

How rising interest rates can affect your portfolio

Over the past two years, Canadian markets have been aided by low interest rates. However, now that the Canadian economy is rebounding strongly, most experts agree that interest rates are likely to rise in the coming months.

U.S. rates have already begun to increase, and Canadian interest rates are expected to follow suit.

While higher interest rates have an impact on the economy, they also affect the financial markets — and your portfolio. So it's important to understand how rising interest rates affect different types of investments.

Fixed-income investments

When interest rates go up, bond prices decline, since existing bonds must compete in the market with new issues bearing higher interest rates. In order to provide the same yield, existing bonds sell at a lower price.

However, rising interest rates aren't completely negative for bond investors. They can also provide opportunities.

For example, as new bonds are issued with higher yields, they provide an opportunity for better returns without higher risk. Having a "laddered" portfolio of bonds that mature at different times can help you take advantage of these conditions. The opportunities for higher yields can also aid the returns of bond funds.

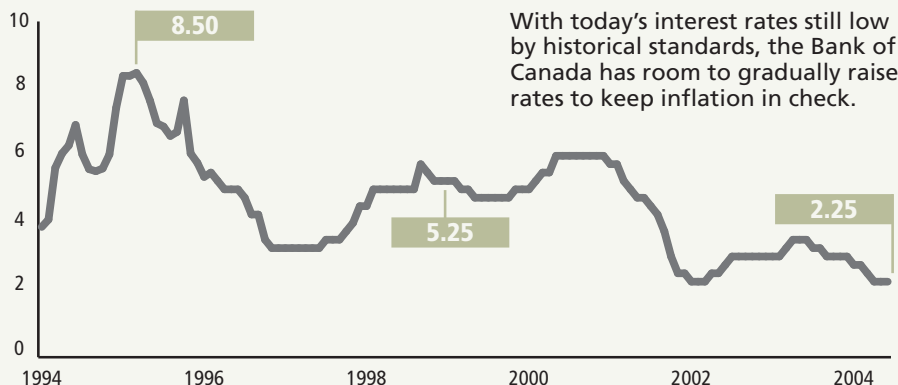
Holding to maturity

It's also important to keep in mind that a bond's current market price is not a major consideration unless you're intending to sell it. If you hold a bond until maturity, it will be redeemed for its face value, and you'll get any prescribed interest payments on schedule regardless of what the markets do.

There is some risk, of course, that the

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Interest rates: room to manoeuvre



Monthly Bank of Canada Bank Rate (%) from January 1994 to July 2004.
 Source: Bank of Canada

Rising rates

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issuer could fail to meet its obligation. However, this is most likely to affect only a small number of lower-quality bonds of highly leveraged issuers that run into trouble when rates rise suddenly and significantly.

Equity investments

Rising rates can also hamper the equity markets, for a number of reasons:

- Higher interest rates make it more expensive for consumers to buy big-ticket items such as cars and houses,

which can reduce demand in those industries.

- Fewer people take out loans, which can affect the returns from companies in the financial services sector.

- Fixed-income investments become a more attractive option for investors, who may sell stocks to buy these investments. The resulting slower market lowers the price that investors may be willing to pay for stocks.

- Because borrowing costs are higher, companies are less likely to make major capital investments. This tends to dampen the outlook for corporate earnings and stock prices.

It's important to remember, however,

that stock prices are affected by many factors, not just interest rates. Market psychology and expected future growth can have an impact on prices. And not all sectors are affected to the same degree by rising rates. Energy and materials, for instance, tend to be driven by commodity prices and global demand more than by interest rates.

While past experience indicates that higher rates tend to slow the stock markets, no one can predict precisely what the effect will be in each case. Even in a period of rising rates, there are still opportunities to find attractive investments.

Note as well that the Bank of Canada usually raises rates when the economy is strengthening, in order to keep it from overheating. In this case, the Bank expects the economy to gain speed well into 2005. That strength can help support the stock markets and offset the effect of higher interest rates.



Take the long view

While it's always wise to be aware of conditions that can affect your portfolio, rising interest rates should not usually be cause for concern. If you are invested for the long term, periodic fluctuations in the economy and interest rates should not be a serious problem.

The best defence, as always, is to have a balanced, diversified portfolio that reflects your investment objectives and risk tolerance. That will help you ride out short-term bumps in the markets.

If you would like to review your portfolio in light of changing market conditions, please give me a call. I'd be happy to meet with you. ■

Strong economic growth is usually good news for investors. But it often produces an unwanted side effect — inflation.

When prices rise beyond the Bank of Canada's target rate of 1% to 3% per year, the Bank responds by raising interest rates to prevent the economy from overheating.

The good news is that "core" inflation — which excludes more volatile components such as energy prices and food — has been moderate in Canada this year, and is expected to remain so at least until the end of 2004.

That should allow the Bank to raise rates gradually, keeping inflation in check while avoiding a sudden spike

in interest rates. Gradual rate increases give consumers and businesses time to adjust to the changing climate.

Keep in mind, as well, that interest rates are near their historic lows. So even if rates were to rise by two percentage points over the next two years, that would still leave the Bank of Canada's key overnight rate at or below the levels seen through much of the 1990s. (See the graph on Page 1.)

If the Bank can achieve moderate economic growth with low inflation, that will help protect the value of your portfolio in the long run, even if it means rising interest rates in the short term.

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