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Turkey base case: Slow adjustment, not crisis

By Jan Dehn

During the summer of 2013 sentiment about Emerging Markets deteriorated to the worst levels seen since 2008/2009. Turkey was singled out for special treatment in the sell-off. Critics focus on the country's large current account deficit, the dependence on short-term portfolio flows to fund this deficit, and rapid growth of domestic credit.[1] The heterodox central bank, the bears say, is too focused on delivering high growth in the short term at the expense of price stability, while the government ignores the tough decisions required to produce a higher trend growth rate that can be sustained through the economic cycle.

There is no doubt that Turkey's economy is in need of adjustment, probably more so than any of the other so-called 'Fragile Five' Emerging Markets economies.[2] But while more adverse scenarios certainly cannot be ruled out (especially if the global economy experiences a more serious bout of financial tightening) our base case is more benign than that of Turkey's harshest critics. We believe that the recent weakness in Turkish markets has not gone unnoticed by policy-makers and that Turkey is prepared to make the required adjustments to avoid a crisis. Moreover, behind Turkey's cyclical challenges lie a number of important fundamental strengths that will continue to justify long-term engagement by investors in Turkey. And it is precisely these strengths that constitute the difference between adjustment and crisis.

Behind the cyclical challenges lie a number of important fundamental strengths that will continue to justify long-term engagement by investors in Turkey.

Still, Turkey is not out of the woods. The key issue over the next few quarters is the central bank's handling of the business cycle. Our view is that Turkey's vulnerabilities are located in the property sector. This will lead the central bank to keep rates low and credit conditions less tight than might otherwise be required, possibly at the expense of low inflation and the currency, though we do not expect the central bank to lose control of either. Slow adjustment is the likely path. A marginally stronger European growth outlook should help Turkey's exporters. There is considerable upside optionality for Turkey in greater stability in the Middle East and a more open Iran.

A weaker currency and even stubbornly high inflation does not preclude exposure to Turkish fixed income, but involvement requires active and selective exposure. Rates and FX can be traded independently and Turkey has a liquid inflation-linked bond market (off-benchmark). Meanwhile, the summer sell-off offers new opportunities to build fresh positions in equities. The weaker currency means that opportunities are perhaps now opening most prominently in the dynamic export sector. Our base case that Turkey avoids a crisis means that the long-term case for investing in Turkish equities remains extremely strong and that the current negative sentiment offers good entry points for strategic investors.

The policy challenge

Cutting to the chase, Turkey's problem is that its current account deficit is close to 7% of GDP. This is too high. Moreover, Turkey has accumulated deficits over a long time, so the country's net foreign investment position has deteriorated. Domestic savings rates are low, so Turkey's external deficit relies on external financing, which can be fickle. As a result, nervous foreign investors have shortened their investment horizons and FDI flows have dropped to lower levels than Turkey could potentially attain if it had a stronger external position.

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The origin of Turkey's external imbalance is excessive domestic demand stimulus. Hence, to address this problem, Turkey needs to restrain domestic demand, particularly private sector demand. The correct policy is a combination of domestic demand restraint and currency adjustment to improve external competitiveness.

[1] http://www.imf.org/external/np/ms/2013/093013.htm

[2] A term coined to describe Turkey, South Africa, Brazil, India, and Indonesia. These five countries became the focus of short-sellers during the summer sell-off on account of their current account deficits, heterodox policies, or both.

Unfortunately, monetary policy has become a source of uncertainty in the past few years as the Central Bank of Turkey (CBT) has changed the balance between FX and rates adjustment at least four times over this period:

- **Phase A:** Orthodox monetary policy. Currency floats and rates are the key policy instrument used to control inflation
- **Phase B:** Shift to heterodox policy. Rates collapse, but currency sells off
- **Phase C:** CBT hikes rates and kills FX volatility, but attracts hot money inflows
- **Phase D:** CBT lets FX go in order to keep rates low

Fig 1: **USDTRY: Four phases of FX policy...so far**

Source: Bloomberg, Ashmore, to 30 September 2013.

