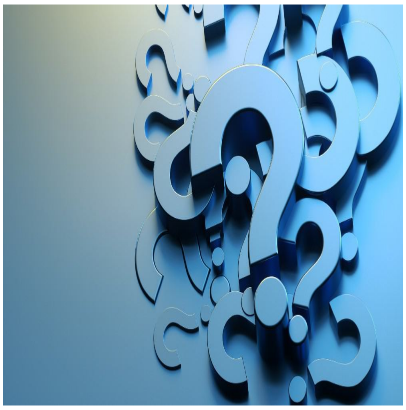

Stock Market Rally: Is TD Bank (TSX:TD) Still Cheap?

Description

Despite the recent stock market rally, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) stock is still cheap by traditional metrics. It trades at 8.6 times earnings and 1.24 times book value — both very low ratios.

However, these valuation metrics are based on trailing 12-month data. TD's earnings will likely be much lower this year than in past years. It's impossible to say by how much, but we'll get a clue on May 28 when the bank releases its Q1 quarterly report. In the meantime, we can speculate about the possible impact by looking at other banks that have released earnings recently.

Likely earnings impact of COVID-19

COVID-19 will have a huge impact on TD Bank's earnings in Q1 and Q2 at minimum.

There are three factors at play that make this inevitable. First, mortgage deferrals are going to take a bite out of interest income. Second, loans made to oil and gas companies are very likely to go into default. Third, credit cards, which were already a concern for Canadian banks pre-COVID, will get even riskier with borrowers out of work.

So, despite the recent stock market rally and the optimism surrounding it, TD Bank is facing a lot of risk factors. These are guaranteed to hit earnings in Q1 and Q2. They could remain in play long after that.

However, there are reasons to believe that the bank's earnings may be better than expected. To understand how that could be the case, we need to look at another bank that released earnings recently: **JP Morgan Chase** (NYSE:JPM).

The JP Morgan case study

On the surface, JP Morgan's Q1 earnings were awful. The bank earned $2.87 billion, down from $9.2 billion in the same quarter a year before. That's a 69% decline. However, a huge part of the earnings decline was provisions for credit losses (PCLs).

PCLs are funds banks put aside to cover potential loan losses. Because of accounting rules, any money committed to PCLs reduces net income. However, it doesn't represent a cash loss unless the expected losses materialize.

In Q1, JP Morgan's PCLs increased by $6.8 billion. That accounts for the vast majority of its loss. Revenue was only down 3%. So, most of JPM's Q1 loss was not a cash loss. Of course, banks don't set aside PCLs for no reason. They're expecting borrowers to default.

If JP Morgan's loan losses add up to what it's expecting, then that would be crippling for the bank. But it's not guaranteed. If most of JPM's borrowers come through, then the bank will eventually be able to reduce its PCLs, which will improve earnings.

This brings us back to TD Bank. If its earnings are anything like JP Morgan's, then its actual cash losses could be much lower than expected. It will likely have to ramp up PCLs dramatically, but who knows if the expected losses will materialize? If they don't, then the bank will prove to have been undervalued at today's prices.

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