Could the Brexit Stop Toronto-Dominion Bank's Rally in its Tracks?

Description

The U.K. voted to leave the E.U. with a 51.9% share of the vote, and global markets have spent the last week attempting to digest precisely what the effect of the decision will be. The U.K. impact will be large—analysts at **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) see their 2016 and 2017 GDP forecasts cut in half, while many other analysts see a recession.

Unfortunately, the effect of the Brexit is not limited to the U.K., and both Canada and the United States are expected to experience significant spillover effects. This is bad news for TD Bank, which obtains 54% and 36%, respectively, of revenues from the U.S. and Canada.

Canada sends 3% of its exports to the U.K., while the U.S. sends 5%, and while this sounds mild, the uncertainty created by the "Leave" vote could have large effects on confidence and investment. The end result is that TD has just seen its downside risks amplified and potential rewards minimized—all bad news for its double-digit rally this year.

The biggest effect for TD will be on revenue growth

Canada and the U.S. are TD's biggest markets, and economists at TD Bank see the Brexit has having substantial GDP effects on both economies; both Canada and the U.S. could potentially see a huge 0.5-1% come off GDP for the second half of the year. This is bad news for TD's revenue growth from both these economies, since GDP growth is a key driver of both mortgage and personal lending growth, which in turn drives the interest income portion of a bank's revenue.

TD had set a medium-term annual earnings-growth target at its previous Investor Day of about 7%, and with 64% of its earnings coming from domestic retail, the performance of the Canadian economy is central to its ability to hit that target. Canada's GDP growth for 2016 and 2017 is likely to be lower than TD anticipated when it set this target.

TD had stated it expects growth to be sub-2%, and it is now looking like 2016's growth could potentially be as low as 1%. TD economics recently revised its Canadian estimate for GDP down to 1.3% (factoring in the effect of the Albertan wildfires), and this estimate does not factor in the 0.5-1% reduction from the Brexit in the second half of the year's GDP growth.

While TD has typically grown its domestic retail revenue well in excess of GDP (6.7% average over the past four years versus Canadian GDP growth average of 1.8%), much of this growth premium was due to the effect of Canadian consumers rapidly expanding their debt-to-personal income ratios largely in the form of mortgages. With this ratio now at a record high of 165%, TD is expected to see deteriorating loan growth. The threat of a coming slowdown in Canadian housing and deleveraging will add to this.

Analysts currently expect 3-4% earnings growth for TD in 2016, and GDP deterioration in Canada and the U.S. puts downside risk on this already weak target.

Prolonged low interest rates are also a risk

There is little doubt that the Brexit will affect the frequency of rate hikes in both Canada and the U.S. The Federal Reserve is now unlikely to pursue a rate hike until December (the probability of a September hike fell from 30% before the Brexit to 0%), and analysts at the **Bank of Montreal** do not expect a Canadian rate hike now until the end of 2017.

This is bad news for TD's net interest margins in both countries, as margins have already been in a steady decline thanks to falling interest rates. The slower rate of interest rate hikes in the U.S. removes a significant tailwind for TD as the bank is especially sensitive to earnings hikes; a small 0.25% hike in U.S. rates alone is expected to add $120 million (1.4% of TD's 2015 earnings) within the first year.

With TD currently trading at 11.1 times its pre-Brexit earnings (which is equal to its long-term average), the stock is likely to pause as the market better digests the impact and as investors look to safer assets.

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amancini