

# Flash commentary

UBS Asset Management | **Turkey update**

After a 50% drop in the Turkish lira against the US dollar since the end of June, **Erin Browne, Head of Asset Allocation**, explains the drivers to the fall and what it means for wider markets.

## **Why has the Turkish lira collapsed against the US dollar?**

Loose fiscal policy, rampant inflation, a large current account deficit, high levels of unhedged US dollar borrowing by corporates and a fast-escalating diplomatic stand-off between Turkey and the US are some of the main reasons behind the recent collapse in the Turkish lira (TRY).

In somewhat of a vicious circle, investor fears about the ability of Turkish corporates to service US dollar loans due to the weakening currency are placing further pressure on the Turkish lira just as rumors about the introduction of capital controls have also added to market stress.

But more than anything the disorderly market reaction of recent days reflects, in our view, investors' growing concerns about the likelihood that a sustainably credible plan to address these issues will emerge under a president that to-date has been dismissive of economic orthodoxy and the views of international investors.

Over the weekend President Erdogan added fuel to an already well-established fire with accusations of an international conspiracy against Turkey, further combative rhetoric towards the US and a diatribe against the 'evil' of higher interest rates. In short, precisely the opposite of what international investors wanted to hear.

## **How did Turkey get to this point?**

The shift from a parliamentary democracy to what is now effectively an executive presidency in Turkey with few checks and balances accelerated last April in a constitutional referendum that abolished the role of prime minister, truncated parliament and gave Erdogan sweeping powers over the judiciary and the power to make law by decree. Perhaps foreseeing where the economy was headed, Erdogan called early general elections in June where he won a narrow majority that brought those changes into force.

While Erdogan's hostility towards higher interest rates is nothing new, markets were previously prepared to at least partly dismiss it as somewhat co-incident to the country's overall economic policy. But it has become clear that Erdogan's hostility to interest rates is as much philosophical as it is economic and as Erdogan's power has increased and the

independence of the central bank has been questioned, investors can no longer ignore Erdogan's dismissal of orthodox policy so easily.

On the political front, simmering tensions between Turkey and the US have now resulted in trade sanctions at a time when Turkey can least afford them. While grievances between the two NATO allies stretch back more than a decade, the focus of the current argument centers on Turkey's plan to acquire a missile defense system from Russia and on Turkey's arrest and imprisonment of an American pastor on charges of espionage relating to the alleged coup against Erdogan in 2016. The US refutes the charges. The refusal of Turkey to release the pastor despite strong diplomatic representations from the US has now resulted in specific action against two Turkish ministers that the US holds responsible for the pastor's detainment – and a doubling of tariffs on Turkish steel and aluminum.

## **What can Turkey do?**

In our view the greatest challenge in overcoming this crisis is investors' disquiet around a perceived lack of independence at the Turkish central bank. Those fears originated with Erdogan's promise to get more involved in monetary policy in the run up to the elections in late June, were exacerbated significantly by the appointment of Erdogan's son-in-law to head Turkey's powerful new treasury and finance ministry in early July – and ultimately confirmed by the failure of the central bank to raise interest rates in its first post-election meeting on July 24 despite soaring inflation.

The scale of the Turkish lira sell-off reflects that investors believe that at least part of the issue is now structural rather than cyclical and that the situation cannot improve without a U-turn from Erdogan that looks some way away based on current rhetoric. From our perspective it is very hard to see how confidence in central bank independence can be restored swiftly and sustainably as things currently stand.

Given net liabilities of around USD 250bn, demand for US dollars to service and repay debt is unlikely to abate any time soon and there are significant repayments due in the coming months. This structural imbalance is also something that cannot be addressed overnight. The good news is that the sharp drop in the Turkish lira should provide at least some positive impact on Turkey's current account deficit, making Turkey's exports cheaper and overseas goods more expensive. But tighter fiscal policy to further slow imports would be the most obvious policy response in any other country.

