

# Investment viewpoint

# Turkey in turmoil – what lies ahead?

For professional investor use only • Asset Management

August 2018

## Executive summary

The introduction of US sanctions has intensified the Turkish macroeconomic crisis, as the country grapples with currency depreciation and inflationary pressures.

We have held a negative view on Turkey since the beginning of the year, when the Central Bank's inaction in the face of a credit-fuelled overheating of the economy was beginning to put downward pressure on the Turkish Lira and associated assets.

At the end of January, the Turkish Lira was at 3.75 vs USD and inflation was at 10.35% – over double the Central Bank's long-term target of 5%. A resurgence in oil prices has added to inflationary and current account deficit pressures. CPI inflation now stands at 15% and PPI at 25%, whilst 10-year sovereign yields have touched 20% for the first time.

The Lira has now depreciated by roughly 40% against the US Dollar this year to around 5.3 at the time of writing. Current trajectories will likely see the Lira become emerging markets' worst performing currency, year to date, in the coming weeks/months.

This latest bout of negative sentiment is partially a result of the CBRT's reluctance to commit to continued monetary tightening under Erdogan's watchful eye. Furthermore, the situation has worsened following the introduction of US sanctions last week against two Turkish ministers. Although recent reports indicate that an agreement is forthcoming, the situation remains volatile.

It now looks as though external support may be required. That could come in the form of IMF support, but this would require a substantial shift towards more sustainable policies. The prospect of capital controls now begins to seem a real possibility.

## Investment Implications

- We expect further policy inaction to continue to put downward pressure on the Turkish Lira and associated assets
- The idiosyncratic nature of events is causing Turkish assets to underperform relative to other emerging markets
- Turkey's Financial sector appears particularly vulnerable, in light of looming refinancing requirements and the sizeable foreign exchange liabilities of Turkish companies
- We think Turkey may need to approach the IMF or seek other external support, otherwise capital control measures seem to be a distinct possibility



Dr Salman Ahmed  
Chief Investment Strategist



Jamie Salt  
Analyst

Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

The Turkish macroeconomic crisis has intensified over the past week, with the emergence of a new risk factor in the shape of US sanctions. This has exacerbated the panic generated by the Central Bank of Turkey's (CBRT) dovish monetary policy response to heavy currency depreciation and inflationary pressures.

We have held a negative view on Turkey since the beginning of the year, when the Central Bank's inaction in the face of a credit-fuelled overheating of the economy was beginning to put downward pressure on the Turkish Lira and associated assets. The concern is rooted in the idea that the Central Bank is heavily influenced by President Erdogan, who strongly believes that looser monetary policy is required to rein in spiralling inflation, contrary to economic theory.

At the end of January, the Turkish Lira was at 3.75 versus USD and inflation was at 10.35% – over double the Central Bank's long-term target of 5%. As the wait for Central Bank action went on, the situation deteriorated, not helped by a resurgence in oil prices which added to inflationary and current account deficit pressures. Falling so far behind the curve meant that when tightening did come, any positive market reaction was short lived. Throwing in further rhetoric from President Erdogan backing rate cuts, an electoral victory which enhanced his Presidential powers, and the appointment of his son-in-law as Finance Minister, it appears as though the market's concerns have crystallised. CPI inflation now stands at 15% and PPI at 25%, whilst 10-year sovereign yields have touched 20% for the first time.