The many shifts in CBT policy appear to have been motivated in a large measure by the CBT's own view of the importance of the global economic backdrop. In this view, abundant global liquidity emanating from money printing in developed economies creates constant pressures for currency appreciation in Emerging Markets (EM). Currency appreciation in turn justifies lower policy rates by putting downwards pressure on inflation, but the search for yield in a world of low rates in developed markets also pushes down yields on EM government bonds and therefore increases bubble risks in the private sector. In turn, this justifies more aggressive application of macro-prudential measures on domestic banks. Since low policy rates are insufficient to discourage excessive flows into the currency, there exists a need for a new instrument to address this particular problem. This new instrument is volatility. The CBT actively manages the overnight interest rate corridor in order to directly impact the cost of funding long positions in TRY. The idea is that by raising the volatility of overnight funding, the overall cost is increased even if actual rates are not raised (because volatility is a negative for the market).

So what has gone wrong? It appears that the CBT has over-estimated the external drivers of credit growth and underestimated the domestic drivers. Moreover, it seems that measures to curb domestic credit growth have been less stringently applied than efforts to curb currency appreciation.

Low rates and a broadly neutral fiscal policy means that the overall macroeconomic stance has been too easy, while the currency's depreciation has provided a tailwind for demand rather than the gentle headwind anticipated from on-going appreciation. The signs that domestic demand pressures have been insufficiently addressed are self-evident. They include the wide current account deficit, inflation levels well above the CBT's own target, policies to stimulate credit in specific sectors of the economy, and overall domestic credit growth rates that earlier this year reached 40% yoy.[3]

On the external side, for all its sophistication, such as the use of volatility as a policy instrument, the CBT's bias in favour of highlighting external risks over domestic ones gives the policy stance a distinctly heterodox flavour. While the recent Fed U-turn on tapering shows that the CBT is right to expect continuing easy monetary policies in developed countries, the last few months have also shown there is no guarantee that easy policies in the US and Europe will lead to inflows to EM currencies; indeed flows have actually been the other way. One of the features of the global financial markets over the past few years is precisely its tendency for big swings in either direction, the so-called 'risk on/risk off'. The market will periodically expect tighter global financial conditions.

Adjustment, not crisis

The good news is that the adjustment is already underway, though it has further to run. The Turkish lira has already declined 12% since April. This will begin to improve competitiveness. But currency adjustment without domestic demand adjustment only provides temporary relief. Ultimately, the adjustment process has to address both domestic and external imbalances, striking a balance between FX and domestic demand measures so as to maximise the efficiency of adjustment (i.e. reducing the economic costs). Finding this balance will be the main challenge.

We think Turkey's policies will be biased more in favour of a weaker currency than higher rates. Why? Firstly, in our view, the sensitivity of the private sector to a weaker currency is not as great as many think. It is mainly large corporates and banks that have big foreign liabilities and many of these have the means to absorb FX losses.[4] Moreover, Turkey's net central bank reserves (net of gold and liabilities) are only USD 40bn, well short of the gross reserve position of USD 104bn, although if it comes to it, we think Turkey could access a tremendous arsenal of other sources, including swap lines and IMF support.

Turkey's net central bank reserves may be substantially lower than reported, but it could access a tremendous arsenal of other sources.

Secondly, Turkey's property sector is vulnerable to higher rates. Given the poorly developed pension system and a paucity of alternative savings instruments, property is not just an investment vehicle but also a store of value. A sharp rise in interest rates could adversely impact the real estate sector, thereby also eroding savings, which would in turn depress consumption and possibly challenge some smaller banks.

[3] *"Turkey: Adrift unless data prove MPC right"*, Emerging Markets Quarterly Q4 2013, Credit Suisse.
[4] For example, a recent amnesty for corporates with undeclared foreign assets revealed USD 26bn of off-shore deposits..

In short, the economic fallout from materially higher rates would extend well beyond the narrow confines of the construction sector. Having said that, the CBT will not refrain from raising rates if the economy picks up.

