AGF INSIGHTS

MARKETS

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Finding the stock market sweet spots

Understanding the impact of rising interest rates on each sector of the market may help investors mitigate some of the potential risk.

By Steve Bonnyman, John Vermeer and Jonathan Lo

Finding the stock market sweet spots

All else being equal, higher interest rates are supposed to be negative for equities because they lead to higher discount rates being used to calculate diminished future cash flows that drive valuations lower.

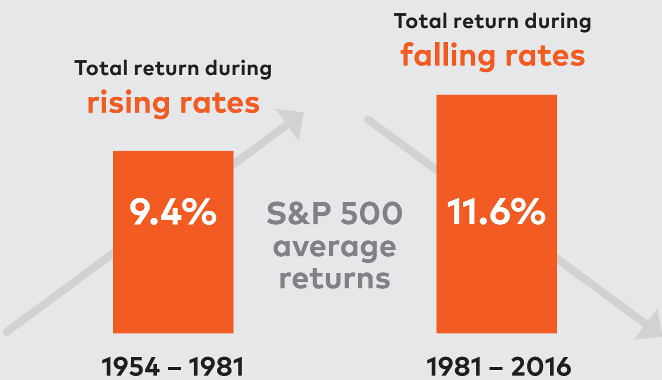
Rarely, however, is all else equal.

Stocks often climb in unison with rates in periods of strong economic growth that make investors feel more confident and willing to accept more risk, therefore driving down the equity risk premium portion of the discount rate.

There may be no better example of this being true than on North American markets over the past few years. On both sides of the Canada/U.S. border, stocks have held up remarkably well in the face of rate hikes to date and may

4 facts about stock returns in rising rate environments

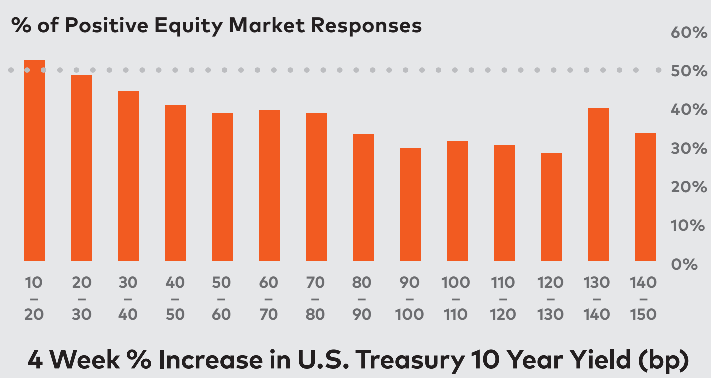
1 | Holding their own by comparison



The S&P 500 netted a total return of 9.4% during the period of rising interest rates between 1954 and 1981, but gained 11.6% during the falling rate cycle that has occurred since then through July 2016.

Source: Bank of America Merrill Lynch, for period from Jan 1954 to March 2018

2 | Slower over faster



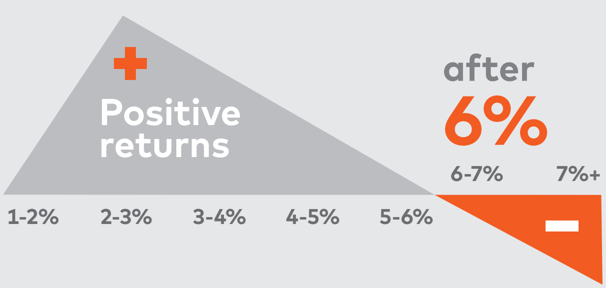
Equity markets have tended to perform better when bond yields have increased slowly and especially when the gradual climb in rates has been the result of a stronger economy. But stocks haven't been so lucky when yields jumped more sharply and/or pushed higher than expected due to a shock in the system such as an upside surprise in inflation or unexpected hawkish monetary policy.

Source: Citi Research for period from December 1927 to April 2018 move higher still if economic growth stays steady, inflation remains moderate and further tightening by central banks in both countries is maintained at a similarly gradual pace as it has been so far.

