Even if a Trade War Erupts, This Canadian Bank Remains a Top Investment

Description

Fears of a trade war continue to build after Trump slapped tariffs on a range of imports, including US$50 million of goods from China, which has seen Beijing retaliate by placing tariffs on US$34 billion on a range of U.S. imports. The E.U. has also weighed in; stung by Trump's steel tariffs, it has launched a range of tariffs on U.S. imports worth US$3.4 billion. It appears that the conflict is only warming up, with Beijing vowing to match U.S. tariffs. Even Canada has retaliated, placing tariffs on $16.6 billion of imports from south of the border.

While this has alarmed markets and triggered fears that it could crimp global economic growth and perhaps even spark the next economic crisis, it shouldn't have investors overly concerned. Over the long term, these types of events typically have little lasting impact on quality businesses with wide economic moats. One stock that stands out as a solid long-term investment and will benefit from a stronger U.S. economy is **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD).

Now what?

Key to the substantial growth potential held by Toronto-Dominion is its U.S operations, where its subsidiary TD Group US Holdings LLC is ranked as the eighth-largest bank by total assets. That gives it considerable exposure to what is recognized as the world's single largest financial services market. In an important piece of recent news, the board of governors of the Federal Reserve System accepted Toronto-Dominion's capital plan, reflecting the strength of its U.S. banking operations, capital position, and risk-appetite framework.

Toronto-Dominion's U.S. business contributes just under 30% of the bank's total net income, and its bottom line is steadily growing. For the second quarter 2018, it reported net income of $845 million, which is a 15% increase year over year, and a notable 38% greater than it was for the equivalent period in 2016.

That solid growth should continue as the U.S. economic recovery gains further momentum.

The IMF has predicted that U.S. gross domestic product will expand by 2.9% year over year for 2018, which is 0.6% higher than the 2.3% reported for 2017. That will be underpinned by improving business confidence and greater consumer spending. Those factors will trigger an upswing in the demand for credit, particularly as businesses seek to expand their operations, because of Trump's fiscal stimulus, where he slashed the U.S. corporate tax rate to 21%.

The president has flagged the possibility of cutting the corporate rate even further to 20% when he looks at additional tax cuts later this year. That would certainly act as a powerful incentive for businesses to borrow, as their cash flow and earnings will grow.

The earlier tax cuts have directly benefited Toronto-Dominion's bottom line by reducing its overall tax expense.

Another important aspect of the bank's U.S. business is that a higher interest rate environment has boosted profitability. In June 2018, the Fed hiked the U.S. headline rate by 25 basis points to 2% and stated that there could be two more increases during 2018.

As a result of an earlier rate hike in March, which saw the U.S. headline rate move to 1.75%, Toronto-Dominion's U.S. retail bank's net interest margin for the second quarter expanded to 3.23% from 3.05% a year earlier. That growth will continue because of the June rate hike and the additional increases forecast for later this year.

Higher interest rates will lift margins and give the profitability of Toronto-Dominion's U.S. operations a healthy boost.

Importantly, Toronto-Dominion's overall financial health remains strong. It finished the second quarter well capitalized with a Common Equity Tier One Capital Ratio of 11.8%, which is well above the regulatory minimum, while the quality of its loan book remains high with a net impaired loan ratio of a low 0.36%. This indicates that the bank is well positioned to keep growing, while ensuring that the quality of its balance sheet and operations remains high.

So what?

Toronto-Dominion possesses considerable growth potential and is well positioned to benefit from the U.S. economic upswing underway. While investors wait for that to translate into a higher share price, they will be rewarded by its regular and sustainable dividend, which yields just over 3%.

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