Where Higher Rates Equal Higher Profits

Description

This past week, the Bank of Canada increased the overnight rate by 25 basis points, or 0.25%, to a rate of 1.25%, making it more expensive for consumers and businesses to take on debt to finance long-term purchases or investments. Although many individuals and small businesses with variable rate borrowings will feel the pain of the higher costs, the benefit of higher rates may start flowing to the bottom line of many financial companies and into the pockets of shareholders.

The most probable benefactors of higher rates are banking institutions in addition to insurance companies. Essentially, any company that lends money is in a position to increase revenues on the condition that the higher rates do not cause an above-average number of borrowers to default on their loans. This translates to a better future for alternative lenders as well.

As one of Canada's major banks, **Bank of Montreal** (TSX:BMO)(NYSE:BMO) may be in one of the best positions to benefit from the interest rate hikes, as the bank has a substantial amount of loans that are based on the Canadian overnight rate. As reminder, certain Canadian banks have a much larger exposure in the United States, which means that these institutions may not reap the benefits of higher rates to the same extent.

On the wealth management side, Canadians holding their accounts at Bank of Montreal now have the opportunity to deploy capital into a greater proportion of fixed-rate investments and grow their investment dollars at a higher rate. As a reminder, revenues are derived on total assets held with the institution (in most cases) instead of a fee for service. The result of this will be higher revenues based on higher rates.

On the lending side, shares of **First National Financial Corp.** (TSX:FN), which currently pay a dividend of 6.5% and trade at a low multiple of 7.5 times trailing earnings, may be in the best position of all lenders to increase the bottom line and use the available cash to undertake a share buyback. Although the company lacks the wealth management business of the major Canadian banks, the truth is that this lender has many A- and B-quality clients, which makes it a much lower-risk investment than fellow competitor **Home Capital Group Inc.** (TSX:HCG).

Although I am a big believer in the turnaround story of Home Capital Group, we must not mislead ourselves: there is considerably more risk (and reward) in shares of Home Capital Group.

The last industry to consider is insurance, as many competitors in the industry have large amounts of capital that are used as reserves for claims that need to be paid at a future time. As fixed-rate investments are starting to offer a higher yield, investors may reap the rewards from these higher returns.

CATEGORY

1. Investing

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1. NYSE:BMO (Bank of Montreal)
2. TSX:BMO (Bank Of Montreal)
3. TSX:FN (First National Financial Corporation)
4. TSX:HCG (Home Capital Group)

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