Why Bank of Nova Scotia (TSX:BNS) Has Lost 29% Since the Start of 2020

Description

Canada's banks have been hit hard by the coronavirus pandemic. Among the most harshly impacted is **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), which is down 29% for the year to date. That is the third-worst performance behind **Bank of Montreal** and **Canadian Imperial Bank of Commerce**.

There are a range of reasons for Scotiabank's sharp decline, many of which it shares with other Canadian banks. Nevertheless, a key reason is Scotiabank's considerable exposure to Latin America.

Declining performance in Latin America

Scotiabank, over the last decade, has built a sizable business in the Latin American nations of Mexico, Colombia, Peru, and Chile. It is a top-10-ranked bank by assets in all four countries, which are part of a trade pact known as the Pacific Alliance. Those operations became a major driver of earnings growth and profit centre for Scotiabank.

By the end of 2019, international banking generated 36% of Scotiabank's net income compared to around 23% five years earlier. Most of that growth has come from the Pacific Alliance nations.

A key issue is that Mexico, Colombia, Peru, and Chile were already facing economic headwinds before the arrival of the coronavirus pandemic. That is evident from Scotiabank's fiscal first-quarter 2020 earnings.

International banking's return on equity, a key profit measure, fell by 3.2% year over year to a poor 10.6%. Net income for the period plunged by 30% compared to a year earlier. That is a direct result of weaker economies in Latin America that saw regional central banks reduce headline interest rates to stimulate growth. This led to lower margins for Scotiabank's international business and increased impaired loans, impacting divisional earnings.

Worsening outlook

The headwinds faced by Latin America's economies are being exacerbated by the coronavirus pandemic. This is because many nations in the region have weak health systems and poor infrastructure. That forced some nations, including Colombia and Peru, to implement total lockdowns to prevent the spread of the virus.

The shuttering of all but non-essential services has caused vulnerable economies across Latin America to falter. This is being magnified by a broad global economic slump as well as major trade partners, the U.S. and China, experiencing their own economic crises. Both are key export partners for the goods produced by Mexico, Colombia, Peru, and Chile.

Softer commodities

A marked drop in the value of many commodities, including oil and base metals, is further affecting regional economies. Most Latin American economies are caught in the extractive trap. This is where the production and export of commodities such as oil, copper, zinc, and lead are key drivers of economic growth.

For these reasons, Colombia, which is Latin America's third-largest oil producer, is facing economic ruin after the latest oil price collapse. Economists estimate that Colombia's gross domestic product (GDP) will contract by anywhere between 1.5% and 7% during 2020.

This, along with unemployment tipped to reach as high as 16% will cause demand for banking products including loans and deposits to crash. A sharp decline in the quality of existing loans will cause impaired facilities and lending loss provisions to rise.

Scotiabank has considerable exposure to Colombia, because it is the fifth-largest bank in the strife-torn Andean nation. Chile and Peru's economic forecasts are not as poor as Colombia's, but GDP in both nations is expected to contract, further weighing on Scotiabank's regional earnings.

Looking ahead

The poor economic outlook for the Pacific Alliance nations will weigh heavily on Scotiabank's earnings. It will exacerbate a sharp decline in the profitability of its Canadian banking and capital markets operations. There are signs that the market has yet to fully price in the impact of such a poor outlook for Scotiabank's international business. That means the bank's stock will likely fall further in value over coming months.

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