



## TSX Sector Strategy #3

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### Overweight: Interest-Sensitive Stocks

Peter Buchanan and Avery Shenfeld

	<u>Market Weight</u>	<u>Recommended Weight</u>
Financials	30.9%	34.8%
Utilities	4.1%	4.7%
Telecoms	5.0%	6.6%

#### Summary

- The key feature of Canada's financial landscape in coming months will be aggressive Bank of Canada easing. With the Fed unlikely to tighten soon, the Bank will have to cut rates several more times to reduce the overly wide spread gap and ease economic pains from the overvalued C\$.
- A decline in the Bank's overnight target to post-1958 low of 1¾% will bolster interest-sensitive equities and bonds. Interest-sensitive sectors comprise a good 10-15%-pts more of the TSX's cap weight than the S&P 500.
- A bullish prognosis for long-term yields warrants overweighting financial stocks, particularly banks, along with utilities and telecoms. Dividend-paying stocks should outperform as falling bond rates whet investors' growing appetite for yield.

#### Key Indicators

<u>Index Level</u>	<u>Latest (Feb.27)</u>	<u>6-Month Target</u>	
Financials	1273	1350	
Utilities	1290	1380	
Telecoms	637	700	

<u>Interest Rates</u>	<u>Latest (Feb.27)</u>	<u>Jun-04</u>	<u>Dec-04</u>
Bank of Canada Target	2.50	2.00	1.75
10-Year GoC	4.38	4.45	4.00

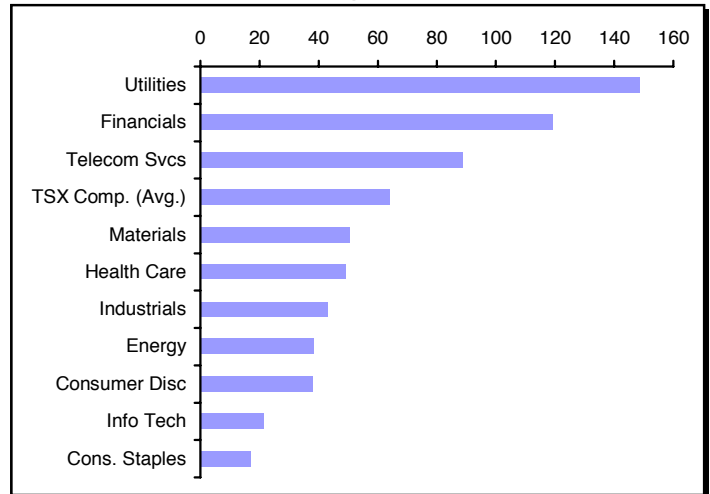
# Identifying Winners from Falling Rates

Canada's economy, tested by the higher loonie and lacking the fiscal lift Washington has provided, is likely to see growth barely top 2½% this year, creating a need for further monetary easing. A March rate cut by the Bank of Canada would cause little market surprise. But further aggressive rate-cutting to ease pressure on the C\$ should help bonds and interest-sensitive stocks. The Fed won't deliver the second half rate hikes built into the US yield curve, with US inflation still securely under wraps. The onus will then fall on the Bank of Canada to cut rates aggressively and thereby validate market expectations for narrower Canada-US short-rate spreads. Meeting those expectations will be key to forcing the C\$ back to the low 70-cent range—a level Canadian exporters can live with.

The TSX is 1½ times more rate sensitive than the S&P 500 (Chart 1), reflecting weighting differences. Ten-year interest rates show a greater correlation to equity performance than short-term yields because changes at the long end of the yield curve capture only the unanticipated part of any short-term interest rate developments.

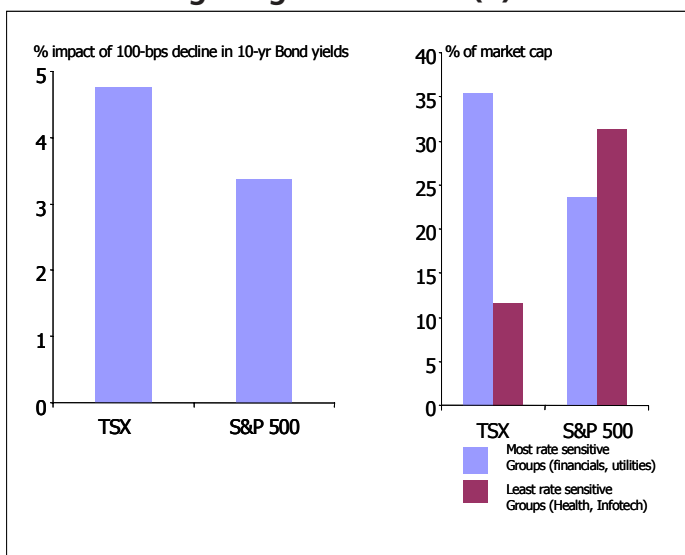
Rising odds of aggressive Bank easing underpin our recommended overweight in TSX financials, utilities and telecom stocks. Lower yields are a greater plus for

**Chart 2**  
Total Debt as Percentage of Revenue



highly levered companies given their larger potential refinancing savings, and debt-to-revenue ratios are currently the loftiest in those sectors (Chart 2). Recent history suggests that utilities and financials (particularly banks) see a particularly well defined benefit from lower rates (Table 1). Telecom valuations had historically also shown a strong inverse correlation to long-term yields. The energy sector, through its high debt and capital intensity, has also been levered to interest rate changes.

