Why an Emerging Market Crisis Could Negatively Affect Bank of Nova Scotia (TSX:BNS)

Description

Emerging markets are coming under increasing pressure because of a stronger U.S. dollar, growing trade tensions and higher oil, triggering considerable turmoil among some of the world's most fragile economies. Those with large current accounts deficits, considerable amounts of U.S. dollar denominated debt and substantial short-term funding needs are among the most vulnerable. These fears have caused emerging markets to tank, as evidenced by the **iShares MSCI Emerging Markets ETF** (NYSE:EEM) plummeting by 12% since the start of 2018.

Now what?

Among the most susceptible is Argentina, which recently secured a US$50 billion life line from the International Monetary Fund (IMF). To defend the value of the peso, the Argentine central bank hiked the headline interest rate to 40%.

Turkey, which has clashed with the Trump administration over a range of political and economic issues, including trade, is also particularly vulnerable. The nation's currency, the lira, has plummeted by almost 40% since the start of the year against the U.S. dollar. That marked decline along with fears of further economic ructions has sparked a considerable uptick in capital outflows, placing further pressure on Turkey's economy. Because of the links between Turkey and other fragile emerging economies, there are fears that a broad-based crisis could flare up across developing economies globally.

The fast unfolding crisis that has roiled financial markets and threatens to engulf a broad swathe of emerging markets in Asia and Latin America is being significantly exacerbated by Trump's approach to trade. His plans to impose a raft of tariffs on a range of U.S. imports, including steel and aluminum as well as a variety of manufactured goods (mostly from China) has the potential to cause significant economic harm to developing economies. This is because many are highly dependent upon the extraction and export of commodities including base as well as precious metals, coal and oil to drive economic growth.

The outbreak of a trade war would crimp global economic growth while causing manufacturing activity in China to weaken, leading to a notable decline in the consumption of metals and energy. This would significantly impact many emerging markets, which, because of a lack of fiscal discipline, high levels of U.S. dollar denominated debt and an overreliance on foreign investment to drive fiscal income as well as growth are extremely vulnerable to such a crisis.

The contagion would spread as fearful investors pulled their capital out of riskier emerging markets and put it into perceived traditional safe havens such as U.S. bonds. This would also cause the dollar to strengthen, placing even greater pressure on already frail heavily indebted economies thereby magnifying the impact of weaker currencies and waning fiscal income.

So what?

In the event of yet another crisis in emerging markets, one Canadian stock that would be hit hard is the third-largest bank by assets, **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS). Known commercially as Scotiabank in recent years, the bank has invested heavily in bulking up its operations in Latin America, particularly in the commodity dependent economies of Chile, Colombia, and Peru.

Because of this investment, Scotiabank now earns almost a third of its net income from international banking, which is focused on those nations and Mexico. This means that any major downturn among Latin America's commodity dependent economies would be a significant headwind for the bank, as it would see an uptick in impaired loans, higher lending loss provisions and lower growth.

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