AMUNDI ASSET MANAGEMENT 東方匯理資產管理

EXPERT TALK

A **"5-minute"** walk-through about what's happening in the market **17 August 2018**

Turkey shakes summer thin markets

- ***Turkish crisis****: Turkish Lira depreciation in August is the consequence of an unsustainable growth regime financed by rising private debt (mainly external debt) and combined with a current-account deficit that had become excessively financed by short-term capital flows. Actually, the economy is experiencing a classical balance of payment crisis. Even before the recent crisis, Turkey was the most vulnerable country among main Emerging Markets (EM). Not a single measure can reassure investors. A mix of monetary policy action, economic adjustments and temporary recourse to some forms of capital control can help mitigating the crisis, with some de-escalation on the geopolitical front between the US and Turkey, but in the short term volatility will remain high.*

- ***Contagion risk:*** *While we can see the contagion effects of the Turkish crisis spreading outside the country (for example through exposure of some European banks, or the potential damage of a much stronger USD on other vulnerable EM), we still believe this to be an idiosyncratic event and not a trigger for a wider systemic move, as it mainly reflects the country's economic fragilities and its political backdrop. The impact on Eurozone economy is expected to be limited. Turkey is crucial for the immigrant issue: it might even be in the interest of European countries to help Turkey to stabilize its economy.*

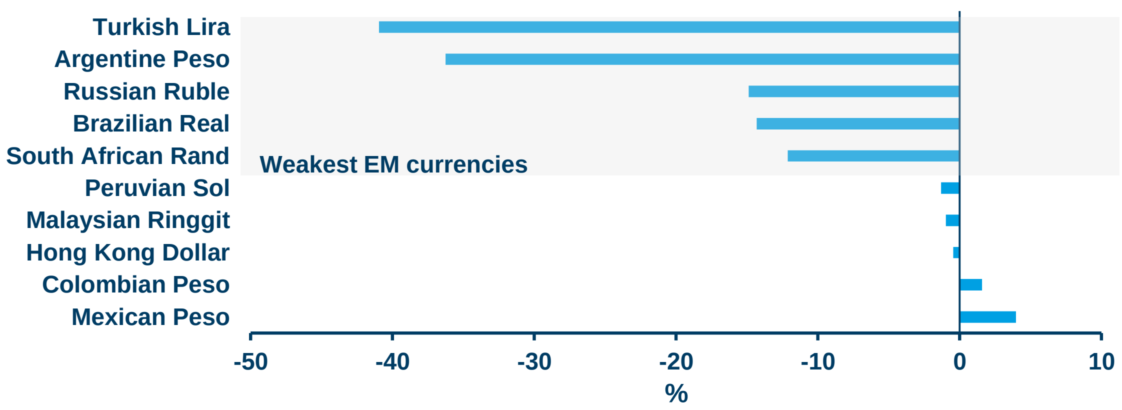
- ***Emerging Markets:*** *We are cautious on Turkish assets. The year to date selloff makes them attractive in an EM context, but we expect macro fundamentals to deteriorate further and* *geopolitical issues to continue at least in the short term. We expect countries with strong fundamentals, less dependent on external borrowing and capital inflows to stay on course. In this environment, we expect divergences to remain in place, and eventually to increase, supporting the case for active selection and opportunities in volatile markets.*

What are the roots of the sell-off of Turkish financial assets?

Didier: The Turkish economy has outperformed most of its peers since the global financial crisis. Real GDP growth stood at 7.4% last year and in 1Q18. Over this period, it remained substantially above its potential level which is estimated to be in the vicinity of 3.5 - 4%. As a result, the unemployment rate has fallen and inflationary pressures have emerged. However, this impressive performance was only possible given rising internal and external imbalances. The domestic boom has been financed by private debt (mainly external debt): credit has risen by more than 40% since 2013 and accounts for almost 85% of GDP. Corporate debt is close to 70% of GDP, and more than half is in foreign currency. The non-financial corporate net FX open position has continuously risen over the past 15 years. Turkish corporates had a record USD 336 billion in foreign debt at end-January. When netted against their assets denominated in foreign currency, the shortfall was at an all-time high (USD 222 billion). The domestic boom has boosted imports and thus heavily weighs on the external deficit. Moreover, the quality of the current account financing has deteriorated since 2017, with shrinking foreign direct investment (FDI) inflows and an increasing reliance on portfolio flows into government and bank debt securities (carry trades). In essence, these capital flows could prove very volatile and sensitive to adverse shifts in investor sentiment. This financing mode has thus increased the vulnerability of the country (the most vulnerable in our EM ranking). With the fall of the lira, corporate balance sheets are under increasing pressure which in turn threatens the financial sector (more defaults to come) and the whole economy.

