

Is Toronto-Dominion Bank Prepared for a Recession?

Description

Technically, a recession is defined as two consecutive quarters with negative economy growth, and by this definition, Canada is certainly in one. In Q1 2015 GDP growth contracted by 0.6%, and in Q2 2015 GDP growth contracted by 0.5%—the first time this has happened since last recession in 2008-09.

While it is likely that the economy will return to growth in Q3 2015 (with the Bank of Canada projecting a 1.5% growth rate), the economy faces major headwinds regardless. This is bad news for banks like **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)), since a bank's performance is largely dependent on demand for loans and fees from managing assets, both of which are propped up by a strong economy.

The Bank of Canada responded by slashing interest rates to 0.5% to stimulate demand. While this could stimulate more demand for loans, it also puts pressure on banks margins, and may worsen an already overvalued housing market, which could put more pressure on banks. As Canada's largest bank, and with a major retail focus, is TD Bank prepared for these headwinds?

How the current economy could affect TD

The current economic climate presents a few major headwinds for TD. Firstly, demand for loans can be affected by lower income, consumption, and housing spending, especially in the oil producing provinces. Since Canadians are already extremely overleveraged (with a debt-to-household income of a record 163%—one of the highest in developed countries), there is little room to take on additional debt, and loan growth will mostly be driven by economic growth.

A bigger risk comes from declining interest rates. Since banks make money on the spread in interest they make between providing loans and receiving deposits (known as the net interest margin), lowering interest rates reduces net interest margins. Margins have been declining over time with interest rates, and lower margins means lower profits.

On top of this, the lower interest rates could mean a slight increase in mortgage and other borrowing, which could provide some loan growth, but it would also worsen the current housing bubble, which is a risk to banks' balance sheets and credit quality should housing prices fall.

TD may be more vulnerable than its peers to falling interest rates. Many analysts expect TD to benefit most in a rising rate environment. This is because it has the highest percentage of demand and notice deposits (chequing and savings accounts) to loans among its peers. These are very low cost funds, which means as interest rates on loans rise, spreads on these deposits would increase quickly.

Unfortunately, the opposite may be true when rates are falling. Banks with fewer low-cost deposits, or more variable rate deposits, have the ability to lower the cost of funding as interest rates fall (perhaps even more than they reduce the prime rate on their loans). It is for this reason analysts at RBC estimate that TD may benefit least from a decline in interest rates, with **Bank of Montreal** benefiting

most.

TD is well diversified, which should reduce risk

While margins may be pressured, and the bank is exposed to low GDP growth, an overleveraged Canadian consumer, and an overvalued housing market, the bank is also well diversified geographically. Currently, TD is almost as American as it is Canadian— it receives 29% of net income and 31% of revenue from the U.S.

TD has 1,302 branches in the U.S., compared with 1,165 in Canada, and the bank is well positioned in seven of the 10 wealthiest states. Currently, about 26% of the bank's total gross loans originate from the U.S. This not only insulates TD from the various problems with the Canadian economy, but also exposes it to the improving American economy. The American debt-to-household income is a low 108%, and Americans are quickly adding more debt, which should result in growing loans.

In addition, U.S. interest rates are expected to rise later this year, which should improve margins.

CATEGORY

1. Bank Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:TD (The Toronto-Dominion Bank)
2. TSX:TD (The Toronto-Dominion Bank)

Category

1. Bank Stocks
2. Investing

Tags

1. Editor's Choice

Date

2025/08/26

Date Created

2015/07/20

Author

amancini

default watermark