From West to East

Weekly Investment View
12th August, 2018

Turkey casts a shadow on an otherwise great year

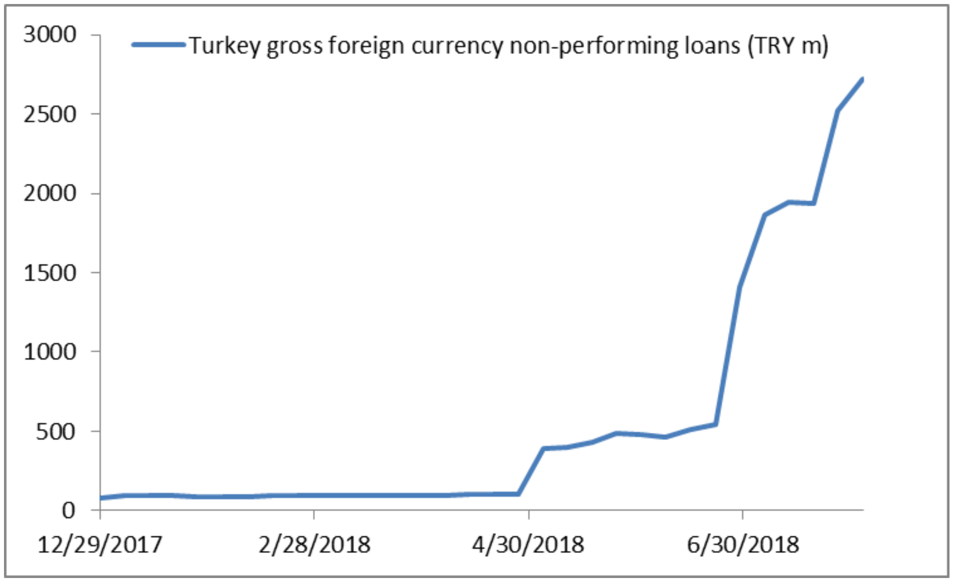
Warren Buffett is credited with saying that investors should get greedy when everyone is afraid and afraid when everyone is greedy. That is a good rule of thumb for long-term investment, but perhaps the Sage of Omaha might have included an addendum: do not stand in the way of a stampede.

That is what the situation in Turkey is becoming. On Friday, the Turkish lira depreciated as much as 16% vs. the US dollar during trading hours, and ended the day down 13.7%. That added to a 30% depreciation for the year-to-date up until Thursday. About the only good news is that Turkish holidays have just become a lot cheaper.

Beyond its beaches, Turkish assets may still be on shaky ground. Such a crisis in the currency of a major emerging market has not happened since Argentina devalued its peso in 2001, when the currency plunged 50% in a matter of days. The last time the lira lost so much was then, too, when the Turkish Central Bank dropped its crawling peg amid a financial crisis. While there are differences between those days and now – the main one being that Turkey and Argentina had their currencies pegged to the dollar – it may be worth drawing some lessons from those dark days.

In late 2000, Turkey sought a US$10.5 billion IMF bailout as its banking system collapsed. Banks were being faced with a run on foreign currency deposits after the lira depreciated 25%. Global financial institutions became wary of lending to Turkish banks and even in Istanbul and Ankara lenders refused to lend to each other.

It was not long before a major bank failed. Demirbank, then the sixth largest bank in Turkey by assets, had been investing in government securities by borrowing in the interbank market. On 20th October, 2000, the bank was unable to borrow in the overnight market and began to sell some of its vast holdings of government securities. That led to losses at other banks holding similar bonds, which then were forced to sell and the whole situation spiraled out of control. At the peak, interbank rates reached 8,000% (yes, four digits).



Ultimately, some 20 banks were taken over and rescued by the government. This time, the financial risks could once again be very real, but for different reasons. The weaker currency could unleash a string of domestic defaults, particularly among corporate borrowers. As much as 40% of loans given by some Turkish banks are in foreign currency, which means repaying them has become 41% more expensive this year.

Banks, therefore, are likely to see bad debts rise further. Total non-performing loans in the country reached US$11.5 billion in August, up from US$9.9 billion in December. Delinquent loans in foreign currency increased 3,346% to US$ 540 million for the year to 3rd August (see chart), according to the central bank. By the end of last year, Turkish corporations had US$316.4 billion in foreign currency borrowings, an 84% increase from 2009. Some 90% of that was owed to banks.

Turkish lenders not only hold a large amount of foreign currency loans, they are also big borrowers in the global debt market, with US$64 billion of bonds outstanding, US$14.4 billion of which are due by 31st December, 2019.

While that may sound scary, the real danger may lie in the less-visible interbank market. Most recent crises in financial markets, including the collapse of Lehman Brothers, were triggered by liquidity issues, rather than longer-run solvency.

As Turks withdraw foreign currency deposits, local banks will need to borrow to meet redemptions. They will depend either on the Turkish Central Bank or on international banks for those dollars. There are US$125 billion in foreign currency deposits in Turkey, and the central bank has US$80.8 billion in reserves. Hence, if global lenders stop giving Turkish banks dollars, the situation could get out of hand.

Since the beginning of August, three-month interbank rates have increased 200 basis points, indicating lenders have already become more wary of each other.

"The situation could get much worse for Turkish assets before it stabilizes."