That doesn't mean stocks have become immune to the potential hazards associated with higher rates. If anything, returns may be harder to come by from here with certain pockets of the market doing better than others. As a result, an active approach that takes into consideration potential outcomes for each sector could help mitigate the possibility for smaller gains and/or bigger losses going forward.

Here below, our team of North American equity analysts weighs in on all eleven sectors and how they might be impacted by further increases in interest rates.

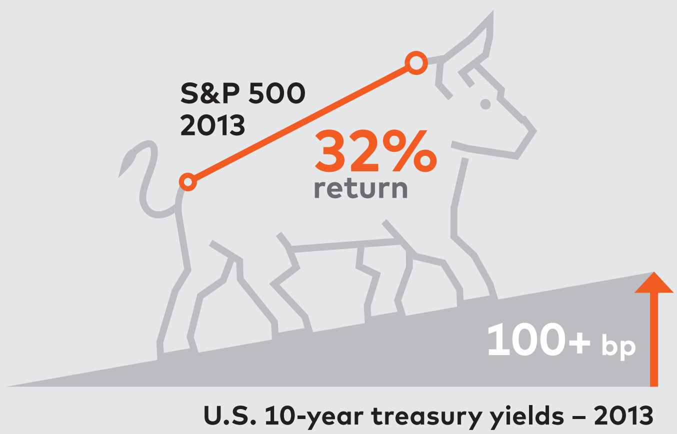
3 | Lower has been better



S&P 500 returns have been best in rising rate environments when the U.S. 10-year treasury yield has ranged between 2-3%, but average returns only turned negative once the yield surpassed 6%.

Source: Bank of America Merrill Lynch, for period from Jan 1953 to March 2018

4 | Returns and rates go hand in hand



Stock returns and bond yields were negatively correlated most of the time from the 1960's to 2001, but they've moved more in lockstep with each other in the lower rate environment that has unfolded so far this century. This includes 2013, the best year for stocks in the current bull market run.

Source: Bank of America Merrill Lynch, Bloomberg

Financials

Slow and steady wins the race

By Richard Fisher, Equity Analyst

Rising interest rates should lead to higher net interest margins and potentially better profitability for North American banks, but the pace of future rate hikes may determine how positive that ends up being for their share prices. While an increase in variable rate lending in recent years has left most banks in better shape to absorb the higher cost of money associated with higher interest rates, a more rapid rise in rates than expected could still diminish what they earn from their fixed term loan assets, leading to some deterioration in book values over the short term. Rates that rise more quickly could also trigger a greater number of loan defaults given the low rate/easy money period we've experienced over the past 10 years, however this risk is being mitigated by better lending standards and better quality loan books.

For life insurance companies, meanwhile, the net effect of rising rates should be positive based on how their products are typically priced. Each "lifeco" sets its reserves in statistical event of a policy claim off an assumed long term rate of interest those reserves would earn. If interest rates rise and remain above that assumed rate, the insurance company is able to release a portion of those reserves to earnings.

Health Care

A mixed bag

By Carmen Tang, Equity Analyst

Upward pressure on interest rates is likely to result in some mixed performance across the healthcare sector. Potential winners include managed care companies and health savings account operators that typically invest their accumulated assets in short term cash vehicles and would earn a higher yield if rates rise from here. On the flip side, higher rates could be a headwind on the most levered parts of the sector, such as hospitals and generic/speciality pharmaceutical companies, and also dividend-paying large cap pharmaceutical and medical technology (medtech) firms, as more investors turn to bonds in search of yield. Moreover, innovation-driven companies in the small to mid-cap biotech or medtech space would not be directly impacted by higher rates but may be penalized indirectly via higher discount rates which will lead to lower valuations.

Energy

Stick with dividend growers

By Dillon Culhane, Equity Analyst

The biggest impact of rising rates on the energy sector is most likely to be felt by midstream & pipeline stocks that have strong inverse correlations to government bond yields. As such, companies who provide consistent dividend growth over time are in better position to defend their stock than those who cannot sustain their payouts. An increase in the rate of inflation, meanwhile, could hinder upstream producers ("E&Ps") but benefit oilfield service companies as the associated cost to drill & complete a well increases. In this case, E&Ps with locked-in service contracts, the ability to offset inflation with further efficiencies, and/or low decline rates that don't require much drilling activity should hold up best, while the most favourable oil service companies are those operating in service lines with high barriers to entry, disciplined competitors, and sustained pricing power.

