



Rising Interest Rates: Which Investments Benefit and Which Suffer?

By Wei Woo

The Lesson Investors Learned in 2022

For decades, investors viewed bonds as the stabilizing force within a portfolio. While stocks could experience significant volatility, high-quality bonds were expected to provide income and help cushion market declines.

Then came 2022.

As inflation surged to levels not seen in decades, central banks around the world responded with one of the most aggressive interest-rate hiking cycles in modern history. The Bank of Canada and the U.S. Federal Reserve rapidly increased policy rates in an effort to slow inflation and cool economic activity.

The result was a dramatic rise in bond yields.

The yield on the U.S. 10-Year Treasury rose from approximately 1.5% at the beginning of 2022 to over 4% by the end of the year. Canadian government bond yields experienced similar increases.

Many investors were surprised to learn that rising yields can create losses for existing bondholders.

Bond prices and bond yields move in opposite directions. When newly issued bonds begin offering higher interest payments, older bonds with lower coupon rates become less attractive. To compensate, the market value of existing bonds falls.

The impact was historic.

Many broad bond market indices experienced double-digit declines in 2022, making it one of the worst years for fixed-income investors in generations. At the same time, equity markets also struggled, creating a rare environment in which both stocks and bonds declined together.

While the experience was painful, it also provided an important reminder: bonds are not risk-free. They carry interest-rate risk, particularly when yields rise rapidly.

Investments That Often Benefit from Rising Yields

Banks and Financial Institutions

Banks often benefit when rates rise because they can charge higher rates on loans while managing the rates paid on deposits.

This spread, known as the net interest margin, can support earnings growth during periods of moderate rate increases.

Canadian banks in particular have historically demonstrated resilience during rising-rate environments when economic growth remains stable.

Insurance Companies

Insurance companies invest large pools of capital generated from policy premiums.

When bond yields increase, insurers can reinvest maturing assets at higher rates, which may improve long-term profitability and strengthen future earnings potential.

Floating Rate Investments

Unlike traditional bonds with fixed coupon payments, floating rate securities adjust their interest payments as rates change.

Examples include:

- Floating-rate notes (FRNs)
- Senior secured loans
- Bank loan funds

Because their income rises alongside interest rates, these investments are generally less sensitive to the price declines experienced by traditional long-term bonds.

Value Stocks, Commodities, and Real Assets

Value Stocks

Periods of rising rates often favour companies generating strong cash flow today.

Investors generally place a lower value on distant future earnings when interest rates rise. As a result, companies with current profitability can become more attractive than businesses relying heavily on future growth expectations.

Examples include:

- Financial institutions
- Industrial companies
- Energy producers
- Consumer staples businesses

These sectors often demonstrate greater resilience when borrowing costs increase.

Energy and Commodity Producers

Higher yields sometimes reflect stronger economic growth, rising inflation expectations, or both.

During these periods, commodity-producing businesses may benefit from higher prices for:

- Oil and natural gas
- Industrial metals
- Agricultural products

Energy and resource companies can provide diversification and may help offset inflation-related pressures within a portfolio.

Infrastructure and Inflation-Linked Assets

Certain infrastructure businesses possess contractual arrangements that allow revenues to rise with inflation.

Examples include:

- Pipelines
- Transportation infrastructure
- Utilities with inflation-adjustment mechanisms
- Toll roads

These businesses can provide a degree of inflation protection while generating stable cash flow.

