What Rising Interest Rates Mean For The Different Sectors Of The Market

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March 15, 2021

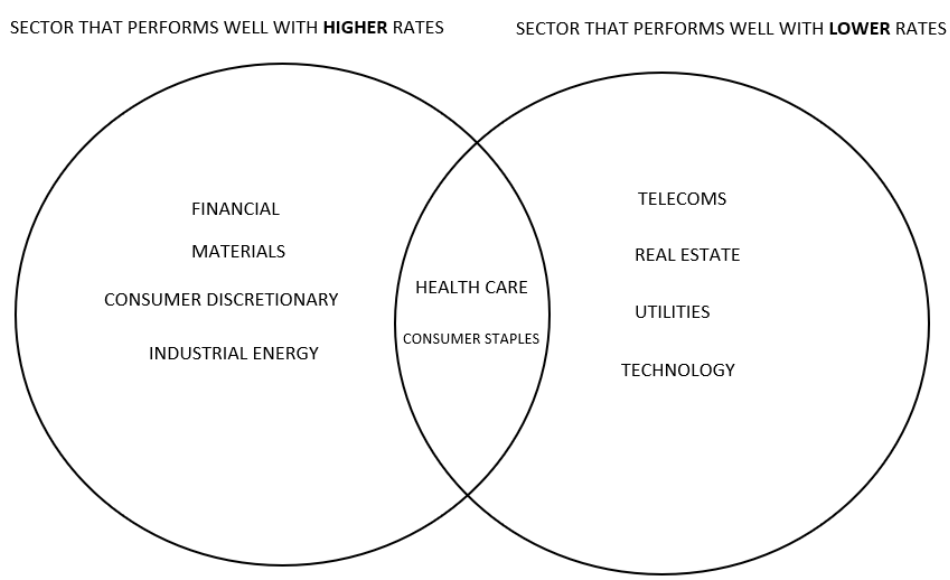
Interest rates are still in the headlines. The yield curve continues to steepen, meaning interest rates 5 years and longer have gone up while short term rates are still low.

TD bank raised their 5-year mortgage rate and inflation concerns are becoming more mainstream. It makes me feel appreciated when people ask, "where are interest rates going to go in the next few months?" My answer of "no idea" is not usually the expected answer. The look of disappointment is like the one I see on my kids faces when I dance in public. But we will look at what rising interest rates usually mean for each sector of the stock market.

We have looked at the history of interest rates. We have looked at what current interest rates may mean for markets in the next year or so. We have examined causes for today's rates. Today, we will take a peak at how these interest rates affect various parts of the economy.

Each public company is assigned a sector defined by the type of business they are in. There are financials, industrials, materials, healthcare, real estate, information technologies, consumer staples, consumer discretionary, energy, utilities, telecom and health care. Each of these sectors has several subsectors. For example, financials have banks, insurance, brokerage firms etc. Consumer discretionary would include automotive, textiles, leisure equipment, hotels, restaurants and retailing. With so many different categories our discussion on interest rates will be in generalities. Some companies in the same sector will be more affected by rising or falling rates and economic conditions than others. Take the above sector of consumer discretionary; Carnival, the cruise line, was more negatively affected by the pandemic than Peloton.

INTEREST RATES



Every cycle is different, and the above chart shows what usually happens when interest rates go up. This time, commercial real estate did not act as expected. When interest rates came down during the pandemic, commercial real estate fell. The REITs were hit hard, especially ones that had small retail and office buildings in their portfolios.

Another anomaly during the pandemic was the huge run up in the price of technology stocks. Some of this was justified by the changing economy but much of it was predicated on zero or near zero rates. Why did zero rates cause some technology companies to soar? Many professional investors use a discounted cash flow model (DCFM) to decide how much a company is worth. The DCFM inputs the current risk-free rate of return, for example, 10-year government bonds. If a risk-free rate of return is zero, then the person doing the modelling can propose to pay almost anything for future cashflows. And that is why companies that may not have positive cash flows for many years in the future suddenly could be given outrageously high price targets. Now that that risk-free interest rate is going up a bit these highfliers are not considered as valuable.

So, as always, this recovery will be different from all the others. But the Venn Diagram above will give you some indication of what should happen if and when rates go up.

Have a good week.