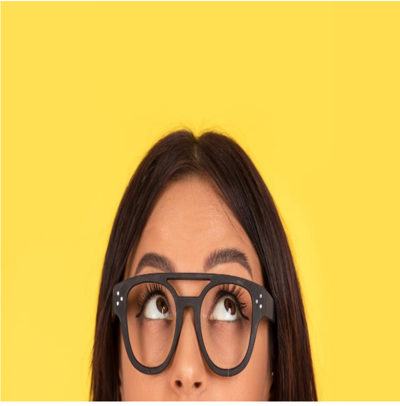

What Happens to Stocks When Interest Rates Rise?

Description

Interest rates have a major influence on asset prices. The influence is most directly felt on bonds. The higher the interest rate goes, the lower the price of old bonds that were issued before the rate hike. That's a direct mathematical relationship that is almost always observed. Interest rate hikes also have an influence on stock prices, although it's less direct. The higher the "risk-free rate" goes, the less sense it makes to invest in risk assets. However, you can sometimes see stock prices rise along with interest rates, when companies' earnings come in better than expected.

Growth stocks hit hardest

Interest rate hikes generally affect growth stocks more than value stocks. Mathematically, interest rate hikes decrease the "present value" of a series of cash flows. The faster the cash flows grow, the greater the percentage reduction in value. If stocks were valued fairly before the interest rates began climbing, then high growth stocks should fall more than value stocks.

We can see this phenomenon in action in **Shopify** (TSX:SHOP)(NYSE:SHOP) stock. SHOP stock was a market-beating titan prior to this year. For more than five years, its stock grew by 100% CAGR — meaning that it doubled every year. But this year, central banks started raising interest rates, and Shopify stock fell 73%. The company is still growing faster than average. In its most recent quarter, it grew its sales by 22%. But with interest rates going higher, that growth looks less enticing than it did before. So, the company's stock is taking a hit.

Bank stocks can thrive

As we've seen, value stocks often outperform technology stocks amid periods of rising interest rates. For the most part, it's just a matter of simple math. But there is one value sector that can really shine when interest rates rise: *banking.*

Bank stocks like **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) can see their net interest income grow when interest rates go up. Banks like TD lend money to make a profit, so, naturally, their revenue grows when interest rates go up. This doesn't work out all the time.

If short-term interest rates go up more than long-term interest rates, then banks can actually see their profits decline. But if you see parallel shifts in the yield curve, you're likely to see bank profits swell. This actually happened in TD's most recent quarter. In the quarter, TD's earnings grew, when analysts only expected them to be flat. The bank attributed that fact to interest rate hikes that raised its net interest income.

Other sectors: A mixed picture

So far, we've seen that tech stocks get hurt by interest rate hikes while bank stocks benefit. That's useful information for investors considering investing in tech companies or banks. But there are many other sectors out there. The effects of higher interest rates on those sectors are mixed. Utilities and energy stocks typically borrow heavily, so higher interest rates reduce their profits.

However, they're usually more modestly valued than tech stocks to begin with, so they take a smaller hit. Commodities often do well in rate-hiking periods, because interest rate hikes are often in response to high inflation, and commodities are seen as inflation hedges. It's a mixed picture overall. One thing is certain: if you look for value, you can find many opportunities in a period of high interest rates.

CATEGORY

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3. TSX:SHOP (Shopify Inc.)
4. TSX:TD (The Toronto-Dominion Bank)

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andrewbutton