Market Bulletin

August 10, 2018

Should U.S. investors worry about Turkey?

Turkish assets have been under severe pressure, with the Turkish lira depreciating by 42% against the U.S. dollar this year, down 22% this week alone. In addition, year-to-date, local equities are down 19% and the 10-year USD government bond yield is up 309 bps to 8.4% since January 23, 2018, the earliest available trading date this year.

The Turkish economy is finding itself in the midst of a perfect storm, in the following ways:

- Turkey is an importer of oil, with net imports representing 0.7% of gross domestic product (GDP). As oil prices climbed since their 2016 lows, Turkey's inflation climbed and its current account deficit widened, leaving it vulnerable to outflows of capital.
- As sentiment soured towards emerging markets this year, Turkey was indeed seen as one of the more fragile emerging market (EM) economies, with a 6% current account deficit as a percentage of GDP and with 39% of its government debt denominated in U.S. dollars.
- As pressure has continued to intensify on its currency and markets, the Turkish government's response has been seen as inadequate by investors, as the central bank has not meaningfully raised rates and the government has yet to present a comprehensive economic plan to deal with the turmoil.
- The last straw was a worsening of relations with the United States, as the U.S. imposed sanctions last week on some Turkish officials over a diplomatic issue and today proposed doubling the tariffs on Turkish exports of steel and aluminum to the U.S. In order to restore investor confidence in Turkey, an improvement in relations with the U.S. would help; however much more needs to be done on the monetary and fiscal side as well.

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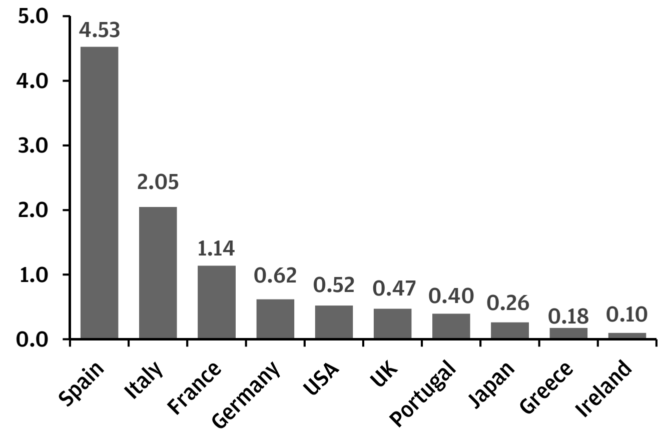
Turkey represents only 0.6% of the MSCI Emerging Markets index and 5.9% of the J.P. Morgan Emerging Market Bond Index Global, thus U.S. investor exposure to Turkey is likely limited, especially on the equity side. Crucially, other EM countries are in a much better position to weather this moment of negative investor sentiment towards the EM asset class. In aggregate, EM countries run a very small current account deficit of -0.1% of GDP, have only 8% of their total government debt in foreign currency, and have inflation rates at or near central bank targets. As a result, investors should remember that Turkey is not representative of the rest of the EM universe.

Today, global markets were under pressure as investors worried about other possible contagion. While Turkey makes up a small percentage of the global economy and financial markets, investors are worried about the issues in Turkey causing damage in other markets around the world, particularly Europe. European banks fell 2.4% on Friday as the European Central Bank raised concerns about bank balance sheet exposure to the deteriorating financial conditions in Turkey.

However, the overall exposure of European banks to Turkey is fairly limited. As seen in **Exhibit 1**, Spanish and Italian banks are most exposed to the Turkish financial system, with 4.5% and 2.1% of total balance sheet exposure to Turkey. These numbers are relatively small and the rest of the global banking system has very little exposure to Turkey. Furthermore, European banks are in a significantly stronger financial position than they were a few years ago. The tier 1 capital ratios for European banks has risen from 10% in 2012 to over 15% in 2018, meaning that European banks can handle Turkish financial issues. Therefore, the risk of contagion in Turkey destabilizing the wider financial markets via the banking channel is fairly limited.

EXHIBIT 1: BANK EXPOSURE TO TURKISH COUNTERPARTIES BY COUNTRY



Source: BIS, J.P. Morgan Asset Management. Exposure to Turkish counterparties is percentage of overall counterparty exposure. Data are as of August 10, 2018.

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