Bank of Nova Scotia (TSX:BNS) Is the Most Vulnerable Canadian Bank to a Global Recession

Description

Canada's banks continue to attract considerable negative attention, with the Big Five banks among the 10 most shorted stocks on the **TSX.** Most of that negative attention is coming from U.S. hedge funds in the belief that the conditions that exist in Canada are similar to those that prevailed in the U.S. in the lead-up to the housing melt down and emergence of the global financial crisis.

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Even renowned short-seller Steve Eisman of Big Short fame has doubled down on shorting Canadian banks, as he believes that a deterioration in credit quality will have a sharp impact on the performance of the banks.

Canada's most international bank, **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), is the most shorted stock on the TSX, followed by **Toronto-Dominion Bank** in third place and **Royal Bank of Canada** as the fourth most shorted stock.

There are signs that Canada's Big Five banks are vulnerable to a range of global economic headwinds, and Scotiabank is the most exposed to the threat of a global recession.

Why is Scotiabank vulnerable?

The bank has rapidly expanded into the South American nations of Colombia, Peru, and Chile, where Scotiabank is a top 10 ranked bank. Those emerging economies are highly dependent upon global demand for commodities — notably oil and base metals — to drive growth.

The ongoing trade war between the world's two largest economies, the U.S. and China, is fanning fears of a global economic slowdown and recession. There is also the slowdown in manufacturing across most major industrial economies, including Germany, the U.S., China, India, Japan and South Korea, which is further impacting the outlook for many commodities, notably energy and base metals.

The international oil benchmark Brent has lost 30% over the last year, while copper and zinc have both weakened by 8%.

That doesn't bode well for GDP growth in those countries, with the International Monetary Fund (IMF) recently downgrading its outlook for Latin America, shaving over 1% off the projected GDP growth for Colombia, Chile and Peru.

Weaker growth coupled with deteriorating credit quality in the region will have a sharp impact on Scotiabank's earnings, as its international division was responsible for roughly 40% of bank's total third quarter net income.

In addition to the deteriorating economic conditions in Latin America, which are being magnified by a strong U.S. dollar and weak regional currencies, Colombia is facing a fiscal crisis and the re-emergence of a decades' long civil war. That will certainly crimp growth in the Andean nation, where Scotiabank is the fifth-largest lender.

Weighing further on Scotiabank's performance is the weak Canadian economic outlook, with the IMF recently downgrading its GDP growth forecast for 2019 to 1.5% and 1.8% in 2020.

When considered in conjunction with a softer housing market, heavily indebted households and falling exports, it's difficult to see Scotiabank experiencing the robust growth to which shareholders have become accustomed.

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For the third quarter of 2019, Scotiabank reported a return on equity of a mere 11.5%, the weakest of the Big Five banks, indicating that it's struggling to deliver value for shareholders.

Foolish takeaway

Because of its international focus, particularly to some of the most vulnerable economies in Latin America, Scotiabank is the most exposed of the Big Five banks to the fallout from a global recession.

It's likely that as the world economy slows further. Scotiabank's earnings will decline, especially because international banking over the last four years has become an important growth driver for the lender.

That will have an impact on its market value, causing its stock to decline, particularly given that Scotiabank has gained 12% since the start of 2019. This will create an opportunity to acquire a quality financial institution at an attractive valuation and lock-in a 5% dividend yield.

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