Bank of Canada’s Massive Rate Hike – Time to Sell Oil?

Description

The Bank of Canada hiked interest rates by a massive 100 basis points last week. It wasn’t the first rate hike of the year, but it was by far the largest. In response to the move, banks’ lending rates immediately moved up. But oil stocks, as measured by the TSX energy index, fell 5.5% for the week.

Oil prices have been rising this year thanks to a supply crunch. Saudi Arabia is out of spare capacity and Russian oil is under sanctions. The result is less oil to go around, compared to last year. Because of rising oil prices, oil stocks have outperformed the market. However, now that interest rates are rising, oil stocks are falling. The question is, should you sell oil stocks now, or hold on for future gains?

What 100 basis points means

A basis point is one 100th of a percent, or 0.01%. A 100 basis point rate hike is therefore a 1% increase in rates. The Bank of Canada’s rate hike took us from a 1.5% to a 2.5% overnight lending rate. It was a pretty big jump. If 1% doesn’t seem big to you, remember that we’re talking about a 1% increase on the amount borrowed. The percentage change in interest expenses when you go from 1.5% to 2.5% is actually 66%.

Consider this example. Imagine you borrow $10,000 to buy a used car. You start off at 1.5% interest, so you pay $150 per year. Later, though, the car dealership tells you they made a typo on your financing agreement, and now you have to pay 2.5%. Suddenly your $150 per year interest payment is $250. A $100 increase. If that doesn’t seem like a big deal to you, imagine the loan was for $100,000. In that case your interest expense would increase by $1,000.

Are oil stocks still good value?

High interest rates can reduce oil prices by reducing demand for oil. Price is determined from the interplay between two forces: supply and demand. When supply is low and demand is high, that tends to push prices upward. This year, supply is low, and that’s putting upward pressure on oil prices. There is nothing the Bank of Canada can do about that. It can, however, influence demand. If you routinely borrow money to gas up your car, you'll probably drive less when interest rates rise. Enough people doing that could bring oil prices down.

Potentially this phenomenon could make oil stocks like **Cenovus Energy** (TSX:CVE) less valuable. This year, Cenovus is making a lot of money from gasoline sales. It operates Husky Energy, a chain of gas stations across Canada. The more people drive, the more revenue CVE makes from these gas stations. If interest rates rise, though, that could discourage people from driving. They wouldn't stop driving altogether, but they might cut back, leading to lower sales volume and lower prices for CVE. That could eventually show up in the company's revenue and profit, taking the stock lower.

On the whole, though, the fundamentals could keep oil stocks up this year. Factors like the war in Ukraine and OPEC's lack of spare capacity keep prices high regardless of demand, and oil stocks have cheap valuations. I can't say for sure that oil stocks are going to resume their raging first-half bull market, but they are cheap compared to their earnings and cash flows. That alone is a good reason to consider them.

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