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INSIGHT

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Another One Bites the Dust? Putting Turkish Stress Into Context:

In the 2013 Taper Tantrum*, the market zeroed in on Fragile Five economies vulnerable to capital market outflows – South Africa, Brazil, India, Indonesia, and Turkey. At the time there was a fear of contagion should one of these economies experience a sudden stop in capital flows. Under pressure from that experience, we have seen some degree of adjustment in four of these economies (i.e. improved current account deficits, lower inflation) so that now the immediate Emerging Markets (EM) vulnerability discussion centers almost exclusively on Turkey and Argentina.

Turkey escaped 2013 benefiting from falling global yields and (at the time) cheap oil. Unlike most other vulnerable EMs, however, the Turkish government doubled-down on unorthodox economic policies, compromising the independence of the central bank and pursuing growth at any price, paying for it with a combination of looser fiscal policy and a substantial run-up in off-balance sheet spending. This led to a sharp increase in Turkish inflation (~16% y/y and rising) and a large current account deficit that stood at 6.5% of GDP in early 2018. At the same time, heightened political and geopolitical risks discouraged foreign direct investment into Turkey and resulted in greater reliance on short-term portfolio flows to finance the growing imbalances. It is therefore not surprising that Turkey stares at a crisis in an environment of tightening global liquidity.

Turkey is almost certainly now headed into recession as market participants discuss the options of capital controls or an IMF bail-out (neither of which we think likely before significant further pain). Investors have understandably become concerned about Turkish contagion, inducing a market wide risk off trade. Contagion generally proceeds along one or more of the following channels: confidence crisis resulting in rapid FX depreciation leading to portfolio outflows, spiking corporate defaults, financial sector stress, and trade disruptions. Of these, given the relatively modest size of the Turkish economy (USD 800 billion until the most recent spike in USD-TRY), we are primarily concerned about portfolio outflows and financial sector contagion (with considerable European bank exposure to Turkey).

* Taper Tantrum: Surge in U.S. Treasury yields, which resulted from the Federal Reserve's use of tapering to gradually reduce the amount of money it was feeding into the economy.

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As pointed out by the Financial Times last week, using BIS statistics, local lenders, including foreign owned subsidiaries, have dollar claims of USD 148 billion and Euro claims of EUR 110 billion. More specifically, the aggregate exposure of Spanish, French and Italian banks to Turkish borrowers is USD 139 billion. Correspondingly, we witnessed a sharp spike in CDS for Unicredit and BBVA last Friday that, along with BNP, have Turkish subsidiaries. The stress in the Turkish financial system is clearly rising as the country has experienced an increase in corporate defaults in recent months, including by some relatively high profile firms. Further tightening of financial conditions is likely to exacerbate this stress.

Now for the Silver Lining…

Developed Markets (DM) growth is in a (fairly) good place. Unlike the 2013 episode, DM growth is solidly above potential, led by the U.S., which is benefitting from a pro-cyclical stimulus via the tax cut. Japan appears to be shrugging off its 1H18 slowdown and the most recent data from Europe and Germany (2Q GDP) surprised somewhat to the upside despite widespread concerns about U.S. protectionism and tariffs against European firms.

In many respects, China remains the most important EM anchor. Policymakers there are in the middle of a targeted stimulus to offset external shock from the trade war. We believe there will be a measured deceleration in Chinese growth, but risks of a sharp slowdown are quite limited with ample policy tools to support growth in case of further external shocks.

Looking at market positioning – with the exception of select credit investors – other investor groups were already roughly neutral Turkish assets and have been reducing their exposure year-to-date, lowering scope for incremental outflows.

Turkey's sovereign balance sheet as it stands today is not the source of vulnerability with a public debt to GDP ratio (strictly defined) below 30%. The main vulnerability is the private corporate FX mismatch and its potential to impact debt service capacity, which in turn could affect bank balance sheets and, by extension, the sovereign.

In addition, Turkey is a real outlier in EM in terms of its vulnerability. We can't emphasize enough the stronger policy mix and better reserve positions of the remainder of the EM complex, providing other countries with tools to withstand external shocks. Even Argentina, for all its vulnerabilities, recently secured a $50 billion IMF package that covers the sovereign's financing needs for the next two years. Thus, the risk of a broad sudden stop in capital flows to EM remains quite low, in our view.

