Are Low Interest Rates Permanent? Top Stocks to Own in the Low Rate World

Description

Central banks around the world continue to cut interest rates in an effort to support the economic recovery.

As a result, the era of low interest rates appears set to extend for some time, which has an impact on how investors should view dividend stocks.

Impact of interest rate changes on dividend stocks

The United States, along with most other developed countries, cut interest rates after the Great Recession. Rates remained low for several years, but started to climb again through 2017 and 2018 as the economy reached record low unemployment.

A quick look at the share prices of some core dividend stocks over that time frame, such as utilities, shows the impact rate moves can have on these companies. These sectors tend to use significant debt to fund capital programs. Higher interest rates make it more expensive to borrow, potentially reducing reduces cash flow available for payouts.

Rising interest rates tend to result in lower bond prices, thus pushing up bond yields. In addition, the interest rates paid on GICs normally increase, as well. These investments compete with dividend stocks for yield-seeking cash, so it wasn't a surprise to see money move out of some utility stocks through most of 2018, which led to a drop in their share prices.

The U.S. started cutting interest rates again in 2019 due to concerns that the trade battle between the United States and China threatened to tip the economy into a recession. The arrival of COVID-19 forced the U.S. Federal Reserve and the Bank of Canada to cut rates sharply once again.

Utility stocks rallied through most of 2019 on the back of the rate reductions. These stocks took a hit along with the broader market in recent months, but could see steady upside moves in the next two or three years.

Appeal of dividends in a world of low interest rates

At one point in late 2018 a five-year GIC offered by the big Canadian banks paid 3.5% interest. Today, an investor is lucky to get 1%.

The U.S. Federal Reserve just indicated it plans to hold rates at or near current levels for some time and might delay hikes that would normally occur when inflation starts to rise. The Fed is adopting an average-inflation target rather than the traditional fixed-rate target of 2%. This means the Fed might allow inflation to creep above 2% for a while before it starts to move rates higher.

Canada generally follows the lead of the United States, so investors shouldn't anticipate any meaningful increase in GIC rates, unless the bond market suddenly plunges. That isn't likely given the economic outlook.

This all bodes well for dividend stocks over the next few years.

Top dividend stocks to own when interest rates are low

Company-specific situations certainly impact share prices, but the utility names deserve to be on your radar right now.

Fortis (TSX:FTS)(NYSE:FTS) appears attractive due to its anticipated growth in cash flow in the next four years. The company's current capital program should boost the rate base significantly through 2024 and the board intends to raise the dividend by an average annual rate of 6% over that time frame.

The current yield is only 3.6%, but the strong dividend growth guidance is rare in the current environment and the stock should have decent upside potential.

Why?

Fortis dropped from $48 in late 2017 to $41 in the summer and fall of 2018 when the U.S. and Canada raised interest rates. The share price started to rebound again when the Fed reversed course.

In fact, Fortis hit a high of $59 earlier this year, before the March crash. At the time of writing the stock trades near $53 per share. It wouldn't be a surprise to see Fortis increase 20% from the current price in the next three years. Fortis has a recession-resistant business and low borrowing costs make it cheap to fund growth projects or strategic acquisitions.

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