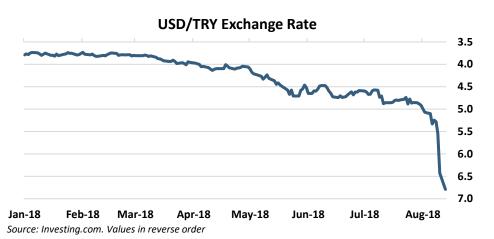


MAKING SENSE OF THIS WORLD

13 August 2018



R&R Weekly Column
By Brunello Rosa



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 <u>recent press report</u>, European banks (especially in Spain, Italy and France) own significant stakes in the Turkish banking sector, which in turn carry an <u>exposure</u> of more than USD 130bn to the Turkish non-banking private sector. In particular, three major <u>lenders</u>— France's BNP Paribas (<u>holder</u> of 72.5% of the retail bank TEB), Spain's BBVA (<u>49.9%</u> 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 <u>the focus of investors' concerns as a result of their own domestic issues</u>. 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 – <u>The Return of the Feudal</u> <u>World?</u>, 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



@RosaRoubini



Rosa & Roubini



Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED







Abbreviations, Acronyms and Definitions

а	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
ВоС	Bank of Canada	mb	Million barrels
BoE	Bank of England	mb/d	Million barrels per day
ВоЈ	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
С	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	у-о-у	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		

Rosa & Roubini Associates Ltd is a private limited company registered in England and Wales (Registration number: 10975116) with registered office at 118 Pall Mall, St. James's, London SW1Y 5ED, United Kingdom. VAT registration number GB 278 7297 39.

Rosa & Roubini

Analyst Certification: We, Brunello Rosa and Nouriel Roubini, hereby certify that all the views expressed in this report reflect our personal opinion, which has not been influenced by considerations of Rosa&Roubini Associates's business, nor by personal or client relationships. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the views expressed in this report. **Disclaimer**: All material presented in this report is provided by Rosa & Roubini Associates-Limited for informational purposes only and is not to be used or considered as an offer or a solicitation to sell or to buy, or subscribe for securities, investment products or other financial instruments. Rosa & Roubini Associates Limited does not conduct "investment research" as defined in the FCA Conduct of Business Sourcebook (COBS) section 12 nor does it provide "advice about securities" as defined in the Regulation of Investment Advisors by the U.S. SEC. Rosa & Roubini Associates Limited is not regulated by the FCA, SEC or by any other regulatory body. Nothing in this report shall be deemed to constitute financial or other professional advice in any way, and under no circumstances shall we be liable for any direct or indirect losses, costs or expenses nor for any loss of profit that results from the content of this report or any material in it or website links or references embedded within it. The price and value of financial instruments, securities and investment products referred to in this research and the income from them may fluctuate. Past performance and forecasts should not be treated as a reliable guide of future performance or results; future returns are not guaranteed; and a loss of original capital may occur. This research is based on current public information that Rosa & Roubini Associates considers reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. Rosa & Roubini Associates, its contributors, partners and employees make no representation about the completeness or accuracy of the data, calculations, information or opinions contained in this report. Rosa & Roubini Associates has an internal policy designed to minimize the risk of receiving or misusing confidential or potentially material non-public information. We seek to update our research as appropriate, but the large majority of reports are published at irregular intervals as appropriate in the author's judgment. The information, opinions, estimates and forecasts contained herein are as of the date hereof and may be changed without prior notification. This research is for our clients only and is disseminated and available to all clients simultaneously through electronic publication. Rosa & Roubini Associates is not responsible for the redistribution of our research by third party aggregators. This report is not directed to you if Rosa & Roubini Associates is barred from doing so in your jurisdiction. This report and its content cannot be copied, redistributed or reproduced in part or whole without Rosa & Roubini Associates' written permission.

