The Bank of Canada Looks Set to Raise Interest Rates

### Description

It’s beginning to look like the Bank of Canada will be raising interest rates soon. Today, the Bank maintained its policy rate at 0.25% but warned of rising inflation and indicated that a rate hike may come in the near future. In a statement, the bank said it expected inflation to run around 4.75% for the remainder of the year. That’s high enough to give us all pause. The Bank of Canada’s official inflation target is 2%. Anything higher than that implies that the Bank doesn’t have inflation under control–after all, its target is not being met.



2020 saw an unprecedented need for monetary and fiscal stimulus. The federal government ran an awe-inspiring $380 billion budget deficit that dwarfed any other in Canadian history. It was a lot of money, and the Bank of Canada supplied it by buying federal government bonds.

This brings us to where we are today. The dramatic increase in the money supply combined with unprecedented government spending and supply chain bottlenecks has led to some seriously heavy inflation. In a statement, Tiff Macklen said that he won’t let inflation …stay as high as it is today.” This implies that the Bank will be raising rates soon. If that’s the case, then it’s a situation that investors will have to keep an eye on.

## What higher rates mean for investors

Generally speaking, higher interest rates are good for newly issued bonds, but bad for stocks and older bonds. When rates rise, old bonds decline in value, until their yield matches the interest rate on newly issued bonds. Stocks generally behave in much the same way. When bond yields rise, stock market gains seem less appealing, because bonds now offer more yield while still being less risky than stocks.

I don’t mean to say that bond yields *exceed* stock market gains–that’s quite rare–but stocks theoretically become less valuable when discounted at a higher risk-free rate. Also, the companies underlying stocks take a hit from higher interest rates because the cost of borrowing rises.

So as you can see, higher interest rates have varying effects on bonds and generally negative effects on stocks. Knowing this, how are you to invest?

## Banks benefit

One way to deal with higher interest rates is to invest in bonds. However, you need to wait until the rate hike before you do so. If you invest *before* the interest rate hike materializes, you will suffer a capital loss.

As for stocks:

One exception to the rule that higher interest rates hurt stocks is banks. Banks are different from other companies because they lend rather than borrow. As a result, their profit margins actually rise when interest rates rise. That's not to say that higher interest rates are a one-way ticket to higher profits for banks, however. It could be that due to higher rates, their volume of loan origination decreases. But generally, investors buy up bank stocks when interest rates rise, expecting higher profit margins.

So, if you think that the Bank of Canada is about to raise interest rates, you might want to consider bank stocks like the **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD). Like most banks, TD will earn higher profit margins if the Bank of Canada raises interest rates. Additionally, TD is a very high-growth bank. It has a 13.5% five-year compound annual growth rate (CAGR) earnings growth rate–much higher than the average **TSX** bank. That's largely due to its U.S. presence.



TD is the ninth-largest retail bank in the U.S., yet it still has many regional U.S. markets it has yet to penetrate. So its U.S. growth has historically been strong and could continue to be strong going forward. By the way, the Federal Reserve has hinted it will raise rates soon as well. So, TD has a lot of potential here.

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