Emerging Trade Risk Won't Impact Toronto-Dominion Bank (TSX:TD)

Description

The risk of a major trade war between the U.S. and China has emerged once again after Washington and Beijing appeared to have settled their differences. This triggered considerable fear among financial markets across the globe, wiping 1% and billions of dollars of value off the TSX over the last month. It has also sparked concerns over the growth prospects for Canada's banks, with some pundits especially fearful that it will have a sharp impact on **Toronto-Dominion Bank**, (TSX:TD)(NYSE:TD), which is a top-10 rated U.S. bank.

The Big Five are already facing plenty of domestic headwinds, including a weaker-than-anticipated economy, cooling housing market, stricter prudential standards, and a saturated mortgage market. Those factors, according to some analysts, have curtailed the growth opportunities available to the major banks. They have also seen U.S. hedge funds and traders increase their short-selling of Canadian banks with **Royal Bank of Canada** now the most shorted stock by value on the TSX.

How will a trade war affect Toronto-Dominion?

There are fears that if the trade war between China and the U.S. intensifies, it will have a substantial impact on the U.S. economy, causing demand for credit to decline, negatively affecting the performance of U.S. banks. Trump has ratcheted up tariffs on US$200 billion of Chinese goods from 10% to 25% and is talking about upping tariffs on another US$300 billion of imports. China retaliated by hiking tariffs on US$60 billion of U.S. imports.

The view among economists is that the current tariffs could shave up to 0.1% off U.S. GDP, which is worth somewhere around US$2 billion in lost economic output.

This, it is believed, will have a notable impact on Toronto-Dominion, because it has expanded its U.S. operations, including wealth management and retail banking, to now be rated as a top-10 bank south of the border. There is a direct correlation between GDP growth and greater demand for credit, which indicates that banks will suffer if U.S. growth deteriorates. A weaker economy also means that therewill be a sharp uptick in loan defaults, impaired loans, and lending loss provisions, thereby increasingcosts as well as the amount of capital deployed to non-earning activities.

For the first quarter 2019, Canada's second-largest mortgage lender earned 32% of its net income from U.S. retail banking compared to around 23% five years ago. Most of that impressive growth came from significant increase in lending with gross U.S. loans expanding by 75% since 2014.

Toronto-Dominion has also made a large investment in growing its TD Ameritrade platform and related businesses in the U.S. If there is a sharp economic downturn, investment as well as trading activity will decline, along with demand for loans, further impacting Toronto-Dominion's earnings.

Nonetheless, the impact of a trade war upon the U.S. economy may not be as severe as markets believe.

Previous concerns were shown to be overblown when the White House and Beijing finally came to an agreement. According to *CNN Business* both economies are heavily reliant on the other, meaning that it could very well amount to political suicide for both the administrations if they allow a full-blown conflict to emerge.

While a trade war will cause growth to slow, it likely won't have a substantial enough impact to materially derail the U.S. economy or demand for retail banking products and services. Economists believe that a trade war won't push the U.S. economy into recession and will likely have a minimal impact, shaving a mere 0.1% off GDP. That means Toronto-Dominion's U.S. earnings will not be as significantly impacted as some pundits believe.

What does it all mean?

It isn't difficult to see the bank's earnings continuing to grow, albeit at a slower pace. Toronto-Dominion remains a premier long-term investment for Canadian investors seeking domestic and U.S. exposure. While they wait for its stock to appreciate, they will be rewarded by its regularly growing dividend, which yields 4%.

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