Rosa & Roubini ASSOCIATES

MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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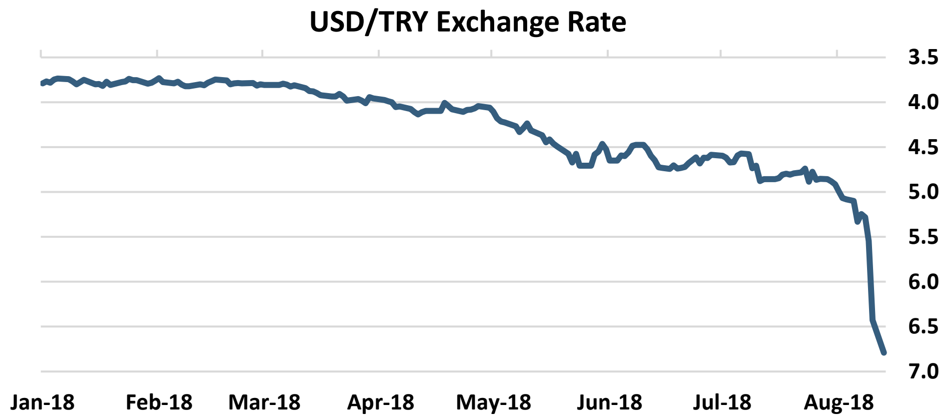

Source: Investing.com. Values in reverse order

Turkey's Debacle, and Wider Contagion Risks

The Turkish Lira (TRY) collapsed last Friday, losing around 15% of its value against the dollar in a single day. The Lira's loss against the dollar has now reached almost 45% since the beginning of the year. We have been following Turkish developments very closely in the last few months, so this crisis did not come unexpected. On August 9th, we warned that the risk of a full-blown balance of payments crisis was rising, thus increasing the downside risks to the muddle-through scenario, which was considered until recently the most likely course of action (chiming with our previous analysis). The volatility we expected to increase ahead of the elections of June 24th, which gave President Erdogan increased political powers deriving from the 2017 constitutional referendum, has persisted even after the elections. This volatility has occurred especially as a result of statements and appointments made by Erdogan, which have reduced the independence of Turkey's central bank (as discussed in our column on July 23rd) and the credibility of Turkey's Ministry of Finance.

The repercussions of the Turkish crisis for international markets can be divided into two fronts: emerging markets (EMs), and financial markets in general. For the former, our working paper published today (*Turkish Lira Tumbles, Contagion Risk Rises*) suggests that contagion from Turkey to other emerging markets is increasing. The impact of Turkey on stocks in India, Brazil, Russia and South Africa has been marginally negative. In the fixed income space, 10-year government bond yields have increased in India, Russia, and especially Brazil (+28bps, to 11.76%) and South Africa (+17bps, to 8.86%). EM currencies have depreciated in China, India, Brazil, Russia and South Africa. This is the result of the increased fragilities we discussed in our recent EM outlook and strategic asset allocation paper.

Somewhat more worrying, however, is the contagion risk that Turkey might pose to financial markets and economic performances in general, in particular via exposure to Turkish banks. As discussed in a recent press report, European banks (especially in Spain, Italy and France) own significant stakes in the Turkish banking sector, which in turn carry an exposure of more than USD 130bn to the Turkish non-banking private sector. In particular, three major lenders— France's BNP Paribas (holder of 72.5% of the retail bank TEB), Spain's BBVA (49.9% of Garanti bank) and Italy's UniCredit (40.9% of Yapı Kredi bank) lost 3.0%, 5.3% and 4.7% of their share value on Friday, respectively. The European Central Bank expressed concern about the three banks' exposure to Turkey; the Turkish market accounts for 14% of BBVA's total loans, 4% of Unicredit's, 3% of ING's and 2% of BNP Paribas'. This situation could be especially concerning for peripheral Eurozone countries, such as Italy, which are already the focus of investors' concerns as a result of their own domestic issues. Italy's "populist" government is in the process of drafting its first budget, even as it faces serious divisions within the governing majority. The Turkish crisis is yet another reminder of the interconnectedness of financial networks; of how a crisis in one area of the global economy can quickly affect wider markets.

