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TURKEY: SHOULD INVESTORS REMAIN LEERY OF THE LIRA?

KEY POINTS

- The Turkish lira suffered a pronounced sell-off in the period before the June 24 general elections due to tepid policy responses to global market conditions.
- Although monetary policy simplification and interest rate hikes were constructive, we believe additional tightening is needed to stabilize the currency in the postelection period.
- However, the Erdogan government's long-standing priority of maintaining high levels of economic growth clouds the outlook for further policy action.
- While the lira appears undervalued and favorable debt profiles benefit the corporate sector, we remain cautious toward Turkish assets in the postelection period.

While Recep Tayyip Erdogan's first-round victory in the June 24 presidential election brings increased political certainty to Turkey's future, the country remains one of the more vulnerable investments in emerging markets due to continued concerns regarding the stability of the currency. While most emerging market currencies declined against the strengthening U.S. dollar this year, the Turkish lira suffered a pronounced sell-off, at one point falling more than 20% below its value at the beginning of the year. Despite the central bank of Turkey (CBT) simplifying its monetary policy framework and implementing rate hikes in May, additional tightening will be needed in the period following the election as large macroeconomic imbalances have not been thoroughly addressed.

POSITIVE STEPS, BUT MORE NEEDED

The announcement of monetary simplification was, in our view, a significant step forward in addressing the rampant inflation and falling lira. The move switched the key funding rate that the CBT uses to fund Turkey's financial institutions to the one-week repo rate from the previous Late Liquidity Window (LLW). The CBT raised the repo rate from 8.5% to 16.5% and then hiked it again the following week to 17.75%. Crucially, the new framework increased clarity and brought a more rules-based approach to how monetary policy is implemented and funding rates are set and maintained.

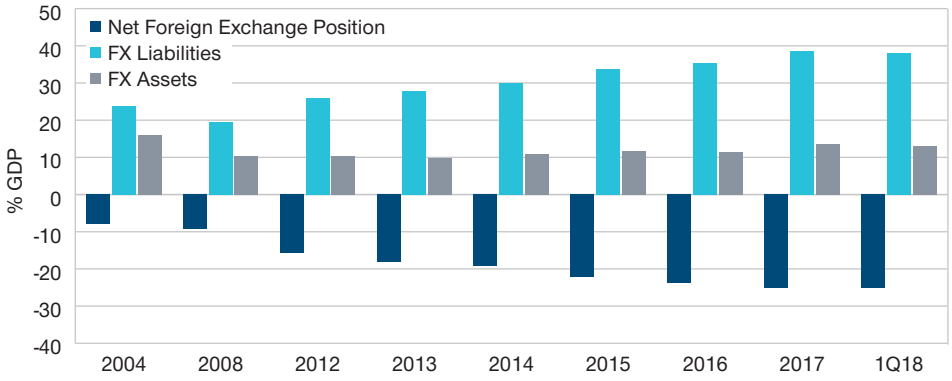
However, we believe that additional policy tightening will be needed to attract capital back into the country and stabilize the lira, for two main reasons. First, a key trigger to the lira's underperformance was the ongoing global shift to a higher-rate, tighter monetary environment, which has seen U.S. Treasury yields climb and the dollar strengthen in 2018. We expect these trends to continue in the medium term, which would exacerbate

pressures on the CBT to keep pace with market trends rather than fall behind as it did earlier this year.

Second, effective real interest rates are still not high enough to stabilize the lira long term and the real rate could get squeezed further as it is likely that inflation in Turkey will continue to rise despite the recent rate hikes. The government's accommodative fiscal policy, alongside the effects of the lira weakness and ongoing fiscal stimulus, could push headline consumer price index inflation up an additional 3% to 4% in the second half of the year, in our view. Currently, the market is pricing in around 75bps more of additional rate hikes on top of the 175bps hike that came on the heels of the policy simplification. If policymakers again fall noticeably behind market expectations for tightening, another run on the lira seems likely. However, further positive steps in the postelection period could result in a sustained rally in the country's assets as the lira is currently cheap relative to its fundamentals and many emerging market currencies.

FIGURE 1: **Nonfinancial Corporate FX Assets and Liabilities**

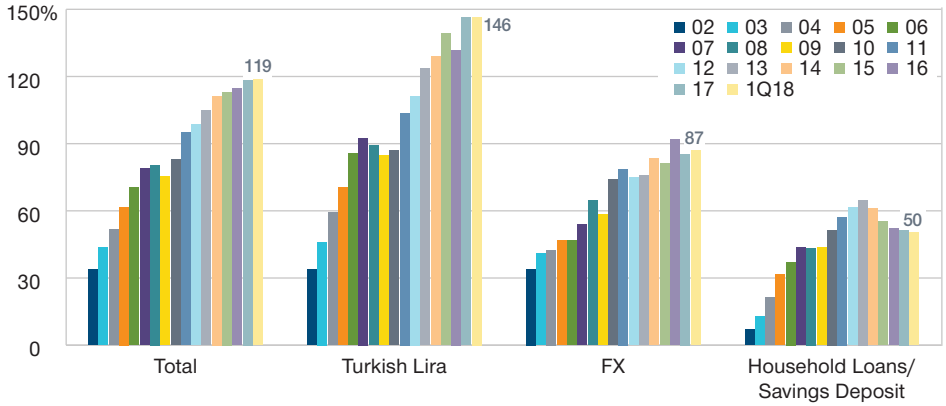
As of March 31, 2018



Sources: The central bank of Turkey and Haver Analytics.

FIGURE 2: **Banking Sector LDP Ratio**

As of March 31, 2018



Sources: The central bank of Turkey and Haver Analytics.

POLITICAL PRIORITIES CLOUD OUTLOOK

Complicating the outlook are the uncertain longer-term priorities of Erdogan following his re-election as president. Erdogan's government has long focused on maintaining a high economic growth rate in order to satisfy the country's youthful demographic and growing population. This economic growth has been achieved largely by increased borrowing in the private sector in order to fill a growing gap between investment and savings levels. Figures 1 and 2 illustrate the rise in foreign currency exposure of the country's corporate sector, along with the escalation in the loan-to-deposit ratio in the banking sector, which was the second fastest, globally, over the past 10 years, following China.

While the victory for Erdogan alongside a majority in parliament for his Justice and Development Party (AKP) should bring political stability in the near-term, it also makes it unlikely that there will be a sudden deviation from Erdogan's long-held objectives. His comments in early May stating that "interest rates are the mother and father of all evil" cannot be easily dismissed.

Sticking to this growth-first agenda at a time when global interest rates are trending higher would likely trigger further sharp depreciations in the lira, which would eventually be felt in the wider economy more severely than the sell-offs earlier this year. The Turkish economy is reliant on foreign capital to grow, and if policymakers fail to rein in inflation, capital will continue to exit the country. Eventually, over the next one to two years, external imbalances and rising leverage ratios would become unsustainable for an increasing number of corporates and could trigger negative asset quality cycle, which would, in turn, put pressure on the country's banks. While the CBT does have room on its balance sheet to step in and support the private sector, this would seriously impact Turkey's credit quality and probably result in a wide sell-off in Turkish assets.

The postelection period is likely to be critical. With the immediate political necessities of winning an election out of the way, the government will have increased flexibility to address the market realities facing Turkey's economy.

POSTELECTION OPTIMISM?

Working in the Turkish economy's favor is the fact that this situation is not likely to occur in the near term. The corporate sector benefits from a favorable duration profile and does not face any serious funding concerns in the immediate future. In addition, the domestic banking sector continues to access long-term external borrowing and is able to provide the liquidity needed for the corporate sector to roll over its debt.

The main concern during the recent sell-offs was not so much unsustainable external debt levels but the direction and speed of the growing imbalances, alongside the lack of policy response. While we believe that no serious threat to the private sector is imminent, it cannot be ruled out over the longer term in the absence of further tightening by the central bank and a willingness by the government to ease its growth objective.

The postelection period is likely to be critical. With the immediate political necessities of winning an election out of the way, the government will have increased flexibility to address the market realities facing Turkey's economy. We are hopeful that the recent policy simplification and increased rate hikes are signs that the CBT and the Turkish government are now more committed to maintaining long-term stability. However, the government's recent policy priorities and inflammatory rhetoric are a reminder of the need to approach the situation cautiously and employ prudent risk management of lira holdings and investments in Turkey more generally.

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