Cash In on Higher Interest Rates by Buying Toronto-Dominion Bank

Description

Bank of Canada's mid-July decision to hike interest rates for the first time in seven years is a boon for Canada's banks. A higher headline rate typically means wider margins and greater earnings, which will give the banks' earnings a healthy boost. It has been an especially important development for Canada's banks because their growth opportunities have been constrained domestically by historically low interest rates, heavily indebted households, and a saturated market place.

One of the best positioned to cash in on higher interest rates is Canada's second-largest bank by assets: **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD).

Now what?

You see, Toronto-Dominion will benefit from higher U.S. interest rates because it is the 10th-largest retail bank south of the border and earns roughly a third of its net income from the U.S. The Fed's June decision to hike the benchmark rate by 25 basis points (bps) to a range of 1% to 1.25% was a key reason for the Bank of Canada's decision to increase the headline rate by 25 bps to 0.75%.

There are signs that the Fed will move to increase rates again over the course of the remainder of 2017, as it seeks to implement a balance sheet normalization program and unwind quantitative easing.

That will help to further boost the profitability of Toronto-Dominion's U.S. operations and ultimately its bottom line.

For the second quarter, Toronto-Dominion's Canadian retail banking business generated a margin of 2.81% which was four bps higher than a year earlier. Its U.S. retail banking operations had a margin of 3.05%, illustrating that this business is more profitable than its Canadian equivalent primarily because of higher U.S. interest rates.

Rate hikes are evidence of a stronger economy. In May 2017, Canadian manufacturing sales rose by 1.1% compared to the previous month, and first-quarter GDP expanded by a healthy 3.7%.

Stronger economic growth in Canada and the U.S. bodes well for increased credit demand, which will see Toronto-Dominion's loan book grow further, giving it the ability to profit from wider margins because of higher rates. It also indicates that business activity is rising and supports higher equity valuations — all bode well for increased activity at Toronto-Dominion's corporate banking, trading, and investment banking operations.

Another notable result attributable to firmer economic growth is the boost that it will give to credit quality. That means the costs associated with Toronto-Dominion's loan book, notably impaired loans, will fall.

So what?

For these reasons, the recent rate hike makes Toronto-Dominion an appealing investment, particularly when it is considered that higher earnings will support further dividend hikes. It is an institution with an established history of rewarding investors through regular dividend increases as its earnings grow. Toronto-Dominion has hiked its dividend for the last six years; it now yields almost 4%, and with a payout ratio of 46%, it remains sustainable.

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