Which Stocks Should You Buy When Interest Rates Are Rising?

Description

On July 12, 2017, the Bank of Canada raised its overnight rate by 25 basis points from 0.50% to 0.75%. This was the first rate hike in seven years. Since then the Bank of Canada has raised its key rate four more times, which now stands at 1.75%.

Further increases are expected in order to contain rising inflation.

Rising interest rates have an impact not only on bonds, but also on stocks. Some sectors will generate better returns than others following rising interest rates.

This has important implications for your portfolio, as the return it generates is largely derived from its sector allocation. Therefore, if you want your portfolio to perform well in times of rising interest rates, you may want to make some changes to it; that is, increase exposure to certain sectors and reduce exposure to others.

We are now going to look at sectors that are performing well in times of rising interest rates and that you should therefore overweight.

Banks and insurance companies will benefit from higher interest rates

In general, stocks in the financial sector, including banks and insurance companies, benefit from higher interest rates.

Banks make money on their interest margin — the difference between the rate at which they borrow and the rate at which they lend. When the Bank of Canada raises its key rate, banks raise their prime rate, so they make more money on their loans. **Royal Bank of Canada** is a strong bank that will benefit from such an increase.

Shares of insurance companies also tend to increase in value as rates rise, especially the shares of life insurers which are more sensitive to interest rates fluctuations than P&C insurers. In fact, the relationship between interest rates and the profitability of insurance companies is linear: the higher the rates, the higher the profit growth.

Insurers must invest the majority of their money in bonds to be able to face claims at any time. Higher interest rates allow them to earn higher returns on their bond investments. This means that a life insurance company such as **Manulife** (TSX:MFC)(NYSE:MFC) will benefit greatly from rising interest rates.

It's time to stock up on commodities

A review of stock returns following interest rates hikes by the Bank of Canada over the last 12 years shows that the materials sector has significantly outperformed all other sectors of the Canadian market.

According to data from *Bloomberg*, the S&P/TSX Materials Index returned 9.7% on average during the three months following a rate hike in five periods of rate hikes, including 2010, 2007, and during an extended eight-month cycle in 2006 and 2005.

Commodities stocks that should perform better following an interest rate hike are those that benefit from a stronger economy; these include the metal miner **Lundin Mining** and the fertilizer producer **Nutrien**.

Gold producer stocks like **Barrick Gold** also typically appreciate in value as a result of rising interest rates. Gold stocks are generally viewed as a good hedge against inflation.

Historically, **Agnico Eagle Mines** has been among the best-performing stocks during tightening cycles.

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