**Chart 1**  
TSX's Greater Sensitivity to Interest Rates (L) Reflects Weighting Differences (R)

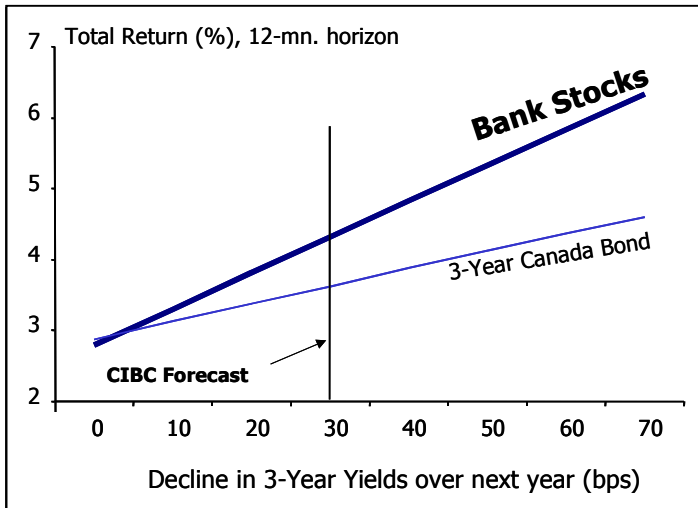


**Table 1**  
Impact on TSX Stock Prices of a 1 Percentage Point Drop in 10-Year Yields (% change)

Financials	8.45
-Banks	8.99
-Insurance	5.58
-Real Estate	5.50
Utilities	5.50
Energy	5.12
Industrials	4.82
-Transportation	4.88
-Capital Goods	6.17
TSX Composite (Average)	4.76
Materials	4.65
Consumer Discretionary	4.02
-Retailing	4.02
Telecom Services	3.24
Health Care	*
Info Tech	*

Source: CIBC Economics & Strategy  
 Note: Based on year over year data, Dec '88 - Jan '04  
 \* Not statistically significant

**Chart 3**  
**Banking on Lower Rates:**  
**Total Return by Asset Class**



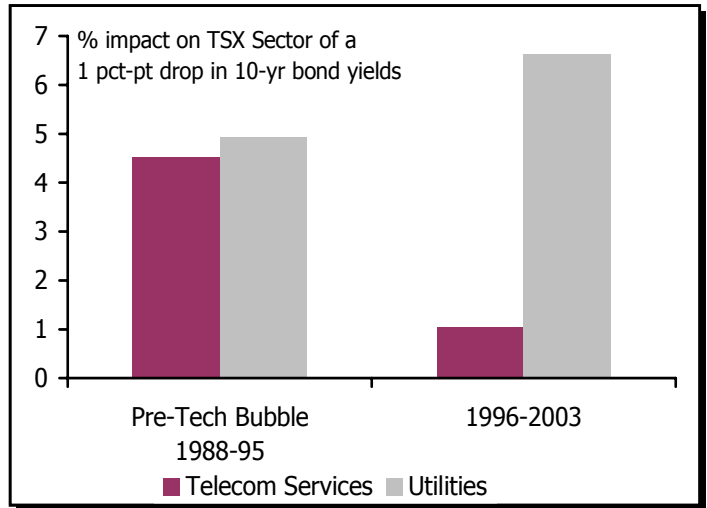
**Financials, Utilities & Telecoms Offer Most Upside**

Financials benefit from the yield-curve steepening that typically accompanies a falling-rate environment, and the resulting boost to loan demand. Lower interest rates also improve the debt-service coverage of the banks' corporate and commercial lending clients, attenuating loan loss rates. While bank stocks have about the same yield as a three-year Canada bond, they have about twice the sensitivity to falling rates (Chart 3).

Power and gas distribution are among the most capital-intensive activities of all. The TSX utility GICS ranks first in two key accounting measures of interest rate sensitivity—the ratio of total debt to revenues, and fixed assets over revenues. The future need to tap external financing sources to meet burgeoning demand should add to the sector's customary rate sensitivity.

