

MAKING SENSE OF *THIS* WORLD

20 August 2018



R&R Weekly Column
By Brunello Rosa



The Turkish Crisis Deepens, Sending EM Stocks Into A Bear Market

The Turkish crisis continues, and it does not seem likely to abate anytime soon. Last week Turkey's Finance Minister Berat Albayrak announced that the country's government will reduce inflation by way of fiscal discipline and structural reforms. Meanwhile Turkey's central bank [announced a new set of measures intended to support financial stability](#), including a 250bps reduction of reserve requirement ratios for all maturities and a 400bps reduction of non-core FX liabilities for selected maturities. At the same time, relations with the US have worsened since Turkey's President Erdogan doubled import tariffs on certain US products (in response to US President Trump's initial move), US Treasury Secretary Mnuchin confirmed that more sanctions on Turkey are being considered, and a Turkish court rejected a new appeal for the American pastor Andrew Brunson's release from house arrest. As a result of all of this, S&P and Moody's both downgraded Turkey's rating by one notch, and USD/TRY closed the week at 6.012 (-6.4% in the past week).


As we discussed in recent reports, the [risk of a full-blown crisis may rapidly become the baseline](#) scenario for Turkey. [Contagion risks have risen](#) significantly, with European and EM funds continuing to suffer outflows. In the Eurozone, the Eurostoxx 50 closed 1.6% lower than it had the previous week, amid worries over Eurozone banks' exposure to Turkey. Stock prices declined in emerging markets, with the MSCI EM index down by 5.2% from a week ago. EM stocks have now reached bear market territory; i.e. they have declined by more than 20% since their January peak. With [Argentina having resorted to accepting an IMF assistance program](#) earlier this year, it would seem obvious that Turkey should or will soon do the same. However, given the tense relationship between Turkey and the US, asking for money from a Washington-based institution like the IMF, which is dominated by US voting rights, is politically toxic for Erdogan. As a result, Turkey is looking for other "white knights" to assist it, whether it be [Russia](#), [China](#), or [Qatar](#).


Turkey's looking to the east for alternative sources of funding will have profound geopolitical implications. As discussed by John Hulsman in his [most recent Geopolitical Corner](#), it could mean that NATO as we know it is now likely to be over; transatlantic relations will never be the same in the future as they have been to this point. This means the US can continue to disengage from the Middle East "reimagining itself as an off-shore balancer", according to Hulsman, "only getting seriously involved in the area if one of the many regional powers (Turkey, Israel, Egypt, Iran, Saudi Arabia) comes to dominate the others."

The Turkish crisis has already spread beyond its epicentre to affect other emerging markets. It could soon impact the more fragile developed economies as well, by way of exposure to banking channels. The ECB has already singled out Spain, France and Italy as warranting the most concern in this regard. Italy in particular is quickly approaching the end of the grace period that international investors were willing to give the new "populist" government ahead of its presentation of a budget at the end of September. The country is better be ready for when this grace period eventually comes to an end.

Our Recent Publications

 [The Risk of a Full-Blown Crisis May Rapidly Become the Baseline](#), by Nouriel Roubini, 14 August 2018

 [Turkish Lira Tumbles, Contagion Risks Rise](#), by Alessandro Magnoli Bocchi, Francisco Quintana and Pablo Gallego Cuervo, 13 August 2018

 [The Geopolitical Corner – How the world really works \(Part 1\)](#), by John C. Hulsman, 15 August 2018

The Week Ahead

In the US, the Fed will release the minutes of the FOMC meeting, providing details on its outlook for the US economy. The Fed will host the annual Jackson Hole CB Symposium, where central bankers from all over the world will discuss the future of monetary policy.

In the EZ, the manufacturing PMI is expected to show signs of deceleration (August, c: 54.6; p: 55.1).

In Japan, inflation is expected to drift further below 1% (CPI July, c: 0.4% y-o-y; p: 0.7%).

