MONTHLY MARKET REVIEW

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From Turkish Delight to Dislike

A Classic Currency Crisis, But More Political in Nature

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Equities delivered another month of "Make America Great Again" -- the S&P 500 Index climbed to new all-time-highs while many overseas markets languished. With the exception of the housing market, which was hurt by the worst affordability measures since the depth of the Great Financial Crisis, the U.S. economy continued to grow above the trend-line. The strong U.S. economy has enabled President Trump to conduct his "America First" trade negotiations from a position of strength. On the positive side, the U.S. and Mexico reached a deal on issues that have held up the North American Free Trade Agreement (NAFTA) re-negotiation for more than a year. On the flip side, Canada has refused to yield to Trump's pressure to take it or leave it. The trade negotiation with China still lacked traction and more tariffs will likely go into effect. Emerging markets had a tough month with currency routs in the Turkish lira, the South African rand, and the Brazilian real due to political and economic concerns. The negative sentiment also dragged down the currencies of India and Indonesia, which were arguably on sounder economic footing. Base metal prices weakened on China's decelerating growth. However, China appeared ready to open up the spigot on infrastructure spending to help stabilize its economy. The Chinese central bank's effort to stabilize the yuan was also a positive development. U.S. Treasury yields declined and the yield curve flattened further in spite of the solid domestic economy. Trump again complained about the Fed's tightening, but Fed Chair Powell has remained steadfast in monetary policy normalization. Lastly, the U.S. Senate lost a man of principle and courage. In an era of hyper-partisanship, reality-TV politics, and divisive populism, the late Senator John McCain was the conscience of the chamber and a voice of civility and centrism. For financial markets, the disappearing political center will likely have unsettling long-term implications here and abroad.

EQUITY MARKETS INDICES[1]	7.31.18 PRICE	8.31.18 PRICE	MTD CHANGE	YTD CHANGE
MSCI All Country World	520	523	0.6%	1.9%
S&P 500	2816	2902	3.0%	8.5%
MSCI EAFE	2006	1962	-2.2%	-4.3%
Russell 2000®[2]	1671	1741	4.2%	13.4%
NASDAQ	7672	8110	5.7%	17.5%
TOPIX	1753	1735	-1.0%	-4.5%
KOSPI	2295	2323	1.2%	-5.9%
Emerging Markets	1087	1056	-2.9%	-8.8%
FIXED INCOME				
2-Year US Treasury Note	2.67%	2.63%	-4	74
10-Year US Treasury Note	2.96%	2.86%	-10	46
BarCap US Agg Corp Sprd	1.09%	1.14%	5	21
BarCap US Corp HY Sprd	3.36%	3.38%	2	-5
CURRENCIES				
Australian *(AUD/$)*	1.35	1.39	-3.2%	-7.9%
Brazilian Real *(Real)*	3.76	4.06	-7.3%	-18.3%
British Pound *($/GBP)*	1.31	1.30	-1.2%	-4.1%
Euro *($/Euro)*	1.17	1.16	-0.8%	-3.4%
Japanese Yen *(Yen/$)*	112	111	0.7%	1.5%
Korean Won *(KRW/$)*	1119	1113	0.5%	-4.1%
U.S. Dollar Index *(DXY)*	94.55	95.14	-0.6%	-3.2%
COMMODITIES				
Gold	1224	1201	-1.9%	-7.8%
Oil	68.8	69.8	1.5%	15.5%
Natural Gas, Henry Hub	2.78	2.92	4.8%	-1.3%
Copper *(cents/lb)*	283	265	-6.4%	-19.7%
CRB Index	195	193	-0.8%	-0.5%
Baltic Dry Index	1747	1579	-9.6%	15.6%

Source: Bloomberg

The world needs more mature behavior rather than populist braggadocio.

From Ottoman to the Republic

On October 7, 2016, Andrew Brunson, an American pastor for a small evangelical Presbyterian congregation in the Turkish city of Izmir, was summoned to the local police office. Brunson thought it was to discuss his visa renewal, but he was instead taken into custody and later charged with "membership in an armed terrorist organization." The Turkish government alleged that Pastor Brunson had ties to the Gülen movement, which was allegedly behind the failed July 2016 coup against President Recep Tayyip Erdoğan, a strongman with the ambition to restore the glory of the Ottoman Empire under Islamist rule.

