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Amundi ASSET MANAGEMENT

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Turkey shakes summer thin markets, but contagion risk is contained

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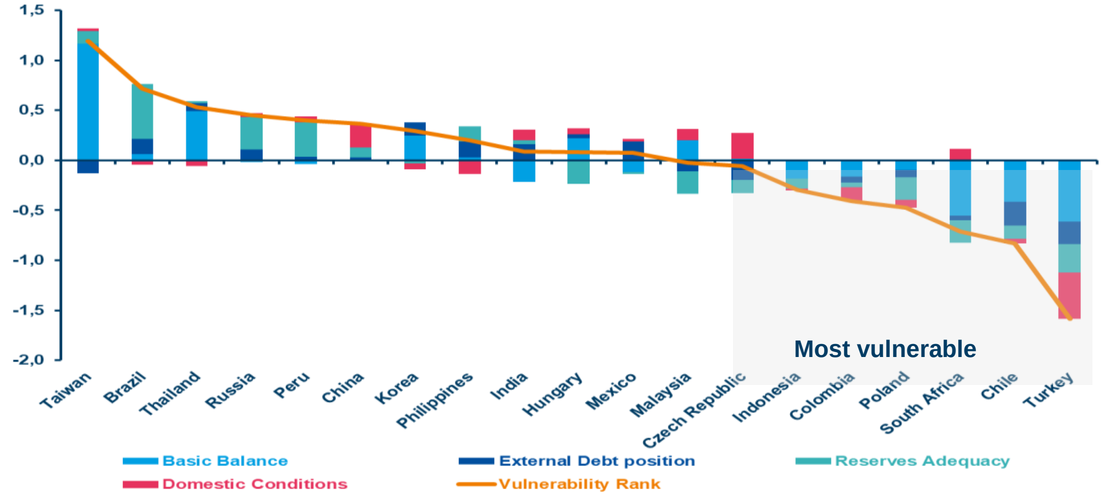
- ***Turkish crisis:*** *Turkish Lira depreciation in August is the consequence of an unsustainable growth regime financed by rising private debt (mainly external debt), combined with a current account deficit that had become excessively financed by short-term capital flows. In our view, the economy is experiencing a classical balance of payment crisis. Even before the recent crisis, Turkey was the most vulnerable country among the main emerging markets (EM). A mix of monetary policy action, economic adjustments and temporary recourse to some forms of capital control could potentially help to mitigate the crisis, with some de-escalation possible 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, not a trigger for a wider systemic move, as it mainly reflects the country's economic fragility and the political backdrop. The impact on the Eurozone economy is expected to be limited. Turkey is crucial regarding the immigration issue: it might even be in the interest of European countries to help Turkey to stabilise 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 that are 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 regarding opportunities in volatile markets.*
- ***Multi-asset:*** *The current turbulence may increase the vulnerability of the developed markets (DM) credit, on which we were already cautious, but the still-positive growth and the solid outlook for corporate earnings should prevent an extended risk-off mode. Consequently, we don't expect DM central banks (CB) to change their policy strategies in response to the current turbulence. Overall, we have gradually reduced our preference for risky assets through the year, as the global economy transitions to a more mature phase of the cycle. This allows us to navigate phases of increased volatility and scarce market liquidity with a lower directional exposure.*

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

D Borowski: 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 336bn 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 bn). 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.

External vulnerability index ranking

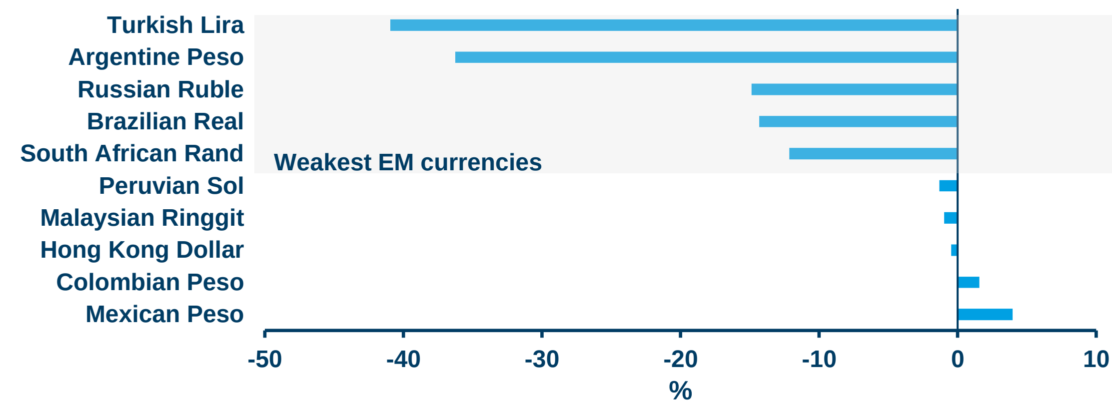


Source: Bloomberg, IMF, CEIC, Amundi Research. Data as at 13 August 2018. The vulnerability index considers four macro risks: 1) Leverage: Debt as percentage of GDP; 2) External liquidity: Reserve ratios, import cover and reserves on ST external debt; 3) Domestic liquidity: Real rates minus real GDP; and 4) External funding: CA and FDI as percentages of GDP.

"The domestic boom has been financed by private debt (mainly external debt). Well before this week's crisis, Turkey was the most vulnerable country in our EM ranking".

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.

"A mix of monetary policy action, economic adjustments, and a temporary recourse to some form of capital control should help to mitigate the impact of the crisis, but short term, volatility will remain high".

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

A Berardi, D Borowski: 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.

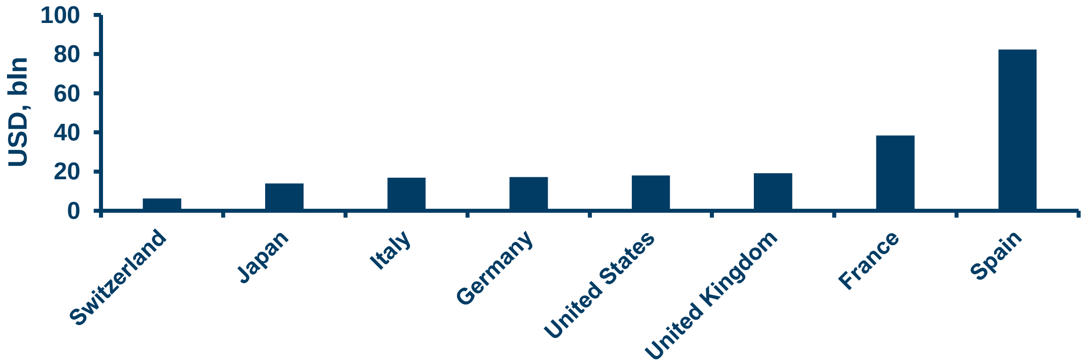
Could this crisis have spillover effects in Europe? Do you see systemic risk rising?

“While we do believe that the macro-financial situation will deteriorate further, we expect a minor impact on the Eurozone”.

D Borowski: 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 13 August 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.

"Turkish assets are attractive now, but fundamentals could deteriorate further. Better to remain on the cautious side, in our view".

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

Y Syzdykov: 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.

"We expect countries with strong fundamentals, which are less dependent on external borrowing and capital inflows, to stay on course".

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

Y Syzdykov: 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.

How do you assess the Turkish crisis from the perspective of a multi-asset investor? Could this crisis spark a risk-off mode in financial markets?

M Germano: While we can see the contagion effects of the Turkish crisis spreading outside the country (for example, through the exposure of some European banks or the potential damage of a much stronger USD to other vulnerable EM), we still believe this to be an idiosyncratic event, not a trigger for a wider systemic move. In fact, it mainly reflects the country's economic fragility and the political backdrop. In DM, the current turbulence may increase vulnerability of credit markets, regarding which we were already cautious, but the still-

"We believe this to be an idiosyncratic event, not a trigger for a wider systemic move".

positive growth and the solid outlook for corporate earnings should prevent an extended risk-off mode. Consequently, we don't expect DM CB to change their policy strategies in response to the current turbulence (we consider this a low probability scenario). While we keep a neutral view on EM (both equity and bonds), identifying EM winners vs leftovers remains one of our main themes. We search for the strongest relative value opportunities, focusing on countries with stronger fundamentals and fewer external vulnerabilities. Overall, we consider EM valuations attractive, but we prefer to look for entry points after the US mid-term elections, when we expect some easing of trade tensions and that most electoral events in EM should be over. Overall, we have gradually reduced our preference for risky assets as the global economy transitions to a more mature phase of the cycle. This allows us to navigate phases of increased volatility and scarce market liquidity with lower directional exposure.

APPENDIX

A snapshot of the Turkish crisis and its consequences: additional comments and data

- **The current account deficit has widened to unsustainable levels** (expected to be close to 6% of GDP in 2018). As a result, net foreign liabilities have deteriorated to the lowest level among G20 EM (53% of GDP).
- **International reserves have declined to excessively low levels** and are now among the lowest for EM, to a level only sufficient to cover five months of imports.
- **The currency has fallen to historically low levels.** The USD appreciated by 30% vs the lira between the beginning of the year and the end of July. It has appreciated further, by 40%, since then (to 7.0 on 13 August). Even though the currency has probably overshot, it is likely too soon to expect substantial re-appreciation.
- **Inflation is now out of control.** The strength of the past recovery, combined with the depreciation of the currency, has pushed inflation higher (+16% yoy in July). The recent fall of the currency will increase inflationary pressure further in the coming months. The lira is unlikely to re-appreciate substantially as long as the policy mix remains inconsistent.
- **Turkey' is particularly vulnerable to movements in its currency**, given the large stock of foreign currency debt. **External debt reached 53% of GDP at the end of 2017** (with 37% from the private sector): (i) bank debt accounts for 16% of GDP; and (ii) non-financial corporate debt has reached 16% of GDP as well (with one-third short-term trade credits).
- **The stress tests completed by the IMF earlier this** year illustrate the vulnerability of the economy to an exchange-rate shock. Given that more than 90% of external debt is denominated in foreign currency, a permanent lira depreciation of 30% would push external debt from 53% of GDP in 2017 to 83% of GDP in 2023.
- **To cope with a depreciating currency, the Turkish CB has raised its key rate by 800bp, to 17.75%, in less than two months. This massive tightening in monetary conditions will weigh on domestic demand.** However, these rate hikes will not suffice to stabilise inflation in the coming months, in our view, and, hence, prevent a decline in household purchasing power.

The level of debt has become unsustainable:

- **Public debt (28.5% GDP) is quite low, with three-quarters at fixed interest rates.** However, 40% of public debt is denominated in foreign currency. Thus, external financing needs (for the government) exceed 15% of GDP, which is quite high.
- **Private sector debt is much more problematic than public sector debt, as 40% of private sector debt is at adjustable rates. The private sector is thus expected to bear the brunt of the adjustment burden:**
    - Tighter financing conditions will weigh on business investment
    - The rise in inflation will dent household purchasing power.
- Against this backdrop, **the probability of a hard landing, leading to a recession, has increased significantly.** We expect to see a considerable domestic slowdown in 2H18 and in 1H19. In light of recent events, we will be revising down our current GDP growth forecast for 2018 (4.3%).

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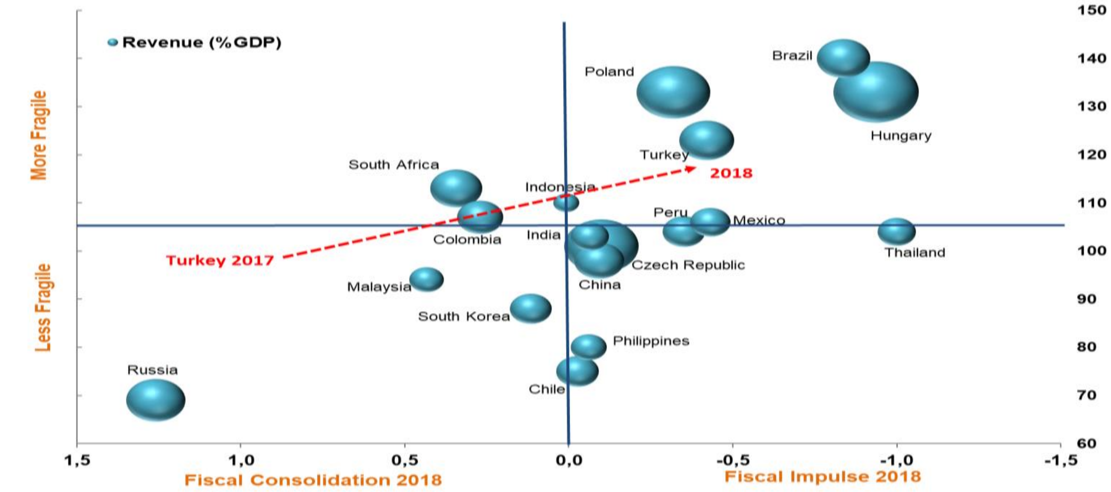
The authorities have very limited leeway to support growth:

- Public statements by President Erdogan this past Friday, 10 August, combined with the additional tariffs imposed by President Trump have made international investors even more wary.
- **The public deficit already stands at 3% of GDP.** Finance Minister Albayrak declared during the weekend that budget discipline would be the most important foundation of Turkey's new economic approach. It is thus highly unlikely that the government will try to dampen the impact of the economic shock through fiscal policy. Unless the Turkish authorities manage to make their economic policies more credible, capital flight, already at high levels, may thus continue.
- Having said that, **at some point, the depreciation of the currency should become beneficial to the economy** (via higher export competitiveness), though the domestic slowdown will weigh on imports. Thus, the trade deficit is expected to rebalance. In these circumstances, currencies typically tend to overshoot on the downside and then to re-appreciate at a gradual pace once conomic policy becomes credible again.

Fiscal fragility among EM



Source: IMF, UN, WB, Bloomberg, CEIC and GAAR Amundi Asset Management. Data as of 13 August 2018.
X axis: Fiscal Impulse (IMF definition): difference of Cyclically Adjusted Primary Balance (CAPB) between 2017 and 2018.
Y axis: Fiscal Fragility Indicator ranks the countries according to: Cyclically adjusted primary balance, gross debt/GDP, expenditures/GDP, CDS, fertility rate, old age dependency ratio, liquidity, reserves on government external debt.

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