

Investors eye rising rates with great interest

It's been a rough spring for stocks around the world. And the cause, for once, is clear: deepening worries that rising inflation will force interest rates up further.

From the US and Europe to rising giants such as China and India, central bankers around the globe are working together to tame inflationary pressures in a world economy that is now in its fourth straight year of 4 or 5 percent growth.

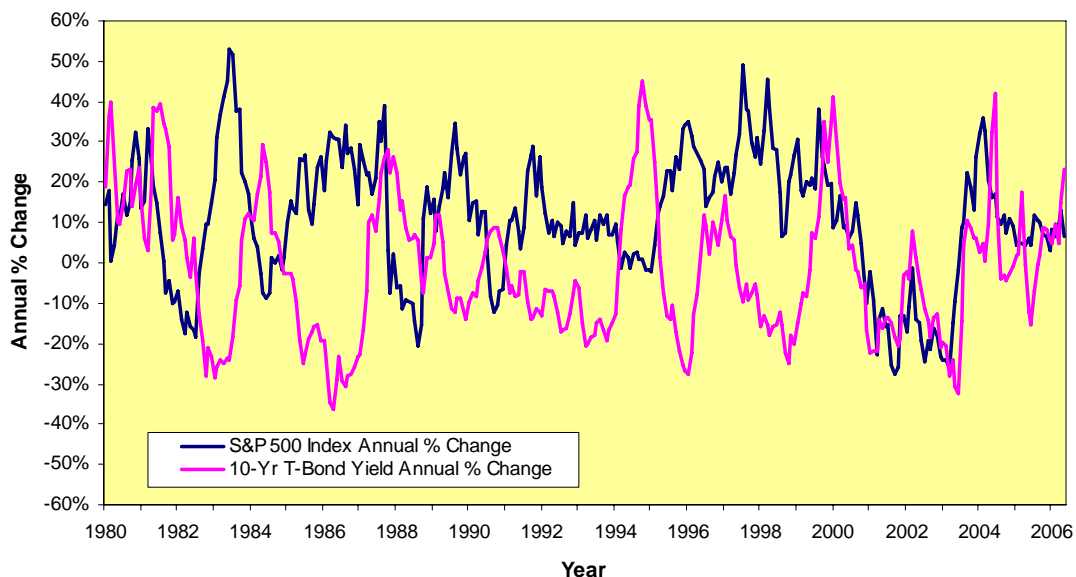
If the policymakers succeed, the current economic expansion could continue. But by raising rates simultaneously, the risk of over-tightening the money supply and stifling the economy is magnified. Stock markets, down globally over the past six weeks, have clearly signaled that worry.

What does all this mean for stock pickers? And what are the best ways to prepare for higher rates?

Stock markets tend to suffer when interest rates rise. The recent volatility in the US market, for example, is partly due to fears about potential rate hikes later this year. When rates go up, stocks begin to look less attractive compared with higher-yielding fixed-income investments. As more investors opt for bonds, the demand for stocks falls and so do their prices.

Higher rates also represent increased interest costs for many companies. And because higher rates are often a response to inflation, they can signal that corporations are encountering other cost increases as well. Consumers also pay more to borrow money, which discourages spending, hurts corporate sales and further undermines stock prices.

**The S&P500 and the 10-Year Treasury Bond Yield Annual Percentage Change
Relative to Same Period Last Year**



The graph clearly illustrates this inverse relationship between interest rates, such as the yield on the prominent 10-year U.S. Treasury bond, and stock prices, as indicated by the S&P 500 index.

Between 1980 and 2006, the periods of negative growth in the S&P 500 occurred when the yield on the 10-year Treasury bond was rising.

The exception to the inverse relationship between bond yields and stock prices is that both the S&P 500 and bond yields can fall during periods of sharp economic slowdown and recession due to falling corporate profits and inflation pressures, both of which contribute to declining bond yields.

Overall, the historic evidence suggests that equity investors have consistently benefited from an expansive rather than restrictive Fed monetary policy. Market participants should therefore focus on the actions of the Federal Reserve when they consider investment.