The weakness of the currency is likely to see inflation in Turkey spike still higher given the oil price has risen more than fivefold in Turkish lira terms since early 2016. Turkey should, of course, hike interest rates immediately, tighten fiscal policy and set out a clear plan for how it intends to address the imbalances in its economy. But given Erdogan's open hostility towards economic orthodoxy, things may have to get significantly worse before such obvious measures are executed. The very basic measures announced on Monday morning, while welcome, have done little to calm investor fears at the time of writing.

### **We see three potential policy scenarios:**

1. Turkish policymakers fail to act with sufficient force to avoid a full blown balance of payments crisis that may eventually require the involvement of the IMF. This is where we are currently. There is a risk that the Turkish lira weakens still further if this remains the situation.
2. Turkey does the bare minimum to avoid the current situation evolving still further into an even larger crisis. Against that backdrop the lira might stabilize in the short-term, but it is hard to see more than transient periods of Turkish lira strength or any meaningful reversal of recent lira weakness
3. A meaningful and coordinated action involving the government and the central bank, with tangible policies. Given the negative sentiment embedded in current Turkish lira levels we believe that this would surprise investors and prompt a sharp rebound in the lira.

### **Are there implications for emerging market asset classes and wider risk assets?**

It is hard to dissect the current crisis in Turkey as definitively economic or geopolitical. In emerging markets (EM), the two are often strongly connected. We believe that the impact on investor sentiment is likely to be greater than the impact on the global economy. Our view is that while the episode is a sharp reminder of the idiosyncratic risks within the emerging market universe and is unlikely to be swiftly resolved, we do not currently ascribe a high probability to sustained wider EM contagion. That said the recent bout of US strength will challenge EM economies like Turkey with large current account deficits and high exposure to US dollar funded liabilities. These economies and related assets will likely remain under pressure as global quantitative easing unwinds and the availability of cheap credit declines.

However, this also presents opportunities for more differentiation across EM. The market reaction and related selloff within EM has been highly correlated in 2018, and

strong EM economies have sold off perhaps unfairly alongside weaker EM economies. As a result, we believe that, there is opportunity across EM given current valuations to cherry pick those economies less externally vulnerable.

More specifically, emerging market equities have fallen a little over recent days, but there has been no evidence of large scale panic selling and overall the MSCI Emerging Markets index remains in positive territory over the past month in local currency terms. At around 0.6% of the MSCI Emerging Markets Index, Turkey is a very small part of the overall EM equity universe. We continue to see long-term value in EM equities but accept that broader investor risk aversion and US dollar strength are likely to constrain upside in the short-term. In EM hard currency debt, spreads over US treasuries have widened around 40bp over the past week to around 430bp – their highest level since April 2016. We see the Turkey situation as idiosyncratic and not reflective of a wholesale change in the risk profile of all EM debt. For investors prepared to accept high levels of volatility and to take a long-term view, we believe that these are potentially attractive levels.

In FX, the weakness in the Turkish lira and new sanctions against Russia by the US are triggering some contagion to broader EM currencies universe. While we don't believe that the issues in Turkey will have a sustained impact on EM currencies, the risk of escalating trade tensions and anemic growth levels outside of the US could place further pressure on EM currencies in the short-term.

Our view is that the Turkish lira is extremely undervalued on fundamentals but that these fundamentals matter little in the short-term when Erdogan's rhetoric is combative and political. Nonetheless the Turkish lira may have the potential to rally sharply in the short-term if more decisive action is taken to address the imbalances in the Turkish economy – and if Turkey is able to resolve its stand-off with the US.

Outside of EM a number of European banks have significant exposure to Turkey. These include Spain's BBVA, Italy's UniCredito and France's BNP Paribas. Share prices in all three have dropped between 5% and 10% over recent days. In our view, the very low valuations of European banks and the poor performance of the sector overall year-to-date partly reflect investors' concerns about Turkish exposure. The euro has also weakened as a result of these factors. We remain moderately constructive on European equities on a longer-term time horizon but see the increased risk premium prompted by recent political developments as likely to constrain upside potential, particularly until more clarity emerges around the fiscal intentions of the new Italian government.

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**Americas**

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