Why Did Canadian Bank Stocks Rally on U.S. Economic Data Last Week?

Description

Last week, the U.S. Bureau of Labor Statistics released surprisingly positive economic data, with our neighbours to the south having added 128,000 jobs compared to the 75,000 forecast.

The numbers predictably led to a rally in U.S. equities. Not only did the economy add more jobs than expected, but the Fed cut interest rates around the same time, so investors got a double dose of good news.

We'd expect that much. What was surprising was the fact that Canadian bank stocks rallied at the same time, despite the most recent Canadian economic data having been negative. Statistics Canada recently released an economic report that showed sluggish 0.1% growth in August — unchanged from July and just barely up year over year.

Given that Canadian banks are largely domestic focused, it's not entirely clear why they rallied. However, as you're about to see, there are several ways that Canadian banks can benefit from strong economic performance down south.

Some Canadian banks have large U.S. operations

One of the main ways that strong U.S. numbers could benefit Canadian banks is by driving activity at their U.S. branches. Many Canadian banks have large and growing U.S. operations and thus benefit directly from any prosperity south of the border.

The classic example here is **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD). Not only is U.S. retail the company's second-largest business unit, contributing 38% of profits in the most recent quarter, but it's also ninth place in its market, making it a major U.S. player.

TD Bank's U.S. operations are growing much faster than its Canadian ones, thanks in no small part to the fact that the company simply has more room to grow in that country. However, faster economic growth in the States can also drive growth in TD's U.S. retail business, especially with factors like lower interest rates creating favourable conditions for borrowing.

U.S. economy has spillover effects on Canada

It's easy enough to understand why U.S. economic growth would drive U.S.-oriented Canadian banks higher. It's less obvious why that would affect other banks. Although TD and **CIBC** have major U.S. operations, the rest of the Big Six don't have much to speak of, so it's not entirely clear why they rallied along with their colleagues.

There are a few possible reasons why this happened.

One is the simple fact that institutional investors tend to buy stocks in large, diversified baskets. For this reason, stocks in a sector that's seeing strength may rise with their peers — even if there's no fundamental reason for it to happen.

A more important reason is the fact that U.S. economic growth has spillover effects on Canada. According to the U.S. Department of State, 20% of Canadian exports go to the U.S., which means that there is more demand for Canadian goods when the U.S. economy is strong. So, growth in the U.S. may anticipate future growth in Canada.

Time to buy the banks?

It's certainly encouraging to see good news coming out of the U.S., which has been locked in a bitter trade war for most of this year. Warren Buffett famously loaded up on U.S. banks last year, seeing their prospects as strong in the current economy. Whether the same thesis applied to Canadian banks remains to be seen, but it's fair to conclude that U.S.-oriented Canadian banks like TD could have upside.

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2025/09/18
Date Created
2019/11/05
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