From West to East

Weekly Investment View
12th August, 2018

Turkey's financial issues could travel. The largest emerging markets have already started to suffer, even though they may not face the same issues.
The MSCI Emerging Markets Currency Index lost a further 0.8% on Friday, its worst one-day rout in 15 months. The move can be partly attributed to the drop in the Turkish lira, but also to weakness in the Russian ruble. However, other emerging market currencies were badly hit too by proxy. The Brazilian real, for instance, which comprises about a sixth of the index, was down 1.6% on Friday. The Korean won, another heavyweight in the benchmark, was down 1.05%. The South African rand lost 2.74% that day too.
While Brazil has its issues, they are different from Turkey's or South Korea's. Investors typically get forced to sell holdings undeservedly because they are more liquid and fund redemptions have to be met. Turkey's stocks and bonds are very difficult to sell at this time.
Hedge funds, for example, may be selling assets in other emerging markets to meet margin calls on their Turkey positions. This kind of move hits even gold, since many hedge funds may have positions in the metal which can be quickly monetized to meet these calls. This helps explain why in the beginning of a crisis even the yellow metal goes down before it rallies. The perfect example is September, 2008. The day after Lehman Brothers announced its bankruptcy, gold dropped 0.9%. It then fell another 4.8%, before reversing and rallying 50% before stabilizing in September, 2011.
In simple terms, the sell-off of other assets due to Turkey has probably just begun, and it has further to go unless Ankara moves heavily to stabilize the situation. In the meantime, market dislocations can be perfect opportunities for investors to pick up cheap, quality assets for the long-term.
The MSCI Emerging Markets equity index, for instance, is already down 8.3% for the year-to-date, driven partly by a 15.5% drop in Chinese equities. Shanghai and Shenzhen stocks have begun to rally, up 2.7% last week as measured by the CSI 300 index, although they ended last Friday 1.5% down for the day, amid Turkish contagion. The MSCI EM index is already trading at 10.5 times expected 2019 earnings, its cheapest in two years. It could still move lower, but that may make it a more compelling investment opportunity.

"The potential emerging market sell-off as a result of Turkey fears may create good investment opportunities."

Developed markets may not be immune to Turkish troubles, either. German lenders have significant exposure to the country, a natural outcome of the large ethnic presence in the country. Almost 5% of Germany's population is of Turkish background, and millions of German citizens have moved to Turkey to retire. Some lenders in Germany have stakes in Turkish institutions, including its banks.
In that, however, the Germans are not alone. Some Spanish and French lenders also have stakes in local financial institutions, or simply large lending exposure to Turkey. Investors have already begun to discount that, and on Friday the financial services sub-index of the STOXX Europe 600 index dropped 0.8%.
Exposure to Turkey, however, does not mean a string of banks in Europe will collapse. On the contrary, some of the lenders which ventured into the country did so because they were thought so solid that they could afford to add risk to boost growth. They will still be bunched together in sentiment terms, however, and sold-off or shorted should fears rise.
This is the point, however, when investors need to start making a shopping list, pending possible further knee-jerk-selling, providing even better entry-points.
For now, the Turkish issue has already created signs of reduced risk appetite.
The yield on 10-year US Treasuries dropped 10 basis points from Tuesday to Friday, while the US dollar index closed above 96.00 for the first time in a year, indicating investors are seeking the safety of US assets. Both moves add to a bearish short-term tendency in emerging markets – and could even begin to impact US stocks.
Earlier last week the S&P 500 was inches away from the record 2,872.9 level at which it closed on 26th January. The index still has every reason to touch that level and indeed hit new all-time highs. Earnings grew 27% in the second quarter compared to a year earlier, and 81% of reporting companies in the US have beaten estimates. Such positive momentum in an economy seeing the lowest unemployment in 40 years means more gains are likely.

However, every bull market has bearish interludes, and there are a few stars aligning suggesting that one could be just ahead. First of all, there is the August effect. Since 1945, the S&P 500 index ended August lower 45% of the time. The numbers look worse for midterm election years, half of which saw stock losses in the eighth month of the calendar year.
History aside, there may be another reason to be cautious in the next two weeks. Data from the Commodities and Futures Trading Commission show very large speculative positions betting the Volatility Index (VIX) would drop further as of 7th August. This matters because the VIX tends to rise when the S&P 500 drops. The gauge was at 10.9 on the day that short position was reported, not too far from the 9.1 record low it hit in November.
The VIX rose on Friday to 13.2, which may force some short-sellers to cover losses, prompting a further spike - all of which could then spill over to the S&P 500 and push stocks down. That is what happened in February. The day after the S&P 500 hit a record, the VIX rose 25% to 13.8 (from 11). That prompted short-covering that pushed the VIX all the way up to 33.5 in about a week. The S&P 500 dropped 10.2% over the same period. Investors who bought the index when it hit this year's low of 2,581 on 8th February, though, gained 8.2% through last Friday.

INVESTMENT SUMMARY: Lastly, the Dubai Financial Market General Index ended the week down by 1.8%, underperforming the broader MSCI GCC Countries index, which was up just 0.3%, reflecting Turkey fears.
Meanwhile, Bahrain announced that it is making progress in financial aid talks with its GCC partners.
The FAB Asset Allocation Committee meets tomorrow and will discuss how investors should position themselves in light of the Turkish crisis.

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com or
Christofer.Langner@bankfab.com

From West to East

Weekly Investment View
12th August, 2018

Disclaimer: