Investment Insights

The Unfolding Crisis in Turkey

Rebecca Patterson
Chief Investment Officer

Highlights

- A deepening economic crisis in Turkey has rattled global markets as investors fear contagion
- Turkey's issues have been years in the making; long-time structural issues have been exacerbated by recent policy changes and discord with the U.S.
- The country has yet to take significant action to stabilize its currency, but has multiple options available
- For now, we see the crisis as a short-term challenge rather than an event that could kick off a global recession

August often brings market surprises — small events can have larger-than-expected impacts during the month, in part because the summer holiday season means fewer traders and reduced market liquidity (i.e., market moves are exaggerated by the lack of trading volume).

As of Friday, it appears we officially have our first (hopefully only) 2018 August surprise: Turkey. Problems in the country have been brewing for some time, but a new phase — a proper crisis — erupted a few days ago. So far this August, the Turkish lira has lost nearly 30% of its value against the dollar. In this *Investment Insights*, we cover Turkey in a little depth: how we got here, what's happening now and where things might be headed. What's most important to remember is this: the global linkages in economies and markets today mean that Turkey absolutely can have spillover to many other asset classes/markets/countries and do damage to the global economy — at least short term. We should all care about this.

How Did We Get Here?

Turkey has had some structural problems for years. It imports most of its natural resources (including oil and gas); it typically runs a large current-account deficit. That deficit means that in order for the Turkish currency to hold steady, the country needs to attract a roughly equal amount of foreign capital (that offsets the selling of lira to pay for the imported goods). Currently, the deficit is quite large — more than 6% of GDP. That means the country really, really needs foreign investors to find it attractive.

In addition, recent years have seen Turkish President Erdogan change policy notably. Early in his tenure, he was a Western-oriented reformer who played down religion in the country. Investors loved this, and capital followed. The lira gained, the deficit shrank, and the economy boomed. I happened to visit Turkey during this period, and was blown away by the entrepreneurial spirit I saw as well as very modern, new construction (commercial and residential).

More recently, with his local support waning, Erdogan has become much more autocratic and religiously minded. Instead of welcoming foreign investment, he is blaming many of his challenges on foreign governments and even media. People who speak out are jailed. Indeed, last month he replaced his head of economic policy with his son-in-law. Markets saw this as a warning sign that economic and central bank policy would no longer be independent — this event in particular weighed heavily on the lira.

This year, Turkey's problems have been made worse by a growing row with the United States. Turkey was a recipient of U.S. steel and aluminum tariffs in March (along with many other countries). It responded in June with tariffs on $1.8 billion of U.S. goods including coal and paper. At the start of August, reportedly to pressure Turkey to release an American pastor who has been held for an alleged coup plot, the Treasury Department sanctioned a few Turkish officials. Then, reportedly in response to the weaker lira (which all else equal makes Turkish exports more competitive), the U.S. announced on August 10 that it would double tariffs on Turkish steel and aluminum imports.

Turkey has not helped itself much in this process. Normally in a currency free fall, central banks raise interest rates aggressively to make selling (or shorting) the currency unattractive and to make local debt look more attractive (via a higher yield). While Turkish 10-year government bond yields are high (now around 20%), and policy interest rates are 17.75%, the central bank, rather than hiking further, kept interest rates steady at its latest meeting. This decision was worrisome to investors, as higher interest rates are seen as needed to steady the currency and arrest inflation (consumer prices rose by 15.4% in June, more than triple the central bank's inflation target). Indeed, Erdogan has suggested he thinks lower interest rates will be more helpful to the economy (might be true in some respects but will not help the currency near-term).

What's Happening Now?

Investors over the last few days in particular have been trying to better understand contagion risks from Turkey. There are a few ways Turkish challenges can spread. First, total foreign bank exposure to Turkish debt was $223 billion as of March. While there is some exposure held by U.S. banks, much more is held by European banks, primarily in Spain, then France and Italy. If U.S. (or other) investors hold exposure to the European banks in question, they could see the value of those securities fall near-term (the selling of European stocks is pulling the euro lower). Second, as the lira falls and the U.S. dollar appreciates, U.S. multinational firms that benefit from a weaker dollar can come under some short-term selling pressure. Third, as investors look for other "Turkey-like" risks, they tend to shed emerging-market equities in general. And finally, fourth, as emerging markets broadly come under pressure and investors question the strength of the global economy, cyclically sensitive assets such as oil start to come under pressure — that in turn can weigh on related equities.

Where Might We Be Headed?

Many investors are looking for Turkey to take more aggressive action to stabilize its financial markets. That could come in a few forms. It could raise interest rates much higher. It could also introduce capital controls (so locals cannot sell lira), and/or it could secure an aid package from the International Monetary Fund (IMF) — normally, funds in return for promises of reform. Right now, it seems Erdogan would prefer not to ask for outside help, but he may have to rethink things if the crisis worsens.

In addition, the U.S. could take a more supportive posture, at least near-term, towards the lira and Turkey more generally. This too seems unlikely given President Trump's view on trade and currencies. With a blocking minority of votes at the IMF, the U.S. could use its leverage to restrict IMF aid to Turkey given the current dispute between the two governments over the detention of the American pastor. That said, we would note that Turkey is a very important geopolitical ally for the United States. The U.S. has important bases in Turkey that it relies on for activity in North Africa and the Middle East. Further, the U.S. sells a lot of military equipment to Turkey and would not want to see it replaced by a less friendly source (Turkey has been in discussions to buy a Russian missile defense system, something that has aggravated the U.S.). There is unconfirmed market speculation that the American pastor at the center of the dispute could be released as early as Wednesday, an action that could ease tensions between the two countries.

One event to watch near-term: the annual meeting of central bank (and other) officials in Jackson Hole, Wyoming, from August 23-25. We expect a lot of officials' comments about Turkey and other challenges to the economic system at this time — often investors can get some "clues" as to the propensity of central bankers to take steps to mitigate risks from these interviews. Any sense that current uncertainties are leaving the Fed feeling modestly more dovish would likely help stabilize global investor sentiment.

Overall, at least for now, we see the Turkish crisis as a short-term challenge rather than an issue that has a significant chance of kicking off a global recession. With that in mind, and given our underweight exposures to emerging market and European equities, we think we can hold steady with our portfolios and just carefully monitor conditions. If we were to see actions that change that risk profile, we could absolutely shift allocations for portfolios where it is needed.

Beyond Turkey, this week includes some key data from China. Recent days have seen China announce forms of stimulus to help the economy offset the trade war. Note that just before Jackson Hole, Washington will hold public hearings (August 20-23) on the next round of tariffs on Chinese goods ($200 billion worth of goods and a 25% tariff rate).

The Investment Department is here, regardless of the season, making sure we constantly question where the world is going and trying our best to position portfolios properly.

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