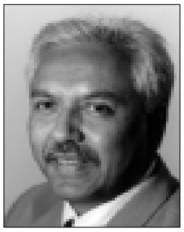
Banking turmoil makes Scotiabank a must buy

By Sunil Vidyarthi



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There are altogether 420 phobias listed on the Internet (*www.phobialist.com*), but not one of them has to do with stock markets or investments. There is chrometophobia or chrematophobia — the fear of money, but that doesn't quite explain what is happening in the markets this summer.

Investors, rather quickly, have gone from an overwhelming desire to get rich (greed) to a gripping fear of losing money. I would say investors are currently experiencing something akin to acrophobia — fear of heights. Last time this phobia roiled the market was during the technology boom of the '90s and, before that, in 1987.

Let me dare say that this time is different from either of the two previous citations. The market is neither trading at nosebleed multiples of 1999, nor has it gone up by 40 per cent in a short period of time while rates are rising (1987).

No, for some reason, a modest 2004 (Dow Industrials up by a mere 1.1 per cent), a losing 2005 (-0.6 per cent) and a make-up 2006 with a return of 16 per cent has everyone thinking we have gone too far too fast.

Actually, it has little to do with stock-market heights and more to do with grossly overvalued real estate all over the world, but particularly in parts of the U.S. Does anyone really know how much of U.S. mortgages is subprime or how much of prime could also be affected? Even more importantly, what is the extent of this contagion? Last time we had a housing- finance crisis in the U.S. (early '90s) people were convinced Citibank was toast. Who will it be, this time?

So what happens if there is no free money around for investors, hedge funds and venture capitalists? The lenders and brokers who have been making hay recently are likely to suffer quite significantly, and that is reflected in a near 30 per cent haircut among U.S. brokerage houses like Bear Sterns, Goldman Sachs and Lehman Brothers. Most banks have also been damaged over the last couple of weeks.

For Canadians, the situation should be far better. Our banks, because they don't have to compete much, offer little easy money to home buyers. And, no bank here will let you walk away from your mortgage without something drastic like a bankruptcy.

So, it is safe to say that it won't be the domestic mortgage holders who would be doing our banks in. But wait; haven't these boys been parlaying money they earn from you and me into "investments" out of the country? Aren't Royal, BMO CIBC and TD hot for many U.S. banks? So, how much of that party is coming back home as a hangover? I have left out **The Bank of Nova Scotia** (BNS-TSX, $50.83) from this list on purpose, as its mission appears to be differently aligned — more with countries other than North America.

BNS provides a full range of banking and investing services to more than seven million retail, wealth-management, small-business and commercial customers across Canada through a network of 972 branches and 2,742 automated banking machines (ABMs), three call centres, four dealer-finance centres, six commercial and business-banking centres, 100 wealth-management branches as well as telephone and Internet banking.

Internationally it has retail and commercial-banking operations in more than 40 countries outside of Canada and includes operations in four geographic regions: Caribbean and Central America; Mexico; Latin America; and Asia Pacific. In the Caribbean and Central America, the bank operates in 25 countries with 372 branches and offices and a network of 884 ABMs. Through 97 per cent-owned Grupo Financiero Scotiabank Inverlat, S.A. de C.V., the bank serves more than 1,400,000 personal, commercial and corporate customers in Mexico through 494 branches and 1,122 ABMs.

In Latin America, the bank's holdings include a 99 per cent interest in Chilean bank Scotiabank Sud Americano, S.A. (53 branches), 77.6 per cent-owned Scotiabank Peru, S.A. (140 branches) and an affiliate in Venezuela. In Asia Pacific region, the bank operates in nine countries with 24 branches and offices.

Note that U.S. is not a key focus for BNS. I do not necessarily agree with that stance since being absent there can have negative repercussions as that economy does finally turn the corner. But as for now, it is in a unique position as being a large industrialized Canadian bank with thin exposure to a potential credit meltdown in the U.S. And that is why the current drop in Scotia's stock price by nearly 15 per cent appears very much like "throwing out the baby with the bath water."

Should we then pick up BNS shares now? If you don't have any, you must. If you do, you may want to watch this movie play out before putting more money to work.

Fundamentally, things couldn't be better for this bank. It has delivered a return on equity of 17 per cent to 22 per cent every year since 2000, yet the stock trades at 12 times earnings per share. According to our model the high price for BNS should be $64, which it might scale in another time when investors conquer their acrophobia, at least temporarily.

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