The Ottoman Empire, founded in 1299, was one of the greatest transcontinental empires in history. At the apogee of its power in the 16th and 17th centuries, its territory spanned Southeast, Central, and Eastern Europe, the Middle East, the Caucasus, and North Africa. Its economy flourished with the control of overland trade routes between Europe and Asia. The empire's expansion aided the spread of Islam, but it was also tolerant of other religions and cultures. Over time, however, Europe's maritime adventures eroded the Ottoman's grip on the highly profitable trade by opening up seaborne routes via the Cape of Good Hope. Europe's technological advances also led to superior military forces that gradually chipped away at the empire's territory. Following the Great War in which the Ottoman Empire sided with Germany, the Allies occupied Constantinople, the capital of the Ottoman Empire, and proceeded to partition the empire.

The Republic of Turkey was founded in 1923, after the nationalist movement led by Mustafa Kemal Atatürk, a war hero and a highly decorated military officer, defeated the occupying forces. Turkey's founding ideology, so-called Atatürkism, embraced democracy and secularism, and it also chose to remain neutral diplomatically during its early years. In 1952, out of fear of a Soviet invasion, Turkey joined the North Atlantic Treaty Organization (NATO). In 1995, Turkey signed a customs union with the European Union (EU) that facilitated bilateral trade and foreign direct investment. In 1999, Turkey was officially recognized as a candidate for full EU membership. However, the success on the diplomatic front could not forestall an economic crisis that broke out in 2000, as foreign investments dried up on fear of domestic political instability. The International Monetary Fund (IMF) had to step in to offer assistance and to institute many market-oriented reforms that eventually brought down chronically high inflation and rekindled growth.

Erdoğanomics & the Strongman

In 1998, Mr. Erdoğan, then mayor of Istanbul, was found guilty of and later imprisoned for inciting religious hatred by reciting a poem that indirectly celebrated Islam at a rally. Turkey's military has historically defended secularism at the expense of democracy. Erdoğan went on to cofound the Islamist-rooted Justice and Development Party (AKP), and won a landslide election in 2002. He served as the prime minister from 2003 to 2014, and then became the president in August 2014.

The timing of AKP's rise was fortuitous, as the Turkish economy was starting to reap the benefits of IMF-mandated reforms. Inflation came down materially and foreign direct investment poured in for the country's closer integration with the EU. The years 2002 through 2007 were an exceptional period: real GDP growth averaged 6.8% per year and the Turkish lira appreciated 24%. Turkey became the darling of foreign investors and the locals also enjoyed the rapid rise in per-capita income – from $3,660 at the end of 2002 to over $12,543 by the end of 2013.

The strong economic credentials enabled Erdoğan to consolidate his power domestically and to pursue a more interventionist policy geopolitically – so called the neo-Ottomanism. Erdoğan also turned more autocratic and Islamist as he systematically weakened the influence of the military and secularism. In the aftermath of the failed 2016 coup, it was estimated that more than 150,000 journalists, military officers, and ordinary citizens have been imprisoned while hundreds of thousands of public servants were dismissed. Erdoğan also repeatedly clashed with the Turkish central bank as he favored a looser monetary policy to fuel economic growth. He espoused an eccentric theory that higher interest rates would lead to higher inflation, which would be viewed as fake news by trained economists. His penchant to compromise the central bank's independence coupled with Turkey's escalating current account deficits and inflation took a toll on the currency. From the time he became the president in August 2014 to the end of 2017, the Turkish lira depreciated from 2.16 to 3.80 lira per U.S. dollar, a cumulative loss of 43%. It also led to a decline of per capita income to $10,541 by the end of 2017, in spite of continued economic growth in Turkish lira terms.

In April 2017, the AKP narrowly won a constitutional referendum designed to create a powerful presidency and abolish the post of prime minister. After his re-election in June 2018, President Erdoğan moved quickly to implement these changes. He named his 40-year-old son-in-law as the treasury and finance minister, and decreed that the president would appoint the governor and key positions at the central bank. After years of attempted intervention with the Turkish central bank, Erdoğan, the self-described "enemy of interest rates" was now fully in charge.

