



## Is It Time to Avoid Risky Exposure to Emerging Markets?

### Description

Emerging markets have fallen sharply to see the **iShares MSCI Emerging Markets ETF** plummet by a whopping 17% since the start of 2018. While some pundits claim that this has created an opportunity for investors seeking to diversify their portfolios and bolster their exposure to rapidly expanding developing economies, there are indications of worse times ahead.

A combination of weaker currencies, declining commodities prices, deteriorating global economic growth and a lack of fiscal stability in many emerging economies will weigh upon them for some time to come. Those hazards have even sparked fears of another crisis in emerging markets, which has the potential to spill over into developed economies. This would impact the performance of Canada's most international bank, **Bank of Nova Scotia** ([TSX:BNS](#))([NYSE:BNS](#)), which has built a [substantial business](#) in Latin America.

### Now what?

One of the [greatest appeals](#) of emerging markets for investors is their rapid rate of economic growth, which provides the opportunity to earn outsized returns. However, they are exposed to greater risk than developed markets, and the latest developments indicate that the worst is not over.

A stronger U.S. dollar and higher U.S. interest rates are weighing heavily on many developing nations. As their currency weakens against the dollar and interest rates rise, the cost of their dollar-denominated debt soars.

In recent years, because of near zero interest rates, many developing countries gorged themselves on dollar denominated debt. Those with the largest volumes include Argentina, Mexico and Turkey, which along with a lack of fiscal discipline, makes them vulnerable to an economic crisis. Argentina already had to approach the International Monetary Fund (IMF) for an emergency loan, which at US\$57 billion dollars was the largest in the fund's history.

Another threat to the economic stability of many emerging markets is sharply weaker commodity prices. Many, like Colombia, Peru and Chile, are caught in the extractive trap where the production of commodities such as base metals, precious metals, oil and coal are responsible for generating

significant export earnings and fiscal revenues, making them key drivers of economic growth.

Colombia, where Scotiabank is the fifth largest bank, generates over half of its export earnings from petroleum and roughly a fifth of fiscal revenues accumulated by the government. Crude has weakened sharply in recent weeks, placing considerable pressure on the Colombian peso and Bogota's budget.

It also means that growth in Colombia will slow significantly unless oil rallies in coming weeks. For 2016 and 2017, when oil prices were at their weakest, Colombia's GDP expanded by less than 2%. It's extremely unlikely that if the current bear market for crude continues that the Andean nation can achieve the 2.8% forecast for 2018 or the 3.6% for 2019. This will undermine the efforts made by Bogota to make Colombia an [attractive destination](#) for foreign investment.

This will also weigh heavily on economic growth and the performance of Scotiabank's international business because of its considerable exposure to Colombia.

You see, when the economy weakens, it not only causes lending growth to slow, but loan defaults tend to rise at a sharp clip, thereby increasing the volume of lending losses and the need for credit loss provisions. That further magnifies the impact of lower than expected GDP on the performance of banks operating in those economies, as there's a direct correlation between economic growth and the demand for credit as well as other financial products.

Scotiabank will likely experience a similar phenomenon in Chile, where foreign denominated debt totals over 50% of the value of that nation's GDP. Through a series of acquisitions, Scotiabank is the third largest privately-owned bank in what is considered Latin America's most developed country. Chile is highly dependent on copper mining for export earnings, economic growth, and fiscal revenues. Over the last year, copper has weakened noticeably, falling by 9% in value. The increasingly pessimistic forecast for global economic growth will weigh on copper prices as well as those for other base metals like lead and zinc.

### **So what?**

Further weakness in commodities and a stronger U.S. dollar will have a marked impact on growth as well as earnings for Scotiabank because of its international operations, which are responsible for almost a third of its net income. The bank has focused on expanding its retail and business banking operations in Colombia and Chile, so it is exposed to the fallout of weaker commodity prices and a stronger dollar for those economies.

### **CATEGORY**

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2. Investing

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1. NYSE:BNS (The Bank of Nova Scotia)
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