Buy Toronto-Dominion Bank to Benefit From the Coming U.S. Interest Rate Hike

Description

The U.S. Federal Reserve made huge news last week: after months of speculation, they decided not to increase the benchmark interest rate. If they had chosen to raise rates, it would have marked the first increase in nine years.

The U.S. benchmark interest rate has been stuck at rock-bottom lows between 0 and 0.25%, and an increase would have been seen as a sign that the Federal Reserve has confidence in the U.S. economy.

Despite this, a majority of experts think an increase is coming this year, with many expecting one in December. You may be wondering what effect the U.S. interest rate has on the Canadian-based **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD). The answer is, plenty.

TD is Canada's most American bank

To start, TD has plenty of direct exposure to the United States, and therefore is affected by the U.S. economy and U.S. monetary policy decisions.

TD currently has 1,305 retail branches in the U.S. compared with 1,116 in Canada, with average U.S. loans of $159 billion and average U.S. deposits of $268 billion in Q3 2015. These U.S. loans currently comprise about 30% of TD's total loans.

In total, about 33% of TD's revenue and about 28% of net income came from the U.S. in the last quarter. The majority of TD's U.S. revenue comes from net interest income (that is to say, the difference in interest between what the bank earns from loans and spends on deposits), and TD's U.S revenues are therefore very sensitive to what happens in the U.S. interest rate environment.

TD has been positioning itself to profit from a U.S. rate hike

While TD's large exposure to net interest income in the U.S. automatically makes it affected by U.S. interest rates, TD has been taking specific actions over the past several years to leverage itself to an increase in rates.

Banks make money by doing something known as borrowing short and lending long. That is to say, banks take in short-term deposits, and lend them or invest in long-term assets like mortgages or other debt securities at higher interest rates

When interest rates rise, loans and bonds that the bank owns gradually come due and are re-priced at the higher interest rate over time, increasing the bank's margins. TD has been taking action to ensure this happens quicker for them by shortening the overall duration of their U.S. securities portfolio.

This means that TD has been selling its long-term securities (like U.S. treasuries), realizing profits on them, and then re-investing the proceeds in short-term securities. In doing so, when interest rates rise, TD's securities will come due quicker and re-price to the higher interest rate faster because they are short term. This means TD's earnings also increase faster.

To make matters even better for TD, most of TD's deposits (about 75%) are in chequing and savings accounts. When interest rates rise, banks typically do not need to increase interest rates on these accounts as much or as quickly because customers are unlikely to switch banks to earn higher interest rates on these kind of transaction-based accounts.

These means that TD's income from loans will rise more and faster than its expenses for deposits.

How much will TD benefit?

While it is difficult to say for sure, TD bank estimated in 2013 that a 0.25% increase in rates would add at least $300 million to income. They also estimated about 40% would occur if rates only rose in the U.S., so that would add $120 million.

Analysts at TD estimate that a 1% increase in U.S. rates would lead to $640 added to income by the fifth year after rates increased, which would be a large 6% increase in profits just from rising rates.

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