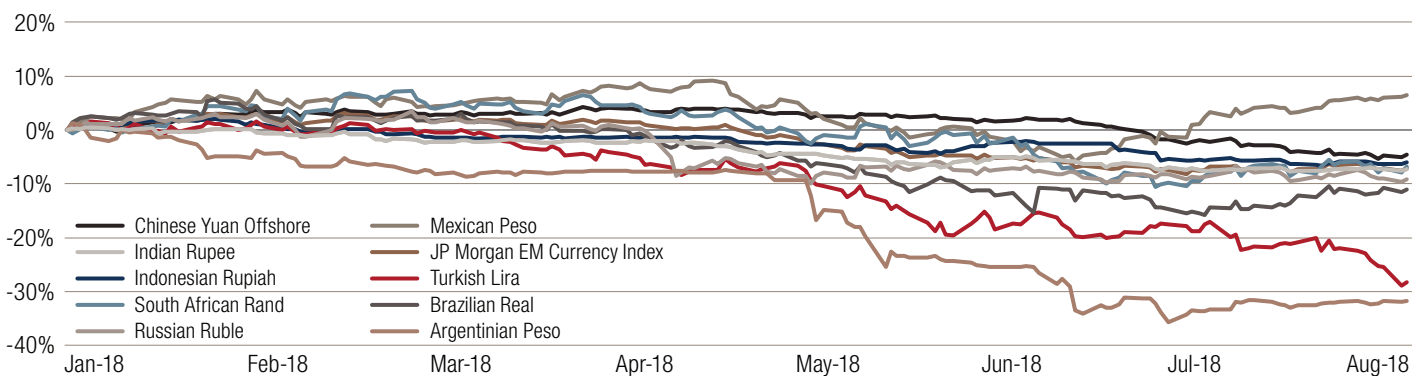
The Lira has now depreciated by roughly 40% against the US Dollar this year to around 5.3 at the time of writing. To contextualise the magnitude of this fall, in a year where Emerging Market currencies have been hit across the board, only the Argentinian Peso has performed worse. Furthermore, the majority of the Peso's decline was condensed into the two months following the country's 12.75 percentage point hike in April. In contrast, Turkey's inferior

tightening of five percentage points has offset the currency's fall substantially less, and current trajectories will likely see the Lira become emerging markets' worst performing currency year to date in the coming weeks/months.

The trigger for this latest bout of negative sentiment is two-fold. Firstly, as was alluded to by the Central Bank's rate hold at their last meeting, it appears as though a reluctance to commit to continued monetary tightening has returned to the CBRT under Erdogan's watchful eye. Indeed, comments last week from Finance Minister Albayrak appeared to affirm a plan to see interest rates contained. One possible factor that could yet bring about some much needed central bank action is that the CBRT has historically stated that it does not care so much about the level of the Lira, but is more concerned about the rate of depreciation. Consequently, the 12% depreciation seen in the two weeks since the inaction at the last meeting may be another test of the commitment to this dovish regime.

The second contributor has come in the shape of US sanctions last week against two Turkish ministers, citing the spat over the ongoing detention of a US Pastor, who has been accused of espionage and terrorism dating back to the failed military coup of 2016. Although this appeared to be the final straw, tensions between the NATO allies have been frosty for some time now, following contrasting positions in the Syria conflict and a looming fine to be imposed on Turkey's Halkbank relating to a bank officials part in circumventing Iran sanctions. Although recent reports indicate that an agreement is forthcoming, the situation remains volatile. The possibility of the Halkbank fine being utilised as a lobbying tool adds another layer of concern to the situation, with Turkey's financial sector particularly vulnerable. Heightened risk and borrowing costs are already causing concern for refinancing a large external debt pile at the end of the year, with external rollover ratios (long-term external borrowing/ repayments) at the lowest levels in five years.

**FIG. 1 EMERGING MARKET CURRENCY PERFORMANCE YEAR TO DATE (VERSUS USD)**

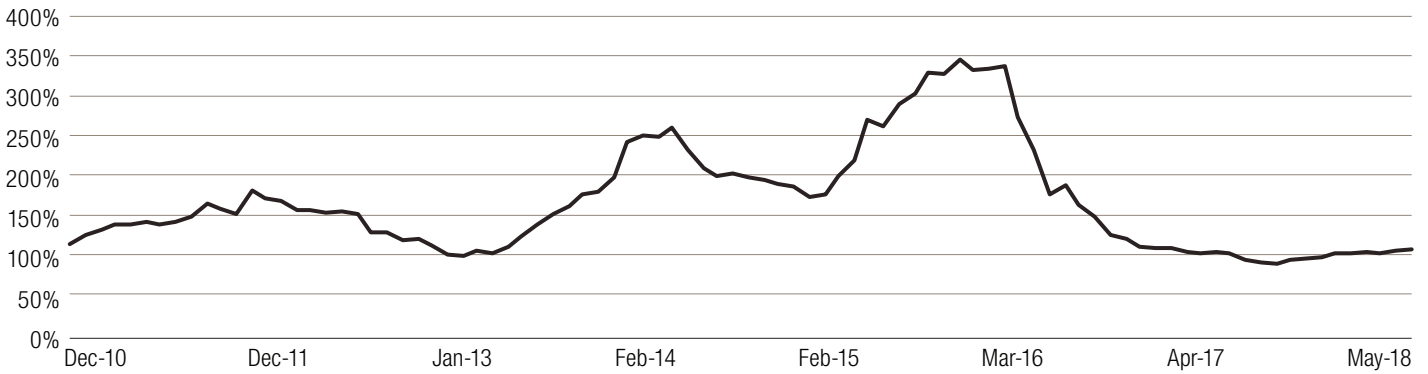


Sources: Bloomberg and JP Morgan. Past performance is not a guarantee of future results.

