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# MARKET PULSE

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## Talking Turkey: What Drove the Crisis, and Where Does It Head Next?

Turkey is in the midst of a financial crisis, with a sharp sell-off in the equity market, a plunge in the currency and a spike in bond yields. The trigger for the latest phase of the crisis is a diplomatic row with the United States over the release of a jailed American pastor. Turkey's unwillingness to release him led President Trump to double metal tariffs on Turkey, further increasing turmoil in Turkish financial markets. The underlying causes of the crisis, however, have been building for some time and include a toxic mix of domestic economic mismanagement, political uncertainty, a structural decline in US Turkish relations and a host of global macro factors, from rising interest rates to trade tensions to higher oil prices.

Turkey has built up a large external debt position and a current account deficit driven by private capital inflows. While this has fueled strong economic growth over the past decade, it also increased inflationary pressure and left the currency vulnerable to a reversal in foreign flows.

President Erdogan has systematically appropriated enormous executive powers over the last few years, weakening other institutions. He has now made it clear in public statements that he intends to take greater control of the economy, including the central bank and monetary policy, and he recently appointed his son-in-law as Minister of Finance and Treasury.

The global macro and liquidity backdrop has also become less favorable for Turkey, with the US Federal Reserve (Fed) raising rates, the European Central Bank on track to end quantitative easing-related bond purchases, and policy normalization by other central banks. Emerging market (EM) currencies, in general, have been weakening amid US dollar strength, escalating trade tensions and Fed rate hikes. Finally, oil prices have been rising, driven by OPEC production cuts and Iranian supply concerns, creating a huge strain for net oil importers like Turkey.

The confluence of all these factors has led to the current crisis. Without comprehensive policy action (which Erdogan and his team appear unwilling to undertake in a timely manner, given the political costs), the plunge in the currency is likely to continue. Given the level of external debt, this, in turn, could spark a full-blown debt and banking crisis. Further delays in comprehensive policy action risk adding to the ultimate political and economic costs, and the pain experienced by Turkey's population.

## Consequences for Global Markets: Is Turkey the Canary in the EM Coal Mine?

While the crisis is a serious one for Turkey, the direct economic impact for the wider world is likely to be limited, in our view. Turkey accounts for just 1% of the global economy (at current market exchange rates), and foreign exposure to Turkey's domestic financial markets is small. That said, a temporary rise in risk aversion related to the crisis seems likely to result in elevated financial market volatility and possible further near-term downside for risky assets.

Concerns about Turkey have already begun to affect global markets, boosting the demand for safe-haven currencies and high-grade government bonds, leading to a rise in the VIX index and some downside in global equity markets.

Among developed economies, Europe likely stands the most to lose. Much of Turkey's debt is concentrated in the private sector, much of that at European institutions. Eurozone banking sector exposure to Turkey amounts to €124bn, led by banks in Spain (€65bn), France (€30bn), Italy (€15bn) and the UK (€14bn). With a large amount of payments coming due over the next months, the lira depreciation is causing major problems for Turkish companies. From a euro banking sector perspective, the risk is that if banks incur significant losses on their Turkish loans, they might be forced to raise more capital, which could be difficult and expensive if needed in a hurry.

Another big worry for Europe is geopolitical. Currently, 3 million Syrians are in refugee camps in Turkey. The EU had come to an agreement with the Turkish government on keeping those refugees from crossing into Europe. If the situation in Turkey becomes desperate enough (or Erdogan chooses to use the issue as leverage) and Turkey backs out of the deal, it would be seen as particularly bad news for Europe.

On the other hand, Europe's direct trade exposure to Turkey is not very large. EU28 exports of goods and services to Turkey accounted for about €85bn in 2016, less than 0.6% of GDP and 1.3% of total exports. So, even for Europe, barring a bad turn on immigration, we believe the negative spillovers are likely to be manageable.

Emerging market economies appear to face the biggest risk from Turkish contagion as the crisis has echoes in EM crises past. In a recent article, economist Paul Krugman highlighted the similarities with the Asian financial crisis of the late-1990s when the contagion spread from Thailand to other Asian countries[1].

However, we believe the risk of an Asian financial crisis II is relatively low. A key reason stems from the significantly improved financial position of most emerging economies since previous major EM crisis episodes (including the Mexican peso crisis of the mid-'90s). Specifically, many EM countries have substantially improved their current account balances, external debt levels and foreign currency reserves.

While Turkey has seen a large increase in credit default swap (CDS) spreads this year (up more than 350 bps through August 14th to above 500 bps), the increase in spreads in other markets with high government debt burdens is relatively modest (see chart on page 3). Where there have been big increases, such as in Italy, Brazil and South Africa, they are largely driven by idiosyncratic factors specific to those countries' political and fiscal situations. Among other countries affected, only Indonesia has seen a big increase in spreads more linked to external factors such as dollar strength and tighter Fed policy.

In general, countries that run large current account deficits depend on foreign capital flows to finance those deficits and are likely to face currency depreciation. Among the emerging economies, countries in this situation include Argentina, South Africa, India, Mexico, Brazil and Poland. Hence, their currencies are vulnerable (if not immediately in danger), especially if the Turkish crisis deepens.