That's just what investors have been doing this spring - trying to predict the future interest-rate moves based on comments by Federal Reserve Chairman, Ben Bernanke. Many investors had expected the Fed to end, or at least pause, interest rate hikes after May's increase to 5 percent.

But Bernanke and others in recent weeks have expressed concerns about rising inflation, suggesting their current credit tightening campaign is far from over. To investors, that came as an unwelcome surprise and subsequently wiped out all previous market gains for the year.

There are, however, ways you can cushion your portfolio against any negative reaction. For investors, it's less about looking for investments that will benefit and more about seeking assets that will not be adversely affected.

Some stocks will clearly be hit harder than others should rates go up. The industries most affected by increasing interest rates are those that sell high-cost items requiring consumers to borrow to purchase their products.

The vast majority of homes, for example, are bought on credit. Rising interest rates will increase payments, which in turn will make homes less affordable. Consequently, it's likely that homebuilders will report disappointing results in the coming months.

Slowing home sales will also hurt related industries such as mortgage lenders as well as the furniture industry, hardware stores, and other sectors that derive a significant portion of their business from homebuyers.

Share prices of utilities and other dividend paying stocks may also come under pressure from rising interest rates because their dividend payouts are no longer as attractive compared to higher yield alternatives such as money market funds.

Traditionally, during periods of tighter credit, investors are advised to move out of rate-sensitive industries and shift into defensive segments of the economy, particularly those that provide necessities (food, personal care products, pharmaceuticals) or low-cost gratification (alcohol, tobacco), which can prosper regardless of a credit crunch.

Banks and other financial institutions are among the most interest-rate-sensitive sectors. Although their revenues rise along with their rates, the higher cost of borrowing lowers their earnings on loans and could increase bad debts.

But many banks have shifted from rate-dependant businesses, like lending, to fee-based lines such as asset management, trusts and dealmaking. Brokerage companies, for example, may continue to do well because of the advisory and underwriting revenue derived from strong M&A activity.

Goldman, Morgan Stanley, Lehman and Bear Stearns reported earlier this month that combined profit for the fiscal half first ending in May jumped 66 percent from a year earlier to \$11.4 billion, despite four consecutive rate hikes during that period.

Commodity-based sectors such as chemicals, natural resources, energy and metals also thrive when rates rise as costs for raw materials increase. Rate hikes certainly indicate that the central bankers see the underlying economy gaining strength and corporations boosting revenues through price increases.

It is important to keep in mind that the Fed is able to raise rates now because the US economy is growing and corporations are turning out phenomenal profit numbers. That has to be good for high-quality growth stocks over the next 3-5 years.

Investors looking for high-quality and consistent growth tend to opt for the large-caps. With steady earnings, solid profit margins and reliable revenue streams, large-cap companies are well equipped to handle higher interest rates.

Most experts agree that choosing quality stocks is critical when interest rates are rising. This includes companies with strong balance sheets and low debt-to-equity ratios that have little need to borrow and are shielded from the money markets. Rising interest rates will likely further weaken firms with already unstable balance sheets.

Intel and Microsoft are examples of low debt companies with zero debt-to-equity ratios while Kellogg and Colgate-Palmolive exemplify very high debtors with ratios of 2.9 and 2.7, respectively. It is useful to use the average debt-to-equity ratio of all companies making up the S&P 500 Index (0.7) as a benchmark. Obviously, the lower the ratio, the less vulnerable a firm is to rising interest rates.

So the message, as always, is to opt for quality as you add to your portfolio in the months ahead. The interest rate risk of your stocks will depend primarily on the industry susceptibility, debt ratio and financial health of the company. Concentrating on low-debt stocks with strong balance sheets can't hurt, even if interest rates remain unchanged.

This spring, inflation data and comments from Fed officials have led many market watchers to wonder whether the Fed will push rates as high as 6%, 75 basis points higher than it is today. The good news is that stock prices may have finished adjusting to this expectation of further rate hikes such that any further increases in the fed funds rate to that point would not be a surprise.

Given the fact that the S&P 500 has fallen about 5% since all this new interest-rate worry began to take hold in May, now is the time to start investing in US stocks. Once rates peak and investors start anticipating cuts, your portfolio will be well positioned for the stock market rally to follow.