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Comments on recent events in Turkey

Heartwood Investment Team

What is happening? The Turkish economy has dominated recent financial news headlines. Amid ongoing economic concerns, political discord and a diplomatic spat with the US, President Erdogan has further fanned the flames in the last few days. Erdogan has framed Turkey as the 'subject of economic warfare', instructing the Turkish population to sell dollars and gold and buy the domestic currency (the lira), and to eschew the US brand Apple in favour of its Korean counterpart, Samsung. Against this backdrop, the country's stock market has fallen substantially and the lira has likewise lost significant value. There are also growing fears over contagion to other markets, as well as the potential for Turkey to default on its debt.

Why is this happening now? Marked economic mismanagement has taken place under the tenure of Erdogan and, more recently, his finance minister (who is also his son-in-law). Consequently, Turkey is labouring under large current account deficits, high inflation and weak growth. Further, much of its national debt is US denominated, making it difficult to service via the weak lira. However, none of this is new information. The triggers for the current turmoil are more likely to be Turkey's diplomatic squabble with the US (over the former's detention of a US pastor on charges of espionage and terrorist links), as well as the fallout of an increasingly strong US dollar, pushed higher by US economic growth and a confident US Federal Reserve. A stronger dollar is generally unwelcome in emerging economies and – as the weakest among these markets – Turkey's negative dynamics may have been disproportionately amplified.

Will this impact other markets? Some commentators are framing Turkey as a bellwether for other troubled emerging economies, and a number of Western European banks are also exposed to Turkey through liabilities on their balance sheets. However, the usual signs of distinct risk aversion are largely absent. Gold (normally a safe haven in troubled times) is currently weak, and bond yields are broadly stable. Some corporate earnings news has been slightly concerning (Chinese internet giant Tencent announced a rare stumble in profits this week), but for now emerging market fundamentals remain broadly robust and most Asian currencies appear relatively stable.

The Heartwood view: Turkey seems to be serving as the poster child for a broader emerging market selloff, but what we believe we are actually witnessing is the strong US dollar picking apart the weakest emerging market currencies. Of late, the market appears to be punishing certain emerging economies, seemingly those with the most challenging idiosyncrasies – Argentina (another victim of economic mismanagement) and Venezuela (enduring ongoing hyperinflation), are notable recent casualties. Nonetheless, we continue to see long-term investment potential in a number of key emerging markets (such as China and India) and our portfolios have extremely limited direct exposure to Turkey. Put simply, our current analysis suggests that recent events in Turkey are unlikely to provide the catalyst for a major market correction. Even so, we are mindful that investor sentiment is fragile, that 2018 is a more volatile year than its predecessors, and that caution is warranted as we approach the end of a long period of expansion.

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