The Straw that Broke the Turkey's Back

The U.S. has repeatedly called for the release of Pastor Brunson, but the Turkish government has sought to use Brunson as a bargaining chip to get the U.S. to extradite Pennsylvania-based Fethullah Gülen, the spiritual leader of the Gülen Movement. On July 26, 2018, Vice President Pence called on President Erdoğan to release the pastor or face sanctions. On August 1st, the U.S. imposed sanctions on two Turkish ministers who were involved with the Brunson case, and it triggered a lira crisis.

Investors have already soured on Turkey's rising current account deficit (a whopping 6.3% of GDP), its 15% inflation, and the potential loss of central bank independence. Over the first seven months of 2018, the Turkish lira has depreciated from 3.80 to 4.91 lira per U.S. dollar, a 23% loss. Yet President Erdoğan remained defiant and claimed that the lira's weakness was part of an economic war against the country. He urged citizens to sell their foreign currencies and gold to help prop up the lira. He also chided the U.S. for sacrificing its "81-million-strong ally Turkey for a pastor with links with terrorists." These remarks sent the lira into a tailspin – at one point on August 13th, it collapsed to as low as 7.24 before settling down at 6.54 lira per U.S. dollar a month end, a loss of 25% for the month.

Sensing weakness in an uncooperative ally, President Trump ratcheted up the pressure by authorizing a doubling of the tariffs on steel and aluminum exports from Turkey to 50% and 20%, respectively. President Erdoğan fought back with the threat of boycotting iPhones and American electronic goods, a response that only serves to highlight his delusion of grandeur. Does he really want to provoke more retaliation from Trump?

The Path Forward

Turkey's predicament is fairly typical of an emerging market currency crisis. The potential remedy often involves a combination of bitter medicines. The first step is to de-escalate the tension with the U.S. by releasing Pastor Brunson for "medical reasons". President Erdoğan also needs to emphasize his commitment to central bank independence. Turkey's central bank should raise interest rates materially to demonstrate a steely resolve to contain inflation. Higher rates will likely result in economic contraction, which would reduce imports to lower Turkey's current account deficit. The weak lira will make Turkey's tourism and exports more attractive. With 40% of business loans in foreign currencies, there will be more bankruptcies and foreign creditors will suffer losses. However, international lending will not dry up as long as the government enforces business contracts and allows for proper asset recovery. Lastly, Turkey could request assistance from the IMF to backstop its dwindling foreign exchange reserves.

On the positive side, Turkey's household and government leverage are quite low – less than 17% and 30%, respectively. The EU, Russia, China, and oil-rich Middle East neighbors are also willing to lend a hand given Turkey's geopolitically strategic position. To the Europeans, Turkey holds a trump card in having control over the flow of migrants into the EU. In short, the Turkish situation can be turned around, but President Erdoğan needs to walk back from some of his unorthodox and inflammatory positions to restore investor confidence.

The Contagion Risk

The downside scenario with the Turkey currency crisis is a wider contagion. Some have suggested that Turkey could impose capital controls to stop capital outflow. However, the inability of Turkish businesses to raise foreign currencies to service their non-lira debt would not only damage the country's credibility, but also result in technical defaults to the detriment of Turkey's foreign lenders. This was why shares of several European banks and the euro have sold off on lira weakness.

The contagion risk has put a bullseye on the back of other emerging market countries, especially those with elevated levels of current account deficits. While some of them should have sufficient foreign currency reserves to meet near-term obligations, they could still be pushed to raise interest rates to defend their currencies, which would slow down their growth.

This situation could deteriorate further if China is compelled to use the renminbi as a weapon to engage the U.S. in a sustained trade war. Further renminbi depreciation above the psychologically important 7 yuan per U.S. dollar could lead to a vicious cycle of competitive devaluation by other countries. Such actions would likely drive the U.S. dollar higher, further angering the mercantilist U.S. President to impose retaliatory measures and hurting U.S. multinational's overseas sales and earnings. Ultimately, it may compel the Fed to stop the tightening cycle and perhaps even restart an easing cycle to provide liquidity to the global economy.

Such a vicious cycle is entirely avoidable, but it requires cooler heads to prevail. The world needs more mature behavior rather than populist braggadocio. In the interconnected global economy, policy mistakes in one location can ripple to unexpected destinations – the so-called butterfly effect.

[1] Index pricing information does not reflect dividend income, withholding taxes, commissions, or fees that would be incurred by an investor pursuing the index return.

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