Buy Toronto-Dominion Bank (TSX:TD) Today or Kick Yourself Later

Description

Canada's second-largest mortgage lender **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is the most heavily shorted stock on the TSX. This is being led by U.S. hedge funds, which, since the U.S. housing meltdown in 2006, have been searching for the next big short. They believe that they have found it in Canada, where a combination of a cooling housing market, heavily indebted households, lower-than-expected growth, and low-quality mortgages will cause the major banks to fall sharply in value.

While there are certainly headwinds ahead, the reasoning behind this investment thesis appears flawed and based upon a fundamental misunderstanding of Canada's housing as well as mortgage markets.

Solid start to the year

These headwinds didn't prevent Toronto-Dominion from reporting some credible first-quarter 2019 results. While reported net income of $2.9 billion was flat compared to the same period in 2018, net interest income shot up by 8% to $5.9 billion and non-interest income grew by 5% to $4.1 billion. That was supported by a 7% increase in the value of loans under management and marginal improvement in Toronto-Dominion's net interest margin (NIM). It was the bank's Canadian and U.S. retail banking businesses which were responsible for that growth.

Despite impaired loans surging by 16% in value, credit risk metrics remained well within acceptable parametres. Gross impaired loans (GILs) as a ratio of total loans came to a 0.53%, which was a mere 0.04% greater than a year earlier and well below the level that would spark concerns over a deterioration in credit quality. The sharp increase in the value of impaired loans can be attributed to Toronto-Dominion's U.S. banking business, where the unexpected collapse of a major U.S. utility caused impaired loans to skyrocket.

While the value of impaired loans for the bank's Canadian business expanded by 12% year over year, that was caused by a spike in commercial loan defaults rather than residential mortgages. In fact, the value of impaired Canadian residential mortgages for the first quarter 2019 fell by almost 1%.

That illustrates the strengths of Toronto-Dominion's mortgage-underwriting and risk-management strategies. Also, claims by hedge funds of low-quality loans and the growing inability of Canadian households to service debt are substantially overblown.

The bank's overall flat performance can be blamed on its Wholesale banking division, which reported a sharp 35% decline in revenue and a net loss of $17 million compared to a profit of $278 million a year earlier. This considerable decline in performance was caused by lower client activity, difficult market conditions, and the revaluation of a range of liabilities. It is anticipated that wholesale banking will deliver an improved performance over the remainder of 2019.

Unlike the more domestically focused banks, Toronto-Dominion is poised to experience strong growth because of its significant U.S. banking operations. It is ranked as a top-10 U.S. retail bank, and while the IMF recently marked down Canada's 2019 forecast GDP growth to 1.5%, the U.S. economy is expected to expand by 2.3%. That will trigger greater demand for credit, which — along with Toronto-Dominion's higher NIM south of the border — will drive higher earnings.

Regardless of the flat bottom line or the first quarter of the year, management expressed considerable confidence in Toronto-Dominion's outlook by hiking its dividend by 10% to see it yielding a tasty 4%. With a payout ratio of 44%, the dividend is not only sustainable, but there is every likelihood of further hikes, even if net income grows at a moderate pace.

Why buy Toronto-Dominion?

The bank is an income-producing machine and Toronto-Dominion's significant U.S. operations will mitigate the impact of the headwinds emerging in Canada, ensuring that its earnings will continue to grow. The claims by short-sellers that Toronto-Dominion is on the verge of experiencing a sharp decline in value because of a looming marked deterioration in credit quality are overbaked and absurd.

Toronto-Dominion's risk metrics, including those that measure credit quality, are well within acceptable levels, and a large portion of its Canadian mortgage portfolio is backstopped by mortgage insurance. If anything, the flat performance of the bank's stock over the last year, because of the considerable short interest, has created an opportunity for investors to acquire one of Canada's highest-quality dividend-paying institutions.

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