News from the financial markets

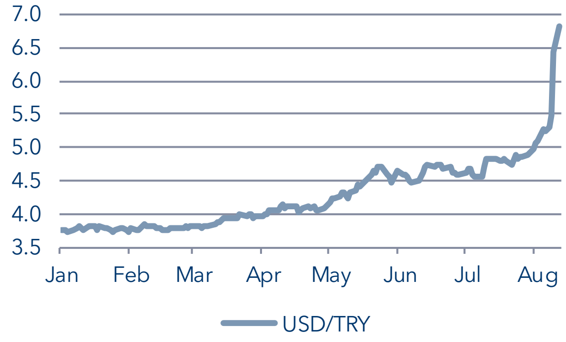
Country focus Turkey: Difficulties on the Bosporus

The new Turkish lira (TRY) has suffered dramatic losses in recent weeks, a move that has accelerated over the past several days due to new sanctions imposed on Turkey by the USA in response to the continued detention of American pastor Andrew Brunson. As Turkey's private sector is mainly indebted in foreign currencies, the domestic banks now run the risk of becoming insolvent. And because they in turn are indebted to European banks, the possibility of contagion to the global financial markets has become a major concern. We, however, do not share that fear, seeing as there are sufficient options for Turkey as well as the ECB to contain the crisis. Equally spoken, we continue to advise against exposure to Turkey.

An end to the economic success story

Several years ago, Turkey was still a source of hope amongst the major emerging nations. Its success was largely attributable to measures taken by current president Recep Tayyip Erdogan. In the early years of his presidency, the EU and Turkey initiated membership talks. Erdogan pressed ahead with economic liberalisation initiatives and maintained strict budgetary discipline – not to mention that he also once came very close to resolving the conflict with the Kurdish population. Turkey had become one of the international business community's most favoured nations precisely because of Erdogan's policies. In the past several years though, the situation has flipped. The post-coup Supreme Leader's increasingly autocratic style has alienated not just the EU but also the financial markets – and were than enough, he has caused the independence of the central bank to be called into question.

Chart 1: USD vs. the new Turkish lira



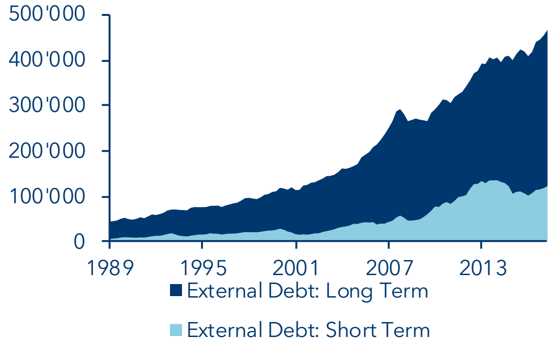
Central bank is losing credibility

For months now, Erdogan has been pressuring the central bank not to raise interest rates, this despite soaring inflation and the plummeting value of TRY. Why? Because the president claims that interest is the "mother and father of all evil". The relentless rise in inflation has pushed yields on 10-year Turkish government bonds from 11 to 20% since the beginning of the year. Consequently, GDP growth for 2019 is likely to wane from 7.4% to 4.1%. The country's new finance minister Berat Albayrak (son-in-law of Erdogan) has assured the Turkish central bank full independence. However, its rate hikes to date have done little to brake the fall in the price of the lira, thus the currency's nosedive can also be interpreted as a loss of confidence in the central bank. The credibility of the latter can only be regained through concrete actions. An additional burden comes from the disquieted relations with the USA. Washington has tried in vain to secure the release of American pastor Andrew Brunson. President Trump last week upped the ante by imposing punitive tariffs on Turkey. The Turkish foreign ministry responded by threatening to take countermeasures, so the crisis could also intensify from the Ankara side.

Outstanding