Telecom service stocks have not matched utilities or banks in rate leverage recently, because investors saw such stocks largely as growth/convergence plays in the dot-com bubble. But, looking further back, the group had been among the most yield levered of all sectors (Chart 4). Income-oriented investors are again zeroing in on high dividend-yielding stocks with stable payment histories, presaging a return to the sector's past "bond-like" behaviour. That makes telecoms a good play from here on falling rates. Lower interest rates, moreover,

**Chart 4**  
**Telecom Sector Highly Rate Sensitive Before Tech Bubble**

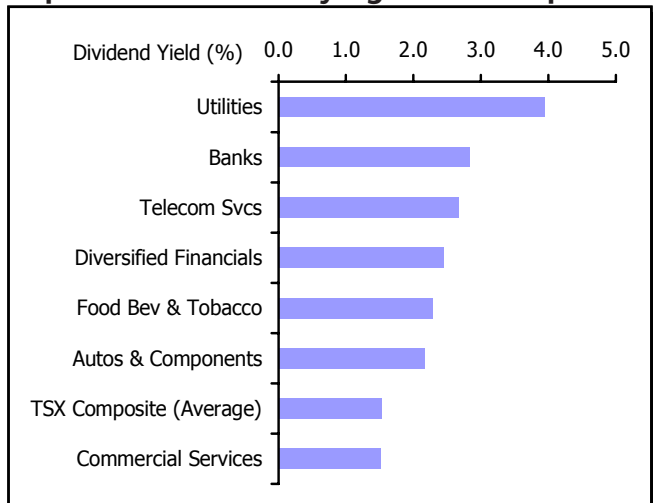


should also support telecom valuations via heightened speculation about partial or total conversions to income trusts.

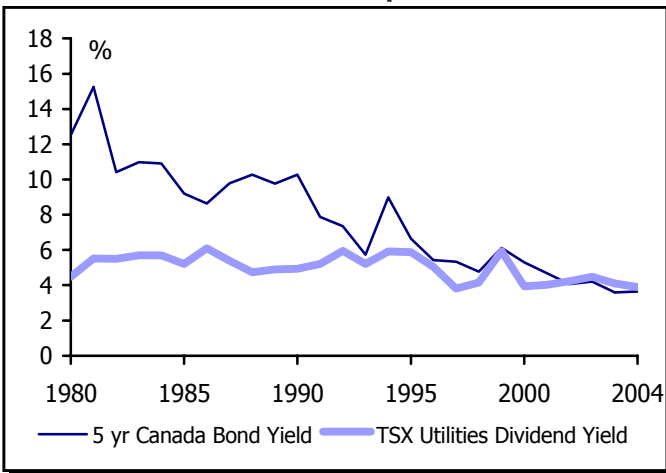
**Renewed Focus on Dividends Likely**

There are several other routes for lower rates to boost equity valuations. Differences in dividend policies in part explain the varying sector rate sensitivities. As bond yields fall, higher dividend-yielding equities, like utilities, financials and telecom stocks, look relatively more promising for yield-seeking investors (Chart 5). Utilities

**Chart 5**  
**Top TSX Dividend Paying GICS Groups**



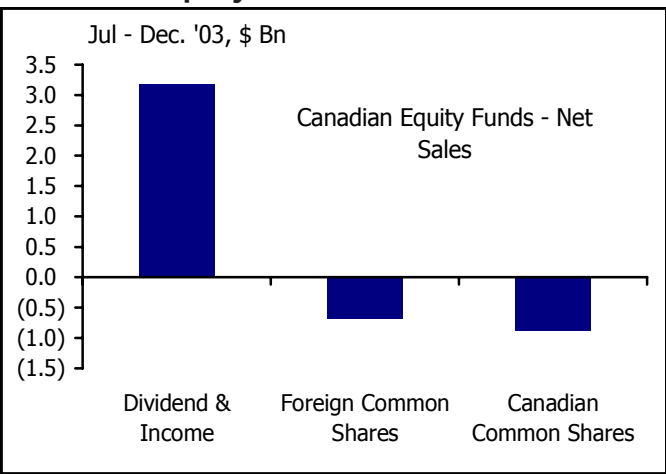
**Chart 6**  
**Dividend Stocks Now Surpass Bond Yields**



dividends are already running neck-and-neck with mid-term fixed income yields (Chart 6).

Canadian investors have, in fact, increasingly sought dividend-yielding equities, alongside income trusts, as

**Chart 7**  
**Canadian Equity Funds—Net Sales**



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a substitute for falling fixed income payouts. Even with the stock market in recovery, income and dividend funds have consistently outsold straight equity funds in the past six months (Chart 7), which should also help to provide a steady bid in the market for high-yielding equities.

The last cycle of aggressive rate easing by the Bank of Canada, during the mid-1990s, corroborates the typical performance edge of high-yielding stocks in a falling rate environment. An investor in high-dividend TSX 35 stocks as overnight and 10-year yields plummeted from early 1995 through late 1996 would have enjoyed a 24% total return edge (capital gain plus dividends) over a portfolio holding stocks paying below average or no dividends (Chart 8). Although the remainder of the current easing cycle won't be as dramatic, it should still prove rewarding for investors who tilt their portfolios towards stocks that benefit from falling bond yields.

**Chart 8**  
**Dividend Stocks Outperformed During Bank's Last Easing Spree**

