The Biggest Problem That Can Reduce Stock Returns

Description

The amount of debt held by Canadian households has been on the rise for decades. However, it has now reached record highs.

According to a Bank of Canada article posted in May, the Canadian household debt is around 170% of disposable income. In other words, the average Canadian owes about $1.70 for every dollar of income they earn per year, after taxes. That ratio is up roughly 100% from 20 years ago.

It's not just household debt, either. Corporate debt has also been on the rise due to super-low interest rates. For example, U.S. corporate debt is now at an all-time high of about 45% of gross domestic product.

Low corporate bond yields have encouraged companies to borrow more heavily from the bond markets. With this capital, some companies have bought back shares or participated in mergers and acquisitions activities.

Share buybacks help lift up or keep stock prices afloat. The easy access to capital might have fueled mergers and acquisitions activities at elevated valuations.

Share buybacks only benefit shareholders if the shares were bought at discounted or fair valuations. On the other hand, they will destroy shareholder value if shares were bought back at excessive valuations.

Meaningful interest rate hikes will put an end to the debt bubble. You can imagine that at such times, companies that carry lots of debt on their balance sheets can be in trouble.

Not to worry, however. Here are two companies that won't be affected or will actually benefit from higher interest rates.

Alimentation Couche-Tard (TSX:ATD.B) has been using debt to help expand its convenience store empire. However, it has a proven strategy to generate high returns from its mergers and acquisitions.

It also has a strong track record of growing its profitability and cash flow and the discipline to deleverage quickly after huge acquisitions. So, rising interest rates wouldn't be a problem for Couche-Tard.

The majority of **Sun Life Financial**'s (TSX:SLF)(NYSE:SLF) portfolio is invested in high-quality fixed income assets. So, Sun Life will benefit from higher interest rates.

At the end of 2017, Sun Life's invested assets include about 85% in cash, cash equivalents, and short-term securities (6%), debt securities (including government and corporate bonds) (50%), and mortgages and loans (29%).

Of course, companies with little to no long-term debt won't be affected by rising interest rates.

Investor takeaway

The stock markets may be artificially lifted by high debt levels at the personal and corporate levels. When interest rates increase up to a certain level, individuals and companies will have no choice but to reduce their debt levels.

Companies that will be the least affected are those that have been disciplined in maintaining strong balance sheets with a track record of growing profitability. Both Couche-Tard and Sun Life appear to pass these tests.

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