## Implications for Investment Strategy: Still "Bearly" Bullish

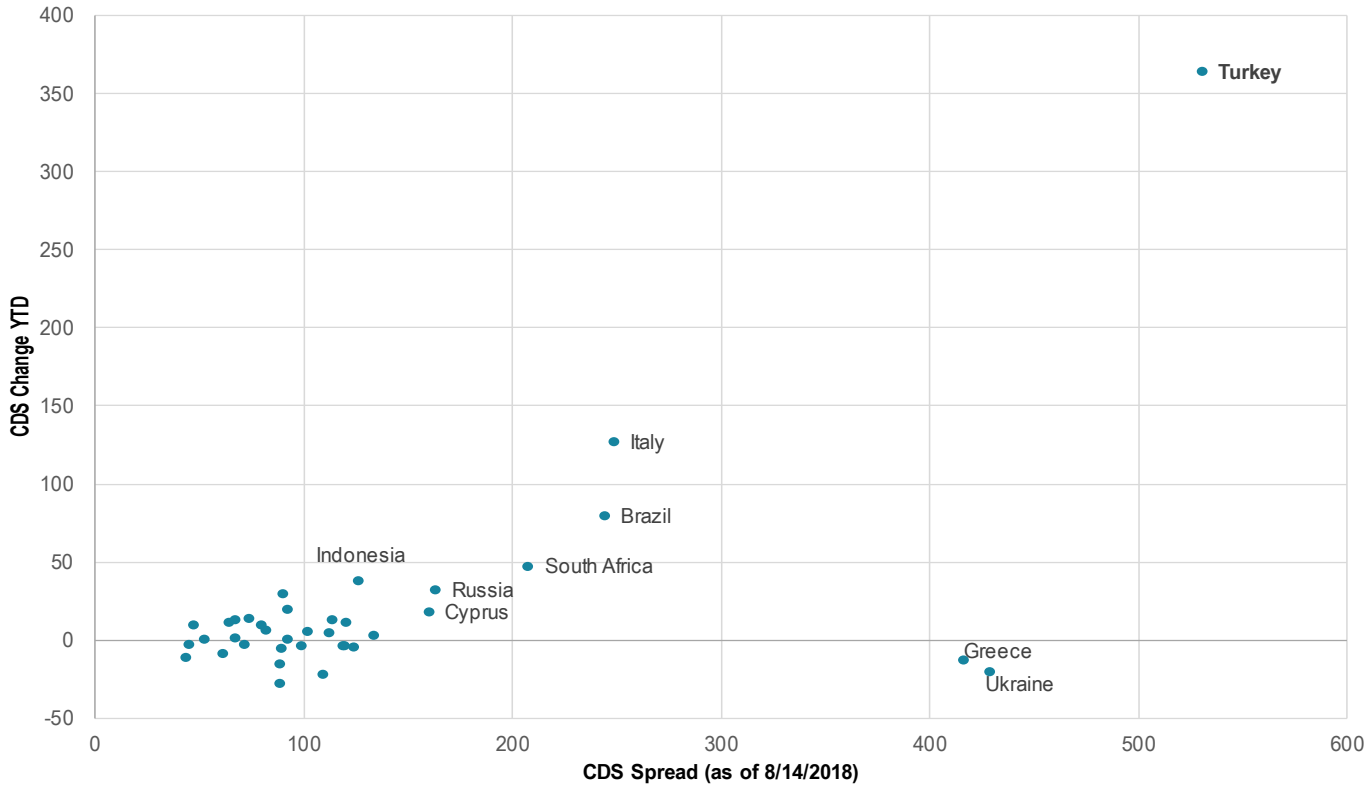
We have not made any changes to our positioning in response to the latest pickup in market volatility. We continue to pursue a strategy that we have described as "bearly" bullish, with modest overweight positions in equities and our exposure skewed toward US equities at the expense of EAFE and EM. We continue to overweight cash relative to government bonds as we believe we have not yet seen the cycle's high in bond yields.

Our underweight exposure to EM equity and debt in our traditional multi-asset class portfolios has benefitted us year-to-date. While we believe significant contagion from Turkey, leading to a broader EM crisis, is unlikely, we are not yet ready to jump in and add EM exposure just yet. As we outlined in our most recent quarterly, we are underweighting EM for broader fundamental reasons. Specifically, the global macro and liquidity backdrop has become more adverse, given Fed rate hikes, dollar strength and rising trade tensions. Pockets of turmoil in countries like Turkey are just another related reason for caution.

[1] "Partying Like It's 1998," The New York Times, 8/11/2018.

In contrast, we expect Turkey to have limited impact on US stocks beyond temporary, modest downside. But looking forward, sustained dollar strength and continued Fed rate hikes could tighten US financial conditions and eventually have an adverse effect on US GDP and earnings growth. So, we will be closely monitoring the impact of these factors on the US as much as, if not more than, on Turkey.

### Turkey's Expected Increase in CDS Spreads in 2018




As of 8/14/2018.
Source: Bloomberg, QMA.

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[2]As of 6/30/2018.

## NOTES TO DISCLOSURE

Sources: QMA, Bureau of Labor Statistics, Bureau of Economic Analysis, Datastream, Haver.

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