The Best TSX Stocks to Buy as Interest Rates Rise

Description

Before I get into the best **TSX** stocks to buy while interest rates rise, let’s look into the relationship between rising interest rates and inflation. *Investopedia* explains this close relationship well:

> “Interest rates tend to move in the same direction as inflation but with lags, because interest rates are the primary tool used by central banks to manage inflation. In general, higher interest rates are a policy response [from central banks] to rising inflation.”

Bank of Canada, the central bank of Canada, aims to keep the long-term average inflation rate at about 2%. *CBC* reported Canada’s inflation rate was 6.8% last month — a new 31-year high! Additionally, in April, *National Observer* reported that Bank of Canada “foresees inflation averaging almost 6% in the first half of this year and remaining elevated for the remainder of 2022, then easing in the second half of next year before returning to the 2% target in 2024.”

Last month, Bank of Canada explained why we’re experiencing higher inflation than normal: “Russia’s ongoing invasion of Ukraine is causing unimaginable human suffering and new economic uncertainty. Price spikes in oil, natural gas and other commodities are adding to inflation around the world. Supply disruptions resulting from the war are also exacerbating ongoing supply constraints and weighing on activity. These factors are the primary drivers of a substantial upward revision to the Bank’s outlook for inflation in Canada.”

Our central bank is there to play a key role in raising the benchmark interest rate to help cool off inflation. In April, the Bank of Canada increased its target for the overnight rate to 1%. More increases are anticipated to be on the way.

Canadian bank stocks

Canadian banks make a profit when they loan money at higher interest rates than the interest rates they pay customers. The wider the spread between the two rates, the higher the net interest margin banks are able to earn. As a result, rising interest rates should be beneficial for banks.

The net interest margin isn't the end-all, be-all metric, though. The big Canadian bank stocks are solid core holdings regardless, because they tend to make good returns on equity (ROE) in the teens range. *Morningstar* also noted that "Canadian banks have generally been able to report higher net interest income regardless of the interest rate cycle, by growing earning assets."

When there's high uncertainty in the economy, in the worst-case scenario, Canadian bank stocks stop increasing their dividends. Right now, they pay decent dividend yields of about 3-5% that are sustainable. For example, **Toronto-Dominion Bank** stock yields about 3.7% and is reasonably valued today. Its adjusted ROE in fiscal 2021 and 2020 were 15.9% and 11.4%, respectively. Since it was able to earn a decent ROE even in disrupted economies, like the pandemic year in 2020, it's a solid long-term holding for dividend income.

Another dividend stock that does well in today's environment

Rising interest rates are here to combat higher inflation. **Brookfield Infrastructure Partners** (TSX:BIP.UN)(NYSE:BIP) has been an exceptional long-term investment when inflation was low. From 2011 to 2021, during which the inflation rate mostly stayed at about 2% if not lower, the dividend stock delivered annualized returns of about 20%! With about 70% of its cash flow indexed to inflation, the utility will do fine in the current higher inflationary environment.

Even when higher inflation tapers off from central banks rising interest rates, BIP will still be able to grow with its tentacles that spread across the globe. Management targets a cash distribution growth of 5-9% per year, supported by a sustainable payout ratio and a higher FFO growth rate.

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