Our Recent Publications

- *Working Paper: Turkish Lira Tumbles, Contagion Risk Rises, by Alessandro Magnoli Bocchi, Francisco Quintana and Pablo Gallego Cuervo, 13 August 2018*
- *Turkey: The Risk of a Full-Blown Balance of Payments Crisis Is Rising, by Nouriel Roubini, 9 August 2018*
- **The Geopolitical Corner** – *The Return of the Feudal World?, by John C. Hulsman, 1 August 2018*

The Week Ahead

In the US, retail sales (ex-autos) are expected to remain stable (July m-o-m, *c:* 0.4%; *p:* 0.4%).

In Europe, both GDP growth and inflation are expected to remain largely unchanged: (EZ GDP Q2, y-o-y, *c:* 2.1%; *p:* 2.1%); (EZ CPI July, y-o-y, *c:* 2.0%; *p:* 2.1%).

***The European Central Bank (ECB) expressed concern about EZ banks' exposure to Turkey*.** EZ banks own significant stakes in the Turkish banking sector: France's BNP Paribas (holder of 72.5% of the retail bank TEB), Spain's BBVA (49.9% of Garanti bank) and Italy's UniCredit (40.9% of Yapı Kredi bank) are under pressure: the Turkish market accounts for 14% of BBVA's total loans, 4% of Unicredit's, 3% of ING's and 2% of BNP Paribas.

The Quarter Ahead

Global growth and inflation will gradually lose momentum. In the US, inflation is stabilizing (CPI July y-o-y, *a:* 2.9%; *c:* 3.0%; *p:* 2.9%). In the UK, Q2 GDP y-o-y growth was at its lowest level since Q2-2012 (*a:* 1.3%; *c:* 1.3%; *p:* 1.2%). In the EZ, Germany's manufacturing orders fell 4.0% m-o-m (*c:* -0.4%; *p:* 2.6%). In the GCC, UAE's GDP growth declined from 3.0% in 2016 to 0.8% in 2017.

In the US, the Fed will continue to tighten, but EM market volatility will reduce expectations of further hikes. The likelihood of "*at least two additional hikes in 2018*" declined to 67.0% (*pw:* 68.5%), driven by concerns about EMs.

Turkish authorities will gradually adopt measures to stabilize the economy. The markets are currently expecting: ***a)*** the CBT to hike interest rates by at least 500bps; and ***b)*** an initial agreement with the US to reassure investors and avoid a full-blown economic crisis. ***The risk of contagion to Europe will remain elevated.*** European lenders accumulate more than USD 130bn of exposure to the Turkish non-banking private sector.

Italian assets will suffer the TRY turbulence. The 10y Italian bond yield rose by 6bps w-o-w (to 3.00%), as concerns about Italian banks exposure to Turkish assets added to worries over tax cuts and increased fiscal spending.

Tariffs are set to escalate, but will likely not lead to a trade war. Tariffs on Turkish and Chinese exports are expected to be softened or eliminated as countries show willingness to accommodate US demands.

Sanctions will create further instability in Iran. The first batch of US sanctions came into effect on August 6th, and causing episodes of unrest in Iran. A second wave of sanctions will be adopted in November. In the near term, Iran will refuse to negotiate with the US.

EMs will continue to suffer outflows due to: ***a)*** declining USD liquidity; ***b)*** rising US interest rates; ***c)*** a stronger USD; and ***d)*** trade war fears.

EM volatility will have a negative impact on Brent oil price. Concerns about global growth stemming from EM instability weighed on prices (-0.5% w-o-w, to 72.8 USD/b).

Last Week's Review

The TRY suffered a 26.5% w-o-w decline against the USD ... reaching USD/TRY 6.427, after experiencing a 15.5% d-o-d decline on Friday, August 10th. The fall was mostly provoked by external factors, in particular: *i)* rising tensions with the US—e.g.: the US imposed sanctions on members of the Turkish government and Trump doubled tariffs on Turkish steel and aluminium, to 50% and 20% respectively. The US wants the Turkish government to free US pastor Brunson and to reduce Turkey's cooperation with Iran and Russia; and *ii)* monetary policy tightening in the US support "periphery-to-core" flows. Internal factors aggravate the depreciation: *i)* a growing C/A deficit (from 5.1% in 2017 to 6.1% in 2018); *ii)* declining reserves (-25.5% since the July 2014-high); *iii)* a rising fiscal deficit (from 1.5% of GDP in 2017 to 2.0% in 2018); and *iv)* uncertainty about economic policy and concerns about the independency of the CBT.