Utilities

Diversified, not regulated

By Carmen Tang, Equity Analyst

Utilities companies typically distribute the majority of their earnings as dividends and as a result, share prices often struggle to keep up in a rising interest rate environment. This is particularly true of regulated utilities who carry large amounts of debt and have limited ability to earn more return on equity when expenses increase. Earnings of power producers are less constrained, by comparison, but they also tend to carry significant debt that can be a drag on share value when rates rise. Ultimately, the best positioned companies in this sector are those with diversified holdings that generate earnings beyond their utilities business and whose cash flow from operations is inflation-protected.

Technology

Disruption could pay off

By Auritro Kundu, Equity Analyst

Technology is one of the sectors that is less impacted by rising rates, however further increases could be a drain on higher multiple names whose value of future cash flows would be impacted by a higher discount rate. That said, high growth tech names are about disruption and investors should continue to win long-term by finding the best secular growth stories.

Industrials

Play it safe with defence

By Wai Tong, Equity Analyst

Industrials is one of the sectors that historically holds up well in rising rate cycles that are driven by better economic growth, but companies with good operating leverage and pricing power are usually the best positioned, particularly when inflation also picks up and drives input costs higher. More specifically, defence stocks have traditionally been among the safest to own thanks to the visibility of their long-term military contracts and low-leverage profiles. Many of these names are trading at record high multiples at the moment, however, and may not be as effective this time around if rates continues to rise from here.

Telecom

Wireless exposure should win out

By Wai Tong, Equity Analyst

With negligible growth and loads of debt, the telecom sector continues to exhibit the markings of a classic yield play that performs poorly in a rising rate environment. That said, we would prefer telecom companies with low leverage and higher top and bottom line growth if rates climb higher. In particular, the wireless industry is one of the faster growing areas in the telecom space, and those companies with more exposure should be favoured.

Materials

Better debt levels, better prospects

By John Kratochwil, Equity Analyst

Miners have been focused in recent years on reining in high debt levels following a "growth at any cost" period which stretched too many balance sheets. As a result, many are in good shape to handle the impact of higher rates on future earnings. This is also true of materials companies that have largely kept their balance sheets in check and now generate more than enough free cash flow to service heftier interest payments. If anything, future rate hikes could stymie plans of multi-billion dollar projects being contemplated in an environment of declining global production rates. That would put some pressure on current supply/demand dynamics and provide a potential tailwind to commodity prices.

Consumer Staples

Wait for a rebound

By John Vermeer, Equity Analyst

Consumer staples have significantly underperformed the broader U.S. equity market since bond yields began to increase two years ago, but may lag further if the U.S. economy continues to strengthen or until such time investors truly begin to fear a recession is imminent. It's at this point that the sector has typically outperformed in past cycles and history could repeat as long as valuations remain reasonable.

Consumer Discretionary

Big ticket items more susceptible

By John Vermeer, Equity Analyst

Consumer discretionary stocks, meanwhile, tend to fare generally well in rising rate environments, but big ticket items that require financing are more susceptible. This includes housing and automobiles, as well as larger, truly discretionary purchases such as boats, mobile homes, snowmobiles, off road vehicles and motorcycles. Moreover, luxury items such as high end jewellery and apparel usually roll over when broader stock markets do too.

REITs

Exposure to economic growth is key

By Richard Fisher, Equity Analyst

Conventional wisdom says that higher interest rates are a headwind for real estate income trusts (REITs) because of the negative impact they have on cost of capital and future cash flow value. But those that have assets more geared to the economy have generally performed better than so-called defensive plays that are not. This includes hotel, industrial and storage REITs that have outperformed the rest of the sector when rates are rising on the back of stronger economic growth. Meanwhile, health care and strip mall REITs have underperformed.

Putting all of this together, it should be clear that stocks can still do well as interest rates move higher and may outperform other asset classes in the process. By understanding the various risks and opportunities facing each sector, investors are even better prepared for what comes next.

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