The Quarter Ahead

In the short term, US growth will remain firm ... the US economic cycle is showing momentum: retail sales (ex-autos) picked up (July m-o-m, a: 0.6%; c: 0.3%; p: 0.2%)

... but global growth and inflation will gradually lose pace. In the EZ, both GDP growth (EZ GDP Q2, a: 2.2% y-o-y; c: 2.1%; p: 2.1%) and inflation (EZ CPI July, a: 2.1% y-o-y; c: 2.1%; p: 2.1%) remained unchanged. In EMs, China's growth is decelerating faster than expected (retail sales July, a: 8.8% y-o-y; c: 9.0%; p: 9.0% - industrial production July, a: 6.0% y-o-y; c: 6.3%; p: 6.0% - fixed asset investment July, a: 5.5% y-o-y; c: 6.0%; p: 6.0%).

In the US, the Fed will continue to tighten, but EM market volatility could reduce the likelihood of further hikes. The likelihood of "at least two additional hikes in 2018" rose to 65.4% (pw: 59.0%), while the likelihood of "at least three additional hikes in 2018" increased to 1.7% (pw: 0.0%).

Turkish authorities will seek financing outside the traditional channels. Qatar pledged to invest USD 15bn in Turkey (equivalent to three months of C/A deficit). Yet, in the short term Turkish assets will remain volatile: substantial tightening and additional foreign financing will be necessary to stabilize the markets.

The risk of contagion to Europe—Italy in Spain in particular—will remain elevated. Last week, the Euro STOXX 600 Bank Index declined by 3.1% w-o-w. The 10y Italian bond yield rose by 13bps w-o-w (to 3.13%), as concerns about the exposure of key Italian banks to Turkish banks added to worries over tax cuts and higher fiscal spending.

Tariffs are set to escalate but will likely not lead to a trade war. China announced that at the end of August its vice-minister of commerce will lead a delegation to the US for trade talks—the first formal attempt at negotiations since Washington imposed tariffs on USD 50bn of Chinese goods.

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 bond funds suffered outflows of USD -287mn w-o-w (c: 180mn), reaching a total of USD 20.3bn y-t-d.

EM volatility will have a negative impact on Brent oil price. Concerns about global growth stemming from EM instability continue to weigh on prices (-1.3% w-o-w, to 71.8 USD/b).

Last Week's Review

The TRY paired some losses, S&P and Moody's downgraded Turkey. The TRY closed at USD/TRY 6.012 (-6.4% w-o-w), after: a) Finance Minister Albayrak announced that the government will reduce inflation through fiscal discipline and structural reforms; and b) the CBT announced a set of measures to support financial stability, including a 250bps reduction of TRY RRRs, for all maturities. However, the TRY remained volatile, as: 1) the relations with the US worsened: i) President Erdogan doubled import tariffs on certain US products; ii) a Turkish court rejected a new appeal for US pastor Brunson's release from house arrest; and iii) US Treasury Secretary Mnuchin confirmed that more sanctions are being considered; and 2) S&P and Moody's downgraded Turkey's rating by one notch.

US stock and bond markets closed the week flat. The S&P500 rose by 0.6% w-o-w, supported by the announcement of a resumption of US-China trade talks. The VIX declined by 0.6 points to 12.6 (52w avg.: 13.6; 10y avg. 19.5). Concerns about EMs kept demand for bonds steady, with 10y UST yields up by 1bps w-o-w, to 2.87%. The USD depreciated w-o-w against: a) a currency basket (DXY -0.3%); and b) the EUR (EUR/USD 1.144, +0.2%).

Europe and EMs continued to suffer outflows. In the EZ, the Eurostoxx 50 closed at -1.6% w-o-w, amid worries over EZ banks' exposure to Turkey. In EMs, stock prices declined (MSCI EMs -5.2% w-o-w), reaching bear market territory (more than 20 percent drop since the January peak).

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

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