How Does the Surprise Rate Hike Impact Stocks?

Description

Bank of Canada surprised markets by increasing the overnight rate by 25 basis points to 1% less than a month after its first rate hike in seven years in early July, when it also lifted the headline rate by 25 basis points (bps). This was justified by the strong economic growth experienced over the last quarter, which exceeded expectations. There are signs another rate hike could take place before the end of the year, particularly with the central bank looking to normalize borrowing costs. This is both good news and bad news for equity markets and investors.

Now what?

The rationale for the recent rate hike is quite simple.

According to data from Statistics Canada, the economy is growing exceptionally well. For the second quarter 2017, GDP expanded by 4.5%, well in excess of even the most bullish estimates. It was also 80 bps higher than the previous quarter and a significant improvement over the 1.6% decline reported for the equivalent period in 2016.

This was a surprise because economists had expected weaker oil prices, a stronger Canadian dollar, and near-record levels of household debt to weigh on growth. Evidently, this wasn't the case; exports rose 2.3% during the quarter, while activity in the oil, manufacturing, and retail sectors was strong. Household consumption also firmed with expenditure on goods rising by 1.9%.

Such a solid performance bodes well for businesses, especially those that are engaged in the provision of financial services as well as discretionary consumer goods and services.

A stronger economy points to higher employment and wages, meaning that households will consume more and have a greater ability to meet their financial obligations.

This is great news for Canada's banks, because it will lift demand for credit, while causing the volume of impaired loans to fall. The earnings growth this creates will be enhanced by the wider margins because higher interest rates generally cause net interest margins (NIMs) to expand.

This growth is already benefiting the banks, which reported yet another stellar earnings season.

Canada's second-largest lender **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) beat expectations, reporting a 17% year-over-year increase in earnings per share, which also beat the consensus analyst forecast by 11%. That can be attributed to a strong performance from its Canadian and U.S. banking businesses, which both experienced solid loan growth. Credit quality also improved across the board with net impaired loans falling by 10 bps year over year to be 0.38% of loans under management.

These trends should continue over the remainder of 2017, meaning that Toronto-Dominion, like the other big banks, will report solid fourth-quarter and full-year results.

However, rising rates are not all good news. They can trigger jitters among equity markets because they cause the cost of capital to increase, making finance more expensive and difficult to obtain.

You see, while higher rates cause existing bond prices to fall, they make newly issued bonds, notably, government treasuries, more attractive because of their higher yields and relatively lower risk compared to stocks. That makes them more appealing for investors seeking income-generating investments.

It also leads to a higher risk-free rate, meaning that investors will seek a higher risk premium when choosing to invest in stocks. Along with higher financing costs, this makes it more difficult for those companies operating in capital-intensive industries to raise much-needed funds to invest in developing their operations.

Gold miners are among the most exposed because of the hazardous nature of mining coupled with the tremendous amount of capital required to construct a mine and bring it to commercial production. **Goldcorp Inc.'s** (TSX:G)(NYSE:GG) Caspiche project in Chile, which it obtained from acquiring junior miner Exeter Resources Corporation, requires an initial investment of US$251 million. **Barrick Gold Corp.'s** (TSX:ABX)(NYSE:ABX) Turquoise Ridge mine expansion has been estimated to need an investment of up to $325 million to complete, but when finished, it will boost annual output by around 500,000 gold ounces.

So what?

The latest surprise rate hike is a doubled-edged sword for investors. Despite indicating that economy is strong, which is beneficial for many business, it makes financing costlier. While that is not a problem for companies with solid balance sheets and mature operations, it impacts those operating in speculative and cash-intensive industries, making their existence more precarious.

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