



## What Does a Donald Trump Presidency Mean for Canadian Banks?

### Description

Shortly after the election of Donald Trump to the presidency, Citibank released a note stating that Canadian banks stand to gain from a Trump administration. The note stated that banks with U.S. exposure stand to benefit most, because a rising-rate environment would improve margins, and a strong U.S. dollar would make U.S. dollar revenues from banks worth more when they are converted back to Canadian.

It is, of course, impossible to forecast precisely what policies Trump will be able to implement; many of his pro-growth policies (like corporate and personal income tax cuts, infrastructure spending, and repatriation of U.S. corporate cash) enjoy broad support and are likely to pass. These pro-growth policies are likely to lead to two things: increased inflation and a faster pace of interest rate hikes.

For Canadian banks, rising U.S. interest rates have massive implications, regardless of whether or not the bank has U.S. assets. The size of a bank's U.S. asset base as well as exposure to domestic residential real estate will determine the degree which a bank is helped (or hurt) by rising rates.

### **Banks with U.S. exposure are set to benefit most**

It is very clear now that interest rates are (and will continue to) rise in the United States. The 10-year bond yield has grown from about 1.8% before Trump's election to 2.35% currently. The market is now expecting a 100% probability of a short-term interest rate hike in December, and analysts at **Goldman Sachs** see the U.S. short-term interest rate (known as the Fed funds rate) rising to 1.5% by the end of 2017 (up from 0.25% currently).

Canadian Banks with U.S. exposure are certain to benefit from this. Higher interest rates (especially when longer rates rise more and faster than shorter-term rates) benefit banks because it means banks can charge more for mortgages and loans than they pay out for deposits (particularly low or no-cost deposits like chequing or savings accounts). This leads to higher net interest margins for the banks, and therefore higher earnings. Net interest margins for Canadian banks have declined sharply over the past decade.

In addition to having exposure to the rising interest rate environment in the U.S., Canadian Banks with

U.S. assets will also benefit from a strengthening U.S. dollar as well the stronger loan growth prospects that are available in the U.S. market (compared to the Canadian market due to U.S. consumers having more room to borrow).

Almost all of Trump's policies are good for the U.S. dollar—tax cuts and infrastructure spending are good for growth, which will encourage more investing in the United States. Repatriation of U.S. corporate cash from overseas will also result in a large demand for U.S. dollars. Back in 2005, a similar policy led to \$350 billion in repatriation and a huge rally in the dollar. Rising interest rates will also strengthen the dollar. This is great news for banks with U.S. dollar earnings, since those earnings need to be converted back to Canadian dollars, leading to a big uplift.

Which Canadian banks are best set to benefit from these conditions? **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)) leads the way, having by far the largest U.S. dollar revenue exposure of its peers thanks to its U.S. Personal and Commercial segment as well as its ownership in TD Ameritrade.

Some old estimates by TD in May 2013 revealed that a fairly small 1% increase in U.S. short-term and long-term rates would lead to a large \$640 million boost in earnings (close to 9% of 2016 earnings).

### **Banks with large Canadian housing exposure will lose**

Canadian interest rate increases typically follow U.S. interest rate increases; it is not surprising that **Royal Bank of Canada** as well as TD have already started raising mortgage rates. This is bad news for many Canadians, who have debt levels that are 170% of disposable income (way above the 139% in the U.S.).

High debt levels and rising mortgage costs means weakness in Canadian domestic segments, and TD will outperform in this regard due to the fact it has the second-lowest exposure to domestic residential real estate of its peer group.

### **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)

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amancini

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