Should we be proven wrong and broad-based financial stress intensifies, we believe the notion of a "DM central bank put" is still valid, albeit with a lower strike. Thus, while there is currently no reason for the European Central Bank (ECB) or the Fed to change its policy path, additional system stress could change the reaction function. This is especially true of the ECB due to Europe's greater trade and financial linkages to Turkey.

Turkey has some obvious steps to buy itself space and lower risk perception:

1. Accommodating U.S. demands to free Pastor Andrew Brunson in exchange for sanctions relief. Erdogan's recent rhetoric (August 10 NY Times op-ed) suggests no quick resolution on this issue but dialogue is ongoing (see the August 13 meeting between Turkey's Ambassador to the U.S. and Trump's National Security Advisor John Bolton).
2. A robust monetary policy response, with the Central Bank of Turkey raising rates aggressively to tame inflation. An aggressive monetary response is needed both to stabilize confidence in the lira and to limit the secondary inflation impact of the steep FX depreciation to date. In the short term, Turkish authorities have taken technical steps to help shore up the market, provide short-term financial stability and reduce speculative positions, but this is not sufficient to address the underlying problem.
3. A large and credible fiscal adjustment (to be communicated in detail soon and implemented quickly) would boost the prospects for a softer landing of the economy and help to deliver a manageable deleveraging process. Slower Turkish growth with greater reliance on exports (likely to be boosted by the huge TRY depreciation) could pave the way for a sustained external adjustment assuming the government and central bank can deliver a strong and orthodox policy response. It goes without saying that all of this would be easier if Turkey were to ask the IMF for support, but as of now this is opposed by Erdogan.

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EM valuations have turned supportive across both debt and equity, while the market is generally underweight EM. Spreads on the EMBI have widened out from the 2018 tights of 260 basis points (bps) to ~370bps, which is 20 bps wide of long term averages. The MSCI EM has pulled back close to 20% from its January 2018 peak and pockets of the market look deeply oversold. Some of the recent market moves appear to be exacerbated by technicals, as the markets tend to be less liquid in August. We see the solid fundamentals in EM cushioning EM markets from full-blown contagion, although weakness could persist in the near term until there is more clarity on the path that Turkey will take. Correspondingly, while we think in the near term we may see stress, especially for the assets that will be viewed by the market as spillover risk hedges (South Africa, Indonesia) and short term liquidity driven pressure as outflows force managers to liquidate across their broader portfolios, ultimately contagion risks from Turkey are likely to be contained, in our view. Historically, liquidity driven market sell-offs tend to be short and ultimately present attractive opportunities as policymakers respond to market pressure and concerns over widespread contagion abate. ■

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Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets and International Equities Groups. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals and is responsible for communicating investment strategies, performance and outlook to clients. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as an EM Fixed Income institutional salesperson. At Morgan Stanley, she also served as the Asia Credit Product Manager, marketing Asian credit products globally to the firm's largest institutional clients. In addition, she spent several years working as part of Morgan Stanley's Institutional Investor-ranked U.S. Credit Strategy research team. Ms. Goodly currently serves on the board of Consano. Ms. Goodly graduated with a BA in Economics from Stanford University.

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Mr. Glukhov is a Co-Portfolio Manager for the TCW Emerging Markets and International Equities Groups. Prior to joining TCW in 2011, Mr. Glukhov spent over a decade in sell side equity research focusing on Internet and enterprise software, most recently as a Managing Director at Brean Murray, Carret & Co. Mr. Glukhov holds a BA in International Business from Peter the Great St. Petersburg Polytechnic University in Russia and an MBA from the University of Texas at Dallas. He is a CFA charterholder.

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Mr. Antin is Head of TCW's Sovereign Research team and works closely with all of the emerging markets and international investment strategies at TCW. Before joining TCW in 2000, he spent the prior seven years with the G7 Group, Inc., an international political economy consultancy in Washington, DC. As Managing Director of G7, Mr. Antin directed the firm's European and Latin American analysis and advised institutional investors and global macro hedge funds on economic and political risk. Mr. Antin also served as a speechwriter for Robert E. Rubin, then the co-Chairman of Goldman Sachs and subsequently Treasury Secretary of the United States. He also worked as a congressional aide to a member of the House Foreign Affairs Committee. Mr. Antin holds an MA in Government from The Johns Hopkins University and graduated cum laude from the University of California at Los Angeles (UCLA) with a BA in Political Science.

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