Diversify Internationally With This Canadian Banking Giant

Description

If the statements being made by U.S. hedge funds and renowned trader of *Big Short* fame Steve Eisman are to be believed, Canada's banks are facing a reckoning that will cause their stock to plunge. Central to this thesis is how a normalization of the credit cycle will trigger a sharp influx in the volume of overdue and impaired loans, leading to higher provisions and a spike in credit losses.

The mixed results from the latest earnings season for Canada's banks appear to have confirmed that the outlook remains poor. For these reasons, they are being heavily targeted by short-sellers, seeing the Big Five ranked among the 10 most shorted stocks on the TSX. While there are considerable headwinds facing Canada's largest lenders, they are not as severe as the short-sellers believe.

Boost exposure to rapidly growing Latin America

Canada's most international bank, **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), is uniquely positioned to avoid the worst of those headwinds. This is because over the last decade, it is has invested significant capital in expanding is operational footprint in Latin America, where it is ranked as a top-10 bank in Mexico, Colombia, Peru and Chile. That gives it exposure to some of the fastest-growing and underbanked economies in the Americas.

The commodities recovery, which commenced in 2017, has seen many of the region's economies return to growth. Firmer base metal prices, including copper, lead, and zinc, will continue to support the economic recovery underway in Chile and Peru, while the outlook for Colombia is improving because of oil's recovery. This saw the International Monetary Fund (IMF) estimate that Chile's GDP will expand by 3.4% in 2019, while Colombia's is forecast to grow by 3.5% and Peru by a whopping 3.9%. Those growth rates are far greater than the 1.5% forecast for Canada.

When it is considered that there is a direct correlation between economic growth and greater demand for credit, it is easy to see Scotiabank's net interest income from Colombia, Chile, and Peru expanding at a solid clip.

This will go a long way to offsetting slower growth and diminished profitability from Scotiabank's

Canadian operations.

Disappointing results

Scotiabank reported disappointing second-quarter 2019 results, missing the consensus analyst estimate because of a poor performance by its global banking and markets division as well as flat results from its Canadian banking business.

Nonetheless, international banking delivered a stellar performance, which was driven by Scotiabank's operations in Colombia, Chile, and Peru. Revenue from Scotiabank's businesses in the Pacific Alliance countries of Mexico, Chile, Colombia and Peru shot up by 22% year over year on the back of solid loan and deposit growth.

Those nations are poised to deliver solid results over the remainder of 2019 and into 2020 because of strong economic growth, young and growing populations, and expanding wealth driving greater demand for credit as well as other banking products. Scotiabank's Latin American operations are also more profitable because of higher headline interest rates in the region, meaning that the second-quarter international banking net interest margin of 4.58% is significantly higher the 2.46% reported for its Canadian business.

The completion of recent acquisitions in Colombia and Chile will see costs fall and earnings rise as greater efficiencies are unlocked.

The ongoing rollout of Scotiabank's digitization program will reduce costs across the board, drive greater efficiencies, and increase its customer penetration, leading to greater profitability and higher earnings.

Credit quality remains high with a gross-impaired-loans ratio of 0.89%, and the bank is well capitalized with a common equity tier one capital ratio of just over 11%. When those characteristics are combined with 42% of all Canadian mortgages being insured and a low average loan-to-value ratio of 55% for uninsured loans, it is highly unlikely that the prevailing headwinds will have a notable impact on Scotiabank's financial strength.

Foolish takeaway

For these reasons, Scotiabank remains a top long-term investment that provides diversified exposure to Latin America. While investors wait for that to propel its stock higher, they will be rewarded by its sustainable, steadily growing dividend, which yields a juicy 5%.

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Date
2025/08/21
Date Created
2019/06/10
Author
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