1 Top Bank Stock to Benefit From an Improving U.S. Economy

Description

It hasn't been all plain sailing for Canada's banks. A saturated mortgage market, slowing housing market, increased regulations, and heavily indebted households are all poised to weigh on growth. That has garnered considerable negative attention for the major banks, including Canada's second-largest bank by assets, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), which is down by 2% since the start of 2018.

Now what?

The bank is the second most-shorted stock on the Toronto Stock Exchange after the **iShares S&P/TSX 60 Index ETF** (TSX:XIU), indicating that short sellers are betting on a major market meltdown. During that meltdown, Toronto-Dominion will be among the worst affected. It is easy to understand the rationale for this play. Recent scandals, the saturated nature of Canada's financial services market, and lack of growth opportunities, as well as a cooler housing market and the vulnerability of Canada's heavily indebted households to a financial crisis will all impact the bank.

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Nevertheless, the impact won't be as severe as many pundits believe.

The bank has also positioned itself for growth, focusing on expanding its U.S. retail banking operations where it is ranked as a top-10 bank.

Trump's fiscal stimulus, including slashing the corporate tax rate from 35% to 21%, will not only act as an important tailwind for economic growth south of the border, but it will also help Toronto-Dominion's U.S. earnings. Stronger U.S. growth will trigger rising employment, greater consumption, higher business confidence, and hence, increased demand for personal as well as business credit. The sharp decline in the corporate tax rate will further boost Toronto-Dominion's U.S. net earnings, which make up a third of the bank's total earnings.

A firmer U.S. economy and greater growth will more than offset Canada's cooling mortgage market and more restricted business as well as mortgage underwriting opportunities. First-quarter 2018 net income from Toronto-Dominion's U.S. retail banking business shot up by an impressive 19% year over year, and there is every sign that such impressive growth will continue.

Neither Toronto-Dominion's financial position nor its loan book are at risk, meaning that any Canadian economic downturn will not have any real impact in the bank. It is well capitalized with a common equity tier one capital ratio of 10.6% and an impressively low net-impaired ratio compared to total loans of 0.37%, which is an eight-basis-point improvement over a year earlier.

More importantly, 41% of Toronto-Dominion's domestic mortgages are insured, meaning that it is able to transfer the risk of default to the mortgage insurer. The remaining 59% of mortgages that are uninsured have conservative loan-to-value ratio of 51%, providing considerable room for the bank and borrowers to renegotiate the loan in the event of financial stress.

It is likely — because of its solid U.S. operational footprint and focus on cutting costs, while driving greater returns from existing customers — that Toronto-Dominion's earnings will continue to grow.

In response to rising government bond yields, the bank raised its mortgage rates to their highest in five years, boosting Toronto-Dominion's profitability. It is also investing heavily in digitizing its operations, which will allow it to more adequately service customers while reducing costs, further expanding margins.

So what?

Despite the short sellers, Toronto-Dominion is an attractive, valued addition to any portfolio at this time. While investors wait for the bank to unlock further value and for its stock to appreciate, they will be rewarded by its regularly growing and sustainable dividend, which yields 3.4%.

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mattdsmith

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