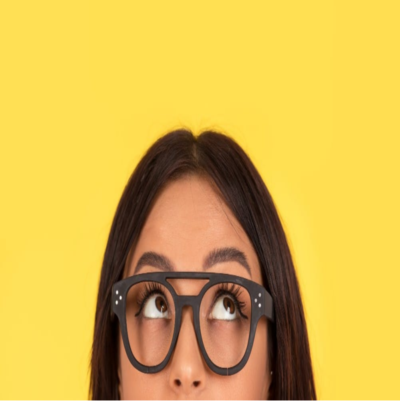

3 Reasons Why Rising Interest Rates Impact Canadian Stocks

Description

Investors have known for a while now that interest rates would be increased this year. In fact, if central bankers had it their way, they likely would have started raising rates even sooner. However, with shutdowns impacting certain sectors and Canadian stocks much more than others, central bankers were forced to hold off on increasing interest rates until the entire economy was back on track.

Those low interest rates were crucial to helping businesses stay afloat over the last couple of years. However, they've also helped contribute to this high inflation environment quite significantly, which is why it's been clear for so long that interest rates would be increased this year.

You may be wondering why stocks are just selling off now over fears of higher interest rates.

For one, rates are forecasted to rise much faster than investors expected. And when interest rates are increased, the main reason is to cool inflation, but they can also have an impact on Canadian stocks and their valuations.

If you're wondering why stocks are selling off lately, here are three main reasons interest rates have a significant impact.

Debt is getting more expensive

For years, ultra-low interest rates have allowed companies to borrow money extremely cheaply. This, combined with all the stimulus injected into the economy in recent years, is what's allowed the economy to recover well and grow. However, it's also been a massive contributor to inflation.

So, as interest rates rise, debt will naturally get more expensive for companies. Whether they have debt that has a variable interest rate, or they need to refinance some of that debt in the coming years, it's bound to become more expensive.

And when Canadian stocks are paying more to service their debt, it ultimately hurts the bottom line and the earnings that these stocks can generate.

Rising interest rates impact valuations for Canadian stocks

In addition to debt getting more expensive, capital, in general, is harder to raise. As interest rates rise, cash typically becomes more valuable. Not only that, but with yields on bonds rising, investors now have more options to invest their cash.

Another impact rising interest rates have is that it affects the amount of risk investors are willing to take on to earn a hypothetical return. As the yields and return potential of lower-risk assets such as bonds increase, the risk-adjusted return potential of stocks will actually fall. This is one of the main reasons why you see valuations across the board sell off.

So, in this environment, it's not surprising that tonnes of companies, even some of the best Canadian stocks you can own for the long haul, such as **Canadian National Rail**, **Shopify** and **Canadian Apartment Properties REIT**, have been selling off lately.

Rising interest rates impact consumers

Lastly, and perhaps most importantly, is that when interest rates increase or decrease, they have a significant effect on consumer habits.

Interest rates are a tool that central bankers utilize to cool down the economy if it's too hot like it is today. Conversely, interest rates can give the economy a boost when it's struggling, as it was at the beginning of the pandemic.

So, when interest rates rise, it's meant to incentive consumers to slow down their spending. Not only does it cost more to buy with debt now, but there are much more opportunities to save and invest your money as interest rates increase.

However, when tonnes of consumers slow down their spending all at once, it's possible it could lead to a significant slowdown in economic growth, which is what a lot of the worry from the market is about today.

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Date
2025/08/22
Date Created
2022/04/26
Author
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