Forget Fears of a Housing Crash and Buy Bank of Nova Scotia (TSX:BNS)

Description

There are significant concerns about the prospects for Canada's banks. Not only are there fears of an imminent housing meltdown but increased mortgage regulation and the saturated nature of Canada's financial services market are weighing on their outlook.

As result, four of the Big Six banks are among the 10 most shorted stocks on the TSX. This includes **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), which is ranked as the eighth most shorted stock. Many of those short-sellers are U.S. investors and hedge funds that are correlating the conditions in the domestic housing market to those that existed in the U.S. during the run-up to the 2006 housing meltdown, which triggered the worst financial crisis since the Great Depression.

A U.S.-style housing bust won't occur

While Canada's housing market does appear vulnerable, it has cooled since 2017 and doesn't possess many of the characteristics that led to the 2006 U.S. housing meltdown. South of the border, it was the confluence of the large volume of subprime mortgages, securitized mortgage derivatives, an oversupply of housing and cascading housing prices which were responsible for triggering the crisis.

In 2006, it was estimated that subprime loans made up a third of all mortgages originated in the U.S., whereas in Canada, because of significantly tighter prudential regulation, it is estimated that they make up less than 5% of all mortgages issued.

Furthermore, any mortgage where the borrower makes a down payment of less than 20% is required to be covered by mortgage insurance, which protects the lender against default. This forms an important backstop that will mitigate any crisis should an external event sharply impact Canada's heavily indebted households, triggering widespread mortgage defaults.

Those loans that aren't insured across Canada's major banks have an estimated loan-to-value (LTV) ratio of around 70%. In the case of Scotiabank, the LTV of its uninsured Canadian mortgage portfolio is a mere 64%, giving plenty of room to renegotiate loans should housing prices collapse or there be a deluge of defaults.

Outlook remains soft

The greatest risk for Canadian banks is that stricter mortgage regulations, heavily indebted households, and a saturated domestic financial services market are all crimping their opportunities for further growth. This is apparent when reviewing Scotiabank's first-quarter 2019 results, where loans and acceptances for its Canadian banking business only grew by 4% year over year to $342 billion, while revenue only expanded by a paltry 3%.

Nonetheless, Scotiabank — unlike the more domestically focused Canadian banks — is uniquely positioned to avoid these headwinds. This is because it has built a significant operational footprint internationally, notably in Latin America — in Mexico, Chile, Colombia, and Peru, which form the economic bloc known as the Pacific Alliance. That investment saw international banking responsible for generating 40% of Scotiabank's first-quarter 2019 adjusted net income compared to 26% five years earlier.

This makes Scotiabank's international business an important driver of growth.

The IMF anticipates that the economies of Chile, Colombia, and Peru will grow at a solid clip with their 2019 GDP expanding by well over 3% compared to Canada's 2%. For the first quarter, Scotiabank's revenue from its Latin American business grew by a healthy 29% year over year on the back of a very impressive 41% increase in loan and acceptances.

That solid growth can only continue because of the recovery in commodities — especially oil and base as well as precious metals, which are key exports and hence drivers of economic growth for Colombia, Peru, and Chile.

It should also be considered that all of Scotiabank's key risk indicators remain well within acceptable parameters. Credit quality remains high, as indicated by the net impaired loans ratio for the first quarter, falling by two basis points year over year to 0.61%. The bank is also more than adequately capitalized with a tier-one capital ratio of 12.5%.

Is it time to buy Scotiabank?

The additional growth provided by Scotiabank's considerable Latin American business will drive earnings higher at a solid clip over coming years, particularly if commodity prices remain firm. When this is considered in conjunction with its high credit quality and resilience to a housing correction, it is a must-own banking stock for any portfolio. While investors wait for its share price to rally further, they will be rewarded by its regularly growing and sustainable dividend yielding a juicy 5%.

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