The escalation has brought discussions of extra-ordinary measures to the forefront. The time for interest rate hikes alone as a mechanism for stabilising the economy looks to have passed, and the radio silence from the Central Bank over the past week suggests that an emergency hike may not be coming anytime soon.

As such, external support now looks to be on the cards. That could come in the form of IMF support, vis-à-vis Argentina earlier this year. However, for the IMF to entertain this idea, a substantial shift in rhetoric towards more sustainable policies will be required by Erdogan and the country's authorities. Failing this, the daunting prospect of capital controls begins to seem a real possibility.

**FIG. 2 TURKISH BANKS' EXTERNAL ROLLOVER RATIOS**



Source: CBRT.

## IMPORTANT INFORMATION

### For professional investor use only.

This document is issued by Lombard Odier Asset Management (Europe) Limited, authorised and regulated by the Financial Conduct Authority (the "FCA"), and entered on the FCA register with registration number 515393

Lombard Odier Investment Managers ("LOIM") is a trade name.

This document is provided for informational purposes only and does not constitute an offer or a recommendation to purchase or sell any security or service. It is not intended for distribution, publication, or use in any jurisdiction where such distribution, publication, or use would be unlawful. This document does not contain personalized recommendations or advice and is not intended to substitute any professional advice on investment in financial products. Before entering into any transaction, an investor should consider carefully the suitability of a transaction to his/her particular circumstances and, where necessary, obtain independent professional advice in respect of risks, as well as any legal, regulatory, credit, tax, and accounting consequences. This document is the property of LOIM and is addressed to its recipients exclusively for their personal use. It may not be reproduced (in whole or in part), transmitted, modified, or used for any other purpose without the prior written permission of LOIM. The contents of this document are intended for persons who are sophisticated investment professionals and who are either authorised or regulated to operate in the financial markets or persons who have been vetted by LOIM as having the expertise, experience and knowledge of the investment matters set out in this document and in respect of whom LOIM has received an assurance that they are capable of making their own investment decisions and understanding the risks involved in making investments of the type included in this document or other persons that LOIM has expressly confirmed as being appropriate recipients of this document. If you are not a person falling within the above categories you are kindly asked to either return this document to LOIM or to destroy it and are expressly warned that you must not rely upon its contents or have regard to any of the matters set out in this document in relation to investment matters and must not transmit this document to any other person. This document contains the

opinions of LOIM, as at the date of issue. The information and analysis contained herein are based on sources believed to be reliable. However, LOIM does not guarantee the timeliness, accuracy, or completeness of the information contained in this document, nor does it accept any liability for any loss or damage resulting from its use. All information and opinions as well as the prices indicated may change without notice. Neither this document nor any copy thereof may be sent, taken into, or distributed in the United States of America, any of its territories or possessions or areas subject to its jurisdiction, or to or for the benefit of a United States Person. For this purpose, the term "United States Person" shall mean any citizen, national or resident of the United States of America, partnership organized or existing in any state, territory or possession of the United States of America, a corporation organized under the laws of the United States or of any state, territory or possession thereof, or any estate or trust that is subject to United States Federal income tax regardless of the source of its income.

Source of the figures: Unless otherwise stated, figures are prepared by LOIM.

Although certain information has been obtained from public sources believed to be reliable, without independent verification, we cannot guarantee its accuracy or the completeness of all information available from public sources.

Views and opinions expressed are for informational purposes only and do not constitute a recommendation by LOIM to buy, sell or hold any security. Views and opinions are current as of the date of this presentation and may be subject to change. They should not be construed as investment advice.

No part of this material may be (i) copied, photocopied or duplicated in any form, by any means, or (ii) distributed to any person that is not an employee, officer, director, or authorised agent of the recipient, without Lombard Odier Asset Management (Europe) Limited prior consent. In the United Kingdom, this material is a financial promotion and has been approved by Lombard Odier Asset Management (Europe) Limited which is authorised and regulated by the Financial Conduct Authority.

©2018 Lombard Odier IM. All rights reserved.