As a result, before last week, Turkey was already walking a tightrope. The growth regime had become unsustainable and the currency was already under pressure. In the absence of convincing structural reforms and a consistent economic policy mix, the currency depreciation is not at all surprising. Actually, the economy is experiencing a classical balance of payment crisis, and as such a situation unfolds, exchange rates tend to overshoot.

5 weakest and strongest EM currencies YTD (vs USD)



Source: Bloomberg 13 August, 2018.

What would you think could stop the capital outflows from Turkey?

Alessia, Didier: In order to stabilise markets, on 13 August, the central bank injected liquidity into the market and cut the reserve requirement ratios to alleviate pressure on the banking system. The measures aim to provide all the liquidity banks might need. It is, however, far from sufficient to reassure foreign investors, as far as we can see. Indeed, the situation in Turkey is unique in the EM space, both from an economic and a political standpoint. Thus, we see few realistic policy options in the short run:

a) In these circumstances, **the central bank would need to take bold action** to defend the currency and anchor inflation expectations. Our internal Taylor Rule model is calling for a 400bp hike assuming inflation declining towards 13.5% and GDP growth at around 4.5% (and potentially even higher if economic conditions remain as they are today). It looks highly unlikely that this bold action will occur, however, following President Erdogan's speech and the way he addressed the "interest rates lobbies". The central bank is not independent, and President Erdogan has made it clear that he does not want interest rates to rise further, calling himself an “enemy of interest rates”. The last monetary policy committee meeting actually called for a forced pause because the economic conditions were not yet mature enough for easing.

b) **Towards capital control?** This is perhaps more likely than any aggressive tightening, but it would be a very dangerous option, in our view. However, the longer it takes to tighten monetary policy, the more likely the introduction of capital controls will be. Such a policy could be perceived as a panic option by markets; having said that, if it is short lived, well targeted on specific assets, and combined with the right macroeconomic policies, it could help in the short term.

c) **Simply let the economy slow down to such an extent that the imbalances would decline?** This is a more structural/long-term option -- necessary, but not very likely in the current weakening economic environment.

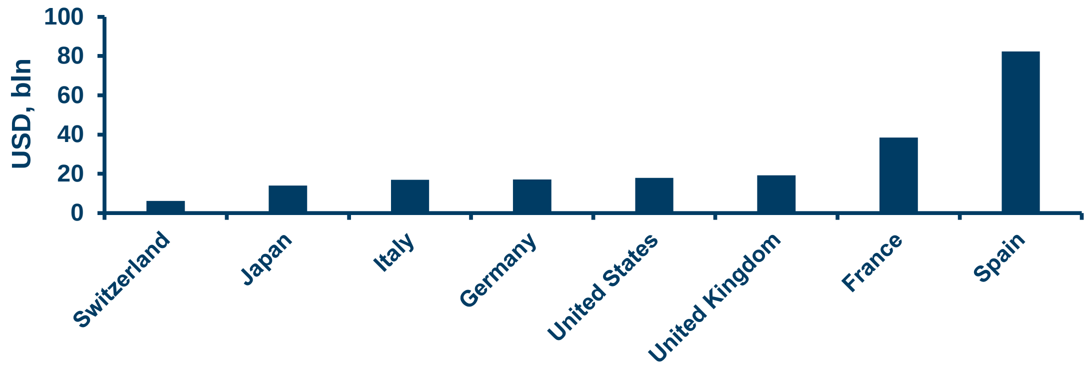
d) **Asking for a “Global Financial Safety Net” (GFSN) from the IMF?** This is probably the least likely option today. Not only have Turkish officials clearly rejected this possibility, but should they consider this option later, they would need the support of the US! Indeed, a GFSN needs the support of the IMF executive board, regarding which the US has the largest voting share.

At the end of the day, a rigorous and calibrated mix of (a) and (c) -- with possibly a temporary recourse to (b) – is probably needed, together with some de-escalation on the geopolitical front between the US and Turkey. Unfortunately, we don’t see that happening in the short term.

