Why Toronto-Dominion Bank Is Set to Benefit From This Huge Trend

Description

Most Canadian investors are acutely familiar with Canada's economic problems—depressed oil prices, an overvalued housing market, and anemic GDP growth (only 1.6% in 2015 compared with 2.8% for the U.S. and 3% globally).

One of Canada's biggest economic headwinds, however, is the fact that the Canadian household is extremely overleveraged. Over the past 10 years, Canadians have been gradually increasing their debt levels, driving the debt-to-household income up from 120% to 163.3% this year. Driven by historically low interest rates, Canadians have been adding debt at a faster rate than disposable income has been rising. The end result is that Canadians are the most indebted in the world.

This bodes poorly for bank stocks like **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD). With consumers already extremely indebted, they will have less ability to take on new mortgages, auto loans, and credit card debt. In addition, high debt loads mean less disposable income—especially if interest rates rise—which dampens overall spending.

Fortunately, TD Bank's fairly large U.S. exposure not only insulates it from the overleveraged Canadian consumer, but positions it to profit from positive developments in America.

The American consumer is in the process of "re-leveraging"

While Canadians have been slowly adding debt over the past decade, the U.S. household has been doing the exact opposite for the past eight years—paying down household debt in a process known as "deleveraging."

For nearly 50 years, the U.S. household, like the Canadian household, steadily added to its overall household debt. However, from 2008 to 2010, this process reversed in the United States. Thanks to the economic collapse and falling home values, new mortgages plunged. New mortgages fell to such a low point that mortgage pay-downs actually exceeded new issuances, causing overall mortgage debt to fall. In addition to this, falling home prices caused foreclosures, and banks were required to write off hundreds of billions in mortgages.

The end result was that household debt fell by nearly a trillion dollars, and rising disposable household income caused the American debt-to-household income ratio to fall to a low 108%. Now the trend seems to be reversing.

With low debt levels, Americans are now able to spend more, borrow more, and invest more, which not only drives GDP growth, but also adds to the bottom line of banks, which benefit from all these activities. Household debt has been steadily rising, and this includes new mortgages, which have been rising quarter over quarter.

How Toronto-Dominion Bank is poised to profit

While the situation in Canada bodes poorly for TD and its competitors, TD Bank is far more American than its peers. Currently, the company obtains about 31% of total revenue from the U.S., and 29% of net income. The company is positioned widely in the wealthy eastern states; it is currently located in seven of the 10 wealthiest states and five of the 10 top metropolitan areas. These include New York, Boston, and South Florida.

With 55 million customers within five miles of TD branch locations, TD Bank has the geographic footprint to benefit deeply from the re-leveraging American household. This is evident when looking at TD's U.S. retail loan growth—overall loan growth has risen 10% over the past year, compared with only 4.9% for Canadian loans.

In addition, TD Bank currently owns 40% of TD Ameritrade, one of the most dominant U.S. e-brokers. TD Ameritrade contributed about 13% of TD's U.S. retail net income, and this is poised to improve. Low levels of U.S. household debt means that Americans have more to save and invest, and Ameritrade is uniquely suited to benefit, since the company has an extremely active customer base, with the average customer making 17 trades per year, 13% of which are derivatives trades, which are more costly.

In addition, rising U.S. interest rates could provide a huge boost to earnings, as half the company's interest-earning assets are tied to short-term rates, meaning when rates rise, TD Ameritrade should quickly see a boost in earnings. Over time, this will only amplify as the remainder of Ameritrade's assets re-price at the higher interest rates. For TD Bank, this will lead to increased U.S. retail earnings.

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Date
2025/08/27

Date Created
2015/06/17
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