Is a Recession in Canada on its Way?

Description

Markets continue to price in an economic downturn for Canada, despite the more positive outlook being expressed by the Bank of Canada. The pessimism runs so deep that the yield curve has inverted with three-month government bonds yielding more than 10-year bonds. When that occurs, it is typically treated as a sign of a looming economic slump.

Is an economic downturn imminent?

While the economic outlook may not be as bright as originally anticipated, especially with the International Monetary Fund (IMF) downgrading Canada's forecast 2019 GDP growth to 1.5%, it is not as severe as the market believes. Key among the emerging headwinds, which have the market deeply concerned, is the brewing trade war between the U.S. and China.

It is assumed that Canada has considerable exposure to China with the world's second-largest economy being responsible for 4.7% of the value of all exports. While this is fueling considerable market pessimism, it appears overbaked. China may be Canada's second-largest export partner, but Canada accepts more in imports than it does of its exports. This is reflected in the 2018 US$37 billion trade deficit with the East Asian nation. Canada's largest and most important trade partner is the U.S., which accepted US$338 billion or three-quarters of its exports, leading to a 2018 trade surplus of US$103 billion.

Some economists believe that if even a full-blown trade war erupts, which is unlikely, the impact on the U.S. economy will be minimal, especially when compared to China. The Bank of Canada believes that the current headwinds are short term and remains optimistic on the economic outlook. The central bank's position is supported by the latest economic data, which shows stronger retail sales and employment.

The outlook certainly remains mixed, but it is doubtful that a full-blown trade war will commence; even if it does, the long-term impact on the economy won't be as severe as financial markets currently believe. An interesting play on the current mixed expectations is **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), which has aggressively expanded its operations in the U.S. to become a top-10 bank. The global financial crisis of over a decade ago demonstrated the resilience of Canadian banks to external economic crises.

Toronto-Dominion’s considerable exposure to the U.S., where it earns around 43% of its net income, will mitigate the impact of weaker Canadian growth. Even if a trade war breaks out, U.S. GDP is still expected to expand by over 2% annually, which is greater than the 1.5% forecast for Canada. That will drive greater demand for credit and other financial services from Toronto-Dominion’s U.S. operations.

Furthermore, if Canada’s economy picks up in going in 2020, as some economist anticipate, Toronto-Dominion will benefit from stronger domestic demand for its products and services. While the national housing market has cooled, real estate brokers and analysts are expecting an uptick in sales activity and prices going into 2020. This will drive mortgage demand higher, which is a key earnings-growth driver with Canadian net interest income from mortgages and other loans responsible for 30% of Toronto-Dominion’s bank-wide revenue.

The focus of the Bank of Canada and the Office of the Superintendent of Financial Institutions on ensuring the financial system’s stability through tighter mortgage underwriting, stress tests, and compulsory insurance for all mortgages with a deposit of less than 20% means there won’t be a massive surge of impaired loans should the economy weaken.

Putting it together for investors

With Toronto-Dominion’s market value remaining flat over the last year, it has created an opportunity to acquire Canada’s second-largest lender before its stock rallies. While patient investors wait for that to occur, they will be rewarded by Toronto-Dominion’s steadily growing regular quarterly sustainable dividend payment yielding just under 4%.

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