Could this crisis have spillover effects in Europe? Do you see systemic risk rising?

Didier: While we do believe that the macro-financial situation will deteriorate further in Turkey, we expect to see only a minor impact on the Eurozone. Eurozone exports to Turkey represent only 0.6% of Eurozone GDP. It is noteworthy that in 2001, when real GDP contracted by 6% (the worst recession that Turkey has experienced over the last 20 year), Eurozone exports to Turkey fell by 20%. The same shock today would have a less than 0.1pp on Eurozone growth. Furthermore, we do not expect a shock as severe as that in 2001. It is true that some key banks in the Eurozone have substantial exposure to Turkish banks (notably in Spain, Italy and France) and will experience some losses. According to the BIS data, Turkish banks owe USD 83bn to Spanish banks, USD 38bn to French banks, and USD 17bn to Italian banks in a mix of local and foreign currencies. **Even though these amounts are significant, they represent less than 15% of banks’ total equity in these three countries.**

Banking sector exposure to Turkish banks



Source: BIS, data available at August 13, 2018. Claims on an immediate counterparty basis. Consolidated positions on counterparties resident in Turkey.

Moreover, it is reassuring to note that based on regulations, Turkish banks are not allowed to carry net open FX positions and, therefore, the balance sheet of the banking system in Turkey should effectively be immune to direct effects of currency valuation. Lastly, the Turkish central bank should continue to inject liquidity if needed to stabilise the banking sector. Consequently, even though the shock on Eurozone banks could be significant, it would definitely not be either a systemic shock or even a shock that could derail ongoing expansion. However, the economic shock may have political consequences in the region which should also be closely monitored, as they could prove much more destabilising for Europe by aggravating the immigration crisis. Indeed, Turkey continues to host about four million refugees, making it the largest refugee hosting and supporting country. We expect Turkey and the EU to continue to cooperate on refugee matters. Against this backdrop, it might even be in the interest of European countries to help Turkey to stabilise its economy.

Have you changed your view on Turkish assets as the crisis has unfolded?

Yerlan: We are cautious on Turkish assets. The YTD selloff makes them attractive in an EM context, but we expect macro fundamentals to deteriorate further and geopolitical issues to continue to be an issue at least in the short term. As such, we do not expect the market to be driven by similar mean-reverting behaviour as some other high-yielding EM. In our view, foreign exchange weakness will likely keep sovereign credit spreads wide, despite relatively attractive levels. Among Turkish assets, we prefer corporate over sovereign, prioritising the quality of the assets. Non-performing loans (NLP) in the banking sector are likely to rise driven by corporate loans, but we do not see a generalised NPL crisis at the moment. If managed well, rising NPLs could be absorbed by banks' capital buffers, excess provisioning and potential profits. However, in this scenario, the additional capitalisations of some banks would still be necessary. Among non-financial corporates, selection is key: some issuers have been able to mitigate the challenges due to foreign currency mismatches, though high (cost) inflation, consumer sentiment and lower affordability are negatively affecting consumer names. While FX mismatches remain the main concern, many corporates have taken steps at operational and balance sheet levels to address this. Also, leverage is still in check, despite grinding higher, free cash flow remains strong and short-term debt looks manageable. For some time now and especially into August, with low market liquidity, we have been even more cautious on Turkish assets: investors could try to protect their portfolio in the short term mainly through hedging strategies.

Do you see contagion risks in EM? Are opportunities emerging from the crisis?

Yerlan: Increased volatility and risk-off attitudes are always an issue, especially in periods of low liquidity, and in particular in this context of less positive external conditions for EM (rise of the short end of the US yield curve and a stronger US dollar). We expect countries with strong fundamentals, which are less dependent on external borrowing and capital inflows, to stay on course. In addition, politics, sanctions and trade-related skirmishes are taking centre stage in investors' minds, and make countries experiencing geopolitical issues more fragile. But, we stress that a focus on fundamentals is key. In Russia, for example, we don't expect that the additional sanctions will derail the economy, which is benefitting from improved macro management and a current account surplus (at least as the oil price stays strong). So, we see areas of opportunities there. In this environment, we expect divergences to remain in place, and eventually to increase, supporting the case for active selection and seeking out opportunities in volatile markets.

BOROWSKI Didier , Head of Macroeconomic Research

SYZDYKOV Yerlan , Head of Emerging Market

BERARDI Alessia , Deputy Head of Macroeconomic Research