… fuelling a wave of global risk aversion. Equity markets weakened w-o-w across the board: globally (MSCI ACWI -0.7%); US (S&P500 -0.2%); EZ (Eurostoxx 50 -1.6%, led by banks with exposure to Turkey); and EMs (MSCI EMs -1.0%). Volatility rose only moderately (VIX, +1.6 points to 13.2—*52w avg.:* 13.6; *10y avg.:* 19.6) The USD appreciated w-o-w against a currency basket (DXY 96.4, +1.2%, reaching a one-year high) and the EUR (EUR/USD 1.141, -1.4%). Rising demand for US bonds reduced 10y yields by 9bps to 2.86%. EM currencies (MSCI EM Currency index) weakened by 1.0% w-o-w and by 4.5% y-t-d versus the USD.

Pablo Gallego Cuervo *and* ***Josiane C. Zhang*** *contributed to this Viewsletter.*

The picture in the front page comes from *this website*

Abbreviations, Acronyms and Definitions

a	Actual	*k*	thousand
AKP	Justice and Development Party, Turkey	*KSA*	Kingdom of Saudi Arabia
ann.	annualized	*LN*	Northern League, Italy
ARS	Argentinian Peso	*M5S*	Five Star Movement, Italy
bn	Billion	*m-o-m*	Month-on-month
BoC	Bank of Canada	*mb*	Million barrels
BoE	Bank of England	*mb/d*	Million barrels per day
BoJ	Bank of Japan	*MENA*	Middle East and North Africa
bpd	Barrels per day	*MHP*	Nationalist Movement Party, Turkey
bps	Basis points	*mn*	Million
BS	Balance sheet	*NAFTA*	North-American Free Trade Agreement
c	Consensus	*NATO*	North Atlantic Treaty Organization
C/A	Current account	*OECD*	Organization for Economic Cooperation and Development
CB	Central bank	*Opec*	Organization of Petroleum Exporting Countries
CBK	Central Bank of Kuwait	*p*	Previous
CBR	Central Bank of Russia	*PBoC*	People's Bank of China
CBT	Central Bank of the Republic of Turkey	*PCE*	Personal Consumption Expenditures
CDU	Christian Democratic Union, Germany	*PE*	Price to earnings ratio
CNY	Chinese Yuan	*PM*	Prime minister
CPI	Consumer Price Index	*PMI*	Purchasing managers' index
DJIA	Dow Jones Industrial Average Index	*pps*	Percentage points
d-o-d	Day-on-day	*pw*	Previous week
DXY	US Dollar Index	*QCB*	Qatar Central Bank
EC	European Council	*QAR*	Qatari Riyal
ECB	European Central Bank	*QE*	Quantitative easing
ECJ	European Court of Justice	*q-o-q*	Quarter-on-quarter
EIA	US Energy Information Agency	*RBA*	Reserve Bank of Australia
EM	Emerging Markets	*RRR*	Reserve Requirement Ratio
EP	European Parliament	*RUB*	Russian Rouble
EPS	Earnings per share	*SHCOMP*	Shanghai Stock Exchange Composite Index
EU	European Union	*tb/d*	Thousand barrels per day
EUR	Euro	*tn*	Trillion
EZ	Eurozone	*TPP*	Trans Pacific Partnership
Fed	US Federal Reserve	*TRY*	Turkish Lira
FM	Future Movement	*UAE*	United Arab Emirates
FOMC	US Federal Open Market Committee	*UK*	United Kingdom
FRB	US Federal Reserve Board	*US*	United States
FX	Foreign exchange	*USD*	United States Dollar
FY	Fiscal Year	*USD/b*	USD per barrel
GCC	Gulf Cooperation Council	*UST*	US Treasury bills/bonds
GBP	British pound	*VAT*	Value added tax
GDP	Gross domestic product	*VIX*	Chicago Board Options Exchange Volatility Index
GOP	Grand Old Party (US Republican Party)	*WTI*	West Texas Intermediate
IMF	International Monetary Fund	*w-o-w*	Week-on-week
INR	Indian Rupee	*y-o-y*	Year-on-year
IPO	Initial public offering	*y-t-d*	Year-to-date
IS	Islamic State	*2y; 10y*	2-year; 10-year
JPY	Japanese yen		