Turkish Crisis: What Next?

August 2018

Market and political events in Turkey continue to make headlines.

Your portfolio has minimal exposure to Turkey, nevertheless, we review below the background to the current situation, the impact on our index and our expectations on how the crisis may be resolved.

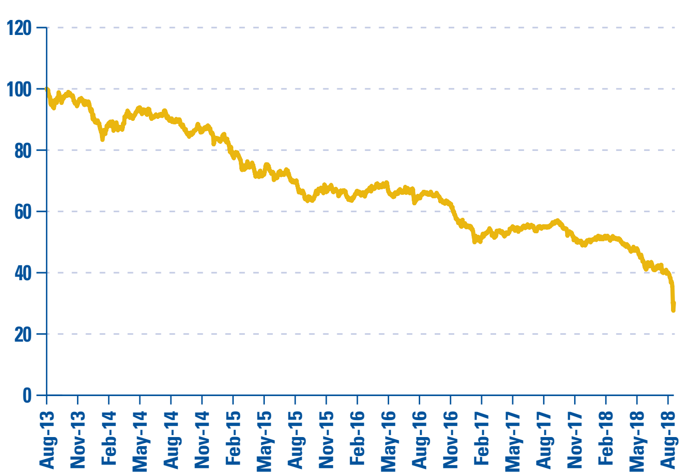
Background

Turkish macro-economic problems have been building for some time, resulting from:

- historically wide and increasing fiscal and current account deficits,
- continued efforts by the administration to stimulate growth, despite an overheating economy,
- persistently high inflation which recently moved into double digits, and
- unorthodox monetary policies driven by political interference at the central bank.

High levels of short maturity corporate and government foreign debt combined with an almost 50% devaluation of the Lira in 2018 has increased the risk of insolvencies. A concentration of power brought about by the executive presidential system and subsequent compromised central bank independence has further undermined investor sentiment. In addition, increased US sanctions, reflecting a deteriorating relationship with the US administration will create additional headwinds for the economy.

TRY vs USD 5 Years Ending 14-Aug-18, Rebased to 100

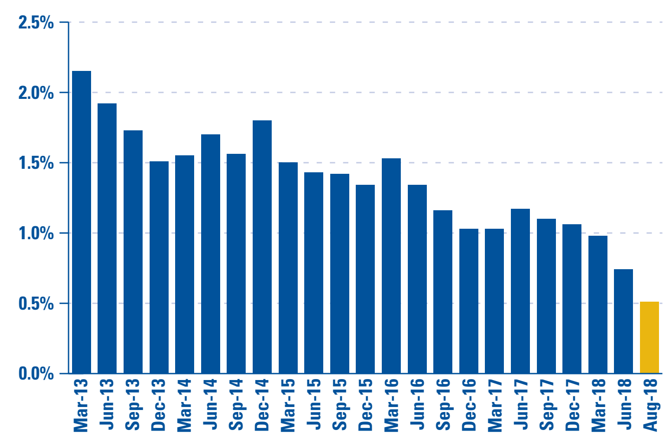


Source: Bloomberg

Impact

The Turkish market has declined by almost 20% in local currency terms; 55% in US dollar terms year to date. The impact on the wider emerging market equity indices however is limited: Turkey comprised only 1.1% of the MSCI EM Index (MXEF) at Dec 2017 and approximately 0.7% at June 2018 – losses year to date therefore amount to c.50bps for MXEF, which has declined approximately 8% this year. The risk of contagion has proved to be high in the short term as investors reappraise their allocations and look to reduce exposure to other fragile / higher beta markets (e.g. Brazil, S Africa and to a lesser extent Russia). These countries are also notable for their higher weights in emerging market debt indices where the search for yield has driven significant largely passive flows in recent years. Longer term, we believe the impact will be limited as there is both the ability and willingness to address macro imbalances via orthodox macro policies across most emerging markets.

Weight of Turkey in MSCI Emerging Markets Index



Source: City of London Investment Management, Bloomberg

Potential Solutions

Turkey is currently attempting to combat the symptoms of the crisis, not the cause. President Erdogan has recently encouraged residents to convert gold, Euro and US Dollars to Lira, appealing to their national pride. In addition the central bank is focused on providing short term liquidity to banks and corporates - these initiatives, in our view, only serve to feed capital outflows and aggravate the problem. We believe that eventually Turkey will require a U-turn in policy (fiscal and monetary tightening) together with changes at the cabinet level. This may also have to be accompanied by an IMF program or potentially restrictions on capital outflows.

Our exposure to Turkey is minimal across our EM portfolios, averaging less than 0.5%; we have been underweight Turkish assets since Q3 2016. In addition, we have no direct exposure to securities listed in Turkey with exposure coming peripherally from East European and Global EM closed end funds listed in London and New York. We continue to evaluate opportunities in locally listed Turkish closed end funds and select investment holding companies where discounts have widened, but valuations are not yet sufficiently compelling.

Outlook

In terms of ongoing contagion we see parallels being drawn with other EM crises as misplaced. The isolated and specific nature of the issues facing Turkey outlined above are unique. Of course, all emerging markets have to deal with the less certain external environment specifically US trade policies and gradually tighter global financial conditions. Many countries which enjoy more robust external positions and stronger institutions are less likely to waver from implementing orthodox policy. We retain a bias towards these markets with overweights to India and Mexico for example and underweights to markets where we see greater risks of policy inaction including Brazil and South Africa. Indeed the recent volatility continues to afford our strategy ample opportunities to add favoured markets at above average discount levels.

Finally, it's worth noting that although Turkey only represents 1.4% of global GDP, given its geography, NATO membership and important role on the periphery of Europe (especially as it relates to the refugee crisis), global institutions and superpowers have compelling reasons to avoid a full blown meltdown of the Turkish economy. For these reasons we believe the crisis will be resolved before it deteriorates much further. We are actively monitoring developments and remain vigilant for an appropriate entry point into Turkish equities.

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