meaning the higher the rate, the higher the growth .

This is because insurers’ investment income, which is directly proportional to interest rates, is likely to increase. Investment income and premiums earned are important components of insurers’ revenue.

Insurers invest the premiums they receive from policyholders in bonds and securities, which are reinvested in fixed-income securities upon maturity. They must hold a lot of safe debt to be able to face claims anytime.

Thus, a higher interest rate allows insurers to generate higher yields and earn higher investment income, which in turn increase their profitability. They don’t perform as well in low interest rate climates because their underlying bond investments yield weak returns.

P&C insurers less sensitive to interest rates changes

The relation between interest rates and stock prices is particularly true for life insurers. Property & Casualty insurers like **Intact Financial Corporation (TSX:IFC)** are less sensitive to interest rates changes, since most of their investment income comes from short-term investments such as Treasury bills. This means that their profitability should be less impacted by an interest rate hike than life insurers’ profitability.

On the other hand, **Manulife Financial Corp.** (TSX:MFC) (NYSE:MFC) and **Sun Life Financial Inc.** (TSX:SLF) (NYSE:SLF), two of the largest Canadian life insurers, will benefit from a rise in interest rates, and their stocks prices should go up.

Better-than-expected Q2 for the two insurance giants

Both life insurers reported on August 9 second-quarter earnings that beat market expectations, benefiting in part from strong growth in Asia.

This fast expansion in Asia help them to grow and diversify from domestic markets where competition is intense.

Manulife reported core earnings of $1.17 billion or $0.57 per share in its second quarter, compared with $833 million or $0.40 per share a year ago. This beats by $0.02 analysts' estimates, who had expected earnings of $0.55 per share on average.

Core earnings include investment gains of $154 million and an increase of $187 million driven by strong new business growth in Asia, higher fee income from its wealth and asset management businesses and a reduction in hedging costs.

Manulife pays a quarterly dividend of $0.205 by share, which gives a yield of 3.35%. Its share price has a forward P/E of 10.89, and a forward PEG of 0.96.

Earnings per share are expected to grow at a rate of 14.8% this year, 8.4% next year, and 11.3% during the next five years (per annum).

Sun Life reported net income of $574 million or $0.93 per share, compared with $480 million or $0.78 per share in the same period last year. This beats by $0.04 analysts' estimates, who had expected earnings of $0.89 per share on average.

Underlying earnings per share, excluding one-off items, were $1.12 per share, compared with analysts' forecast of $0.97 per share.

Sun Life's net income from its Asian business increased to $77 million in its second quarter from $68 million in the same quarter last year, reflecting strong growth in Asia.

Sun Life pays a quarterly dividend of $0.435 by share, which gives a yield of 3.63%. Its share price has a forward P/E of 11.86, and a forward PEG of 1.49.

Earnings per share are expected to grow at a rate of 7.1% this year, 6.6% next year, and 7.95% during the next five years (per annum).

With other interest rates hikes coming, Manulife and Sun Life should both continue to have strong quarters. But if I had to choose between the two, I would buy shares of Manulife, for its stronger growth perspectives.

CATEGORY

1. Dividend Stocks

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1. NYSE:MFC (Manulife Financial Corporation)
2. TSX:IFC (Intact Financial Corporation)
3. TSX:MFC (Manulife Financial Corporation)
4. TSX:SLF (Sun Life Financial Inc.)

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