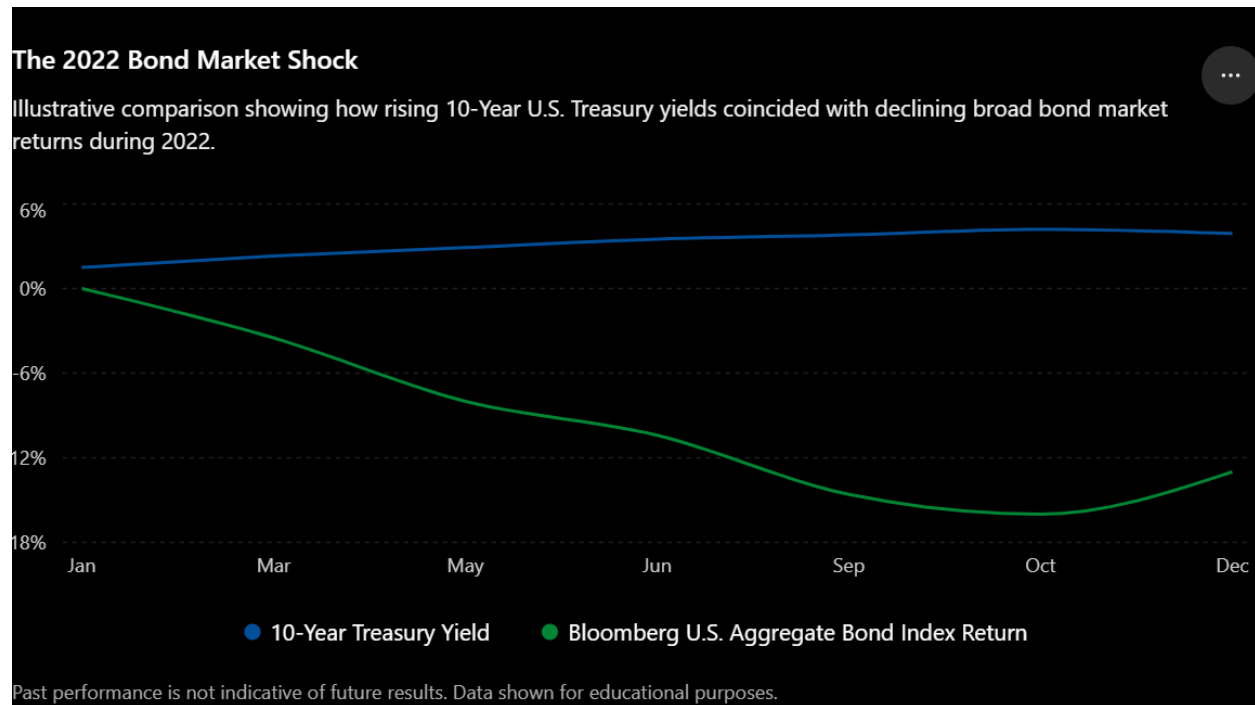
Investments That May Face Challenges

Bonds

Bonds, especially long-duration bonds are often the most sensitive to rising yields.

Bond prices move inversely to interest rates. As yields increase, existing bonds with lower coupon payments become less attractive, causing their market values to decline.

The longer a bond's maturity, the greater its sensitivity to rising rates.



**As central banks in 2022 aggressively raised interest rates to combat inflation, government bond yields rose sharply. Existing bonds with lower coupon rates lost value, contributing to one of the worst years for fixed-income investors in decades.*

Growth Stocks

Many technology and growth-oriented companies derive much of their value from profits expected years into the future.

When interest rates rise, investors use a higher discount rate to calculate the present value of those future earnings, which can pressure stock valuations. There could be a tug of war for technology stocks price actions due to positive effects of growing AI demand and limited supply of semi-conductor hardware required for AI, and negative effects of rising yield.

This does not mean growth investing becomes unattractive, but valuations often face greater scrutiny.

REITs and Utility Stocks

Real Estate Investment Trusts (REITs) and utilities unable to leverage inflation adjustments mechanisms are still frequently viewed as income-producing alternatives to bonds.

As bond yields rise:

- Borrowing costs increase for these corporations, which could be significant if they hold a heavy burden of debt.
- Property financing becomes more expensive.

These factors can create short-term challenges for portions of the real estate sector.

The most important lesson is that diversification remains essential.

No asset class performs well in every environment. A thoughtfully constructed portfolio should be designed to navigate periods of economic growth, inflation, recession, and changing interest rates.

While 2022 was a difficult year for both stocks and bonds, it also reset valuations and created income opportunities that had been largely absent for more than a decade. For patient investors, higher yields may ultimately provide a stronger foundation for future portfolio returns.

If you want to explore post-retirement goals aimed at creating healthy and balanced financial strategies, please contact me at wwoo@researchcapital.com.

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