How are Canadian portfolio managers preparing for higher interest rates? We asked four of them

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Markets this month rose to fresh record highs even as surging inflation put pressure on central banks to move up their timeline for interest rate hikes and begin a new cycle of monetary tightening.

Higher interest rates tend to negatively affect corporate earnings, posing a significant risk for investors who have accumulated large capital gains since the early days of the COVID-19 pandemic.

We asked four Canadian portfolio managers – Brian Belski of BMO Capital Markets, Christine Poole of GlobeInvest Capital Management Inc., Jennifer Radman of Caldwell Investment Management Ltd. and Anish Chopra of Portfolio Management Corp. – for their thoughts on the current investing landscape.

How are you preparing your portfolio for higher interest rates?

BELSKI: Investors are way too focused on the mistaken belief that stocks cannot go up in a rising rate environment. To the contrary, stocks are positively correlated with bond yields and interest rates over very long periods of time. And remember, when interest rates rise from excessively low levels – which is the current phenomenon – it means that the stock market and economy are improving and can stand on their own two feet, with less monetary stimulus.

POOLE: We have not pro-actively readjusted our client portfolios in anticipation of higher interest rates. Our client portfolios are diversified across industry sectors consisting of both income – high-dividend-paying stocks – and growth stocks. Our investment philosophy remains focused on buying financially sound income and growth stocks at reasonable prices to preserve and generate capital appreciation over the long term.

RADMAN: We’ve been selective about how we’re positioned in growth stocks, given their sensitivity to higher interest rates, focusing on companies that have strong pricing power and can successfully pass through higher costs. We also started adding commodity exposure to the portfolio last year as an inflation hedge.

CHOPRA: There are a few different things. One is holding slightly higher cash balances. Second is reducing the duration, or the maturity, of the bonds that we own. So, rather go to, say, 30 years, we’re keeping it at less than 10 years to maturity. And when it comes to the equities section, we are assessing what the impact of higher interest rates will be on businesses. We’re stress-testing the portfolio of the current stocks that we own for higher rates.

Do you think the bull market in stocks can survive the rate hikes that seem to be right around the corner?

BELSKI: Yes. Our call remains steadfast. The second half of the bull market began March 20, 2020 – part of our 20-to-25-year secular bull market that we diagnosed in our work in 2010.

POOLE: Given that valuations for the broad equity indexes are above historical levels, corporate profit growth will be the primary driver of higher stock prices – rather than multiple expansion. So, assuming earnings growth continues into next year and beyond, the markets have further upside in a rising rate scenario. Corporate profit margins for the S&P 500 companies reached a high of 13.1 per cent in the second quarter of this year, reflecting investments made in technology to increase productivity. The resurgence in capital spending is encouraging as increasing productivity will be an offset to any upward pressures on wages.

RADMAN: We've seen volatility in interest rates since last summer, and while markets have continued to climb higher, there has been a lot of internal rotation within the market in terms of the sectors that are outperforming. The key will be how volatile the rate moves will be; a slow grind higher will be less violent to markets than large and quick step-ups.

CHOPRA: Yes, assuming the interest rate hikes are in line with what the market is expecting. If the interest rate hikes are much higher than the market is expecting, I think that would be a tough time for stocks to perform well in. … But the market is anticipating rate hikes, whether it's in Canada, the United States or in certain other countries. Investors know that they are coming, and in general, there will still be earnings growth across equities.

How much do you think markets are already pricing in when it comes to higher interest rates?

BELSKI: Inflation fears have actually peaked in our view. Yes, supply chains remain in question. But the timing of additional supply onto the market is the wild card – and it's very misunderstood by investors, who remain too reactive and always defaulting to the negative instead of focusing on the potential structural changes that result from supply chain disruptions.

POOLE: I think the markets are beginning to expect higher rates in the foreseeable future as the yields across the benchmark yield curves in both Canada and in the U.S. have risen since June 30. There were negative returns posted by equity markets in September, with the S&P/TSX Composite Index total return down 2.2 per cent and the S&P 500 Index U.S dollar total return down 4.7 per cent, with relative underperformance from technology and utilities – higher interest rates are potential headwinds for both these sectors. Relative outperformance from banks – which benefit from higher interest rates through increased net interest margins – also suggests markets are starting to reflect the prospect of higher interest rates.

The rebound in markets in October suggests that investors will continue to reward companies that can grow their profits regardless of the interest rate environment, such as technology behemoths Alphabet and Microsoft. On both sides of the border, financials continued to outperform while utilities lagged.

RADMAN: The fact that we're talking about risks related to rate hikes likely means some of the impact is already priced into the market. There's still a gap between the earnings yield on the S&P 500 and the U.S. 10-year Treasury bond yield, so there is some cushion there, but the path of rates will matter.

CHOPRA: What the stock markets are pricing in, and what the bond markets are reflecting, is modestly higher interest rates. They are not pricing in higher interest rates that would take into account very high rates of inflation.

If you buy one investment and hold it for the coming cycle of higher interest rates, what would it be?

BELSKI: Stocks are inherent, best inflation hedge of all.

POOLE: One investment to buy and hold is TD Bank; we hold it in our client portfolios. TD, along with other banks will benefit from higher interest rates. Its net interest margin or profit margin should improve – that is, the spread banks earn from interest paid on deposits and interest earned on credit products such as loans, credit cards and mortgages. Rising interest rates tend to point to a strengthening economy and, along with it, loan growth and healthier borrowers to make loan payments. TD is very well capitalized and has a high degree of financial flexibility to raise dividends and repurchase shares when regulatory restrictions are lifted. TD's current dividend yield is 3.6 per cent.

RADMAN: We believe Watsco, which is the largest distributor of air conditioning, heating and refrigeration products in the Americas, is a good stock to own given the non-discretionary nature of its products and its strong competitive position, ability to pass through pricing, technology differentiation and ability to add value through acquisitions given a fragmented market.

CHOPRA: Royal Bank of Canada. We own it for our clients. It has a diversified set of operations, with banking in Canada and the U.S., it has a big wealth management arm and it has a global capital markets footprint. Generally, when you have higher interest rates, financial stocks outperform because the rates they pay for their deposits tend to stay quite low, whereas the rates they lend at tend to go up with the market. That spread widens and that's how they are able to make more money. The same thought process would apply generally to the financial services sector, in Canada, the U.S. and even in global banking. The only caveat is you can't have rates rise so much that it causes credit problems. The benefits of higher rates would be offset by loans going bad.