If, as we think, the CBT in steering Turkey through its adjustment, will be biased towards letting the currency weaken further in preference to raising policy rates then the growth outlook is likely to be subdued. Real GDP growth in the 3.5-4.5% range seems realistic to us over the next couple of years. Since the currency is an important anchor for business confidence the maintenance of policies to gradually weaken TRY will help the domestic demand adjustment by slowing down the pace of domestic credit creation. In turn, this limits the extent to which currency weakness passes through to the main inflation index, though it does not eliminate pass-through altogether, so inflation will only come down gradually. In an environment of relatively low rates, banks are likely to continue to roll their existing lines to corporates and households, which will help to prevent a sharp downside to growth. However, barring the abandonment of the heterodox policy regime at the CBT, which we do not expect, we think investment spending will continue to be subdued.

One of the reasons we do not expect inflation to get out of control is that the government maintains a relatively conservative fiscal stance. Even so, the slowdown in growth required to address the external imbalances is likely also to reduce revenues and hence precipitate a modest fiscal erosion. One silver-lining is that the supply-side of Turkey's economy does not suffer from many of the rigidities observed in other countries – in other words, wages can adjust more quickly to lower demand and Turkey's generally sound infrastructure means that private investment does not run into the constraints seen in many other countries. On the other hand, this also means that there are few obvious things the government can do on the supply-side in the near-term; Turkey's productivity could undoubtedly be enhanced (thereby reducing the need for demand side adjustment) with more investment in human capital, more inclusive political institutions, and resumption of EU accession talks along with further progress in Turkey's South East, but these are all longer-term interventions.

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Risks

What are the main risks facing Turkey as it undertakes its gradual adjustment process? The single biggest economic risk is a sudden material spike in real US interest rates that would put upwards pressure on the Dollar. The resulting sharp TRY depreciation would force the CBT to hike rates, thus hurting the economy where it is most vulnerable, namely the property sector. In an environment of more sustained pressure investors will also focus on the relatively low level of net FX reserves.

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However for reasons we have discussed elsewhere, we think there are serious limitations to the US economy's ability to handle higher real rates on a sustained basis.[5] Moreover, in the longer-term we expect the US to experience inflation, which should put downwards pressure on both the Dollar and real interest rates. In other words, the global environment in the next couple of years is more likely to subject Turkey to interest volatility than sustained higher rates, in our view.

Our base case is that Turkey's macroeconomic adjustment will be gradual and manageable.

Our base case is that Turkey's macroeconomic adjustment will be gradual and manageable. If Turkey maintains its gradual approach to adjustment, the external balances should improve significantly over the next few years. On the domestic front, the slower growth rates will mean that NPLs rise, but we do not expect to see major banks fail, though housing will cool down.

On the political front, Turkey is a democracy with regular elections and 2014 will be heavy with political events, including municipal elections in March, the first election of a directly elected president in the summer and, on current projections, a parliamentary election in Q3 2014, though it is possible that presidential and parliamentary elections will be combined. The institutionalisation of democracy has progressed materially in the past decade, but a busy political agenda is bound to create volatility.

The most likely outcome at this early stage is that Prime Minister Erdogan runs for and wins the Presidency, while the AK Party retains its dominance in parliament. We do not expect constitutional changes to further empower the Presidency so the main source of uncertainty on the political front will revolve around the balance of power between Prime Minister, the party, and the elected president. This uncertainty will only diminish once the personalities and the relative strengths between the key institutions in Turkey become apparent following the outcome of the elections. However, we believe Turkey's elections will be peaceful, free and fair and adhere to the rules stipulated in the Constitution.

[5] *"A pleasant fiction"*, The Emerging View, September 2013.

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Fundamental strength

Looking beyond the immediate cyclical challenges, Turkey, like many other Emerging Markets countries, has tremendous strengths:

- Turkey's demographics are strong for its income class due to a large population of young people. This translates into a rapidly growing labour force and rapid formalisation of labour markets
- Turkey's private sector is highly adaptable and dynamic. This means that Turkey is likely to continue to be a high growth economy compared to other countries
- Turkey's economy is flexible due to absence of influential unions or excessive regulation
- Turkey has very good infrastructure, including ports, roads, and power
- Turkey continues to occupy an extremely important geostrategic position, which will ensure strong support from powerful allies
- The rapid development of Turkey's financial markets is likely to continue. At the heart of this evolution is the establishment of the private domestic pension system, which is still small by international standards. The experience from other Emerging Markets countries is that development of the domestic pension systems is critical to imparting stability to domestic bond markets, which in turn encourages both savings and investment

Beyond these strengths, there are two distinct upside risks on the horizon:

- First, the recent more accommodating political signals coming from Iran are important. A less confrontational Iran would open large export markets for Turkey. Turkey's manufacturers (and construction companies in particular) are already among the most important in the Middle East, and they would be well positioned to expand into Iran. Similarly, improvements in domestic conditions in Iraq and Syria would present a big opportunity for Turkey. If Turkey's domestic construction sector is slowing down, which we think is both necessary and likely to happen, the industry would benefit significantly from greater expansion into its two large neighbours to the south east.
- Second, Turkey still retains the option to re-establish closer ties with the European Union. President Francois Hollande of France is far less opposed to Turkey EU accession than his predecessor. Chancellor Merkel has also become less vocal in her opposition to Turkish EU membership. Ankara has not exploited this option yet, but the Turkish public would strongly welcome a return to closer ties with the EU, including the prospect of full membership. One of the major advantages of an EU anchor for the government would be that the government could shed allegations from some quarters following the government's handling of the Gezi Square protests in June of this year that the administration has become less inclusive.

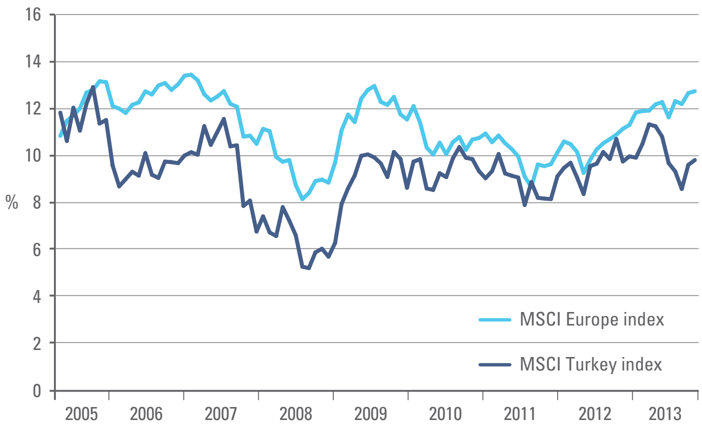
What this means for equities and fixed income

Investors have been wary of socio-political issues in early summer, as well as recent currency weakness. As a result, returns in Turkey (both in local and USD dollar terms) have certainly not been impressive recently.

Looking forward, the near-term opportunities in fixed income are likely to be in the short end of the yield curve, although we also see opportunities in tactical trading of the currency and inflation-linkers. In general, we favour a tactical approach to fixed income pending full rebalancing of the economy.

In equities, valuations are now at the best levels we have seen in some time. Currently Turkish equities are trading at a PE 2014 of 9.6x and PE 2013 of 10.1x. This is at a significant discount to its historical average, and even to Emerging Markets as a whole, which are trading at 10.2x and 11.4x respectively. When comparing to regional peers such as Europe, the discount is even more dramatic, with European equities trading at PE 2014 of 12.2x and PE 2013 at 13.7x.

Fig 2: **12 month forward-looking PEs: Turkish stocks trade at a large discount to European stocks**



Source: Bloomberg, Ashmore, to 30 September 2013.

Fundamental strengths will drive earnings growth in the medium and long-term. In Financials, banks have borne the brunt of the market sell-off as investors assessed the impact of the Fed tapering and weakening currency levels. The heavy exposure to property in the financial sector means that it is important to be selective, identifying institutions where asset quality is strong and loan books are growing, non-performing loans are stable and net interest margins less volatile. Within the consumer sector, we are finding selective opportunities within both Consumer staples and Discretionary, where we are looking for companies that are beneficiaries of a growing export market in the Middle East and long-term secular spending trends at home. Overall, there are plenty of attractive opportunities.

We are confident that as the market risks subside and investors recognise the strength of fundamentals and attractively priced opportunities, the market will once again deliver attractive returns.

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