2 Stocks That Will Benefit From Higher Interest Rates — and 1 to Avoid

Description

This week's report coming out of Canada's Central Bank suggested that Canadian businesses are as optimistic as ever heading into the fourth quarter.

On the surface, that may seem all well and good, but the hidden undertone is that continued economic expansion is likely going to force the Bank of Canada to continue to raise the country's policy interest rate.

Companies that participated as part of the survey reported that they are seeing increased pressures on capacity, labour, and prices.

If that's going to continue, the inevitable result is going to be inflation, and that's something that the Bank of Canada is going to have to take action to prevent.

After all, it's already hiked rates four times since last summer. Most believe that at the next meeting, scheduled for October 24, another increase is all but imminent.

One sector that's obvious to benefit from higher rates is the financial sector — more specifically, lenders like **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD).

The central bank's official policy rate doesn't have any direct bearing on what banks charge their customers to borrow money, but it does affect the rate at which the banks themselves pay to borrow money, which they are then all too happy to pass on to their customers — and then some — as part of the cost of doing business.

What makes TD stock even that more interesting is the bank's exposure to the U.S. market.

Canadian households are already at their limits in terms of how much more they can borrow; meanwhile, the U.S. market has already gone through a decade of deleveraging and is now primed and ready to start borrowing again.

TD stock currently yields an annual dividend of 3.55 and boasts a very conservative payout ratio below

45%, which only makes it that much more attractive as a potential investment idea.

Meanwhile, insurance companies, like Canada's second-largest insurer **Sun Life Financial** (TSX:SLF)(NYSE:SLF), also stand to be beneficiaries of higher interest rates.

The way that insurance companies basically make their money is by taking the monthly insurance premiums paid to them by customers and reinvesting those proceeds to generate a return in order to pay out their customers' claims when they come due.

And like the rates banks charge for mortgages, the yields that insurance companies earn on their fixed-income investments are tied to the central bank's official policy rate.

As rates increase, insurers earn better returns on their investment portfolios, which they then bank as profits, returning any excess to shareholders.

SLF stock is currently yielding a very attractive 3.93% dividend yield with just a 47% payout ratio.

One stock to avoid…

But while higher rates should be good for the financial sector as a whole, one company that makes me a little nervous these days is **Home Capital Group** (TSX:HCG).

Warren Buffett and **Berkshire Hathaway** famously bought a 19.99% stake in the alternative mortgage lender last year for over $150 million, and while I'm not often one to disagree with Mr. Buffett, I have doubts about the company's short-term performance.

Not only does the company already have to deal with the obstacle of tighter mortgage regulations that have been aimed primarily at its core customer demographic, but higher rates also stand to affect those at the heart of Home Capital's clientele more than any other.

Long term, HCG stock probably a fine play, but if Toronto's housing market were to slow down or even experience a more significant correction, things might get worse before they get better for the company's shareholders.

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1. Bank Stocks
2. Dividend Stocks
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2. TSX:HCG (Home Capital Group)
3. TSX:SLF (Sun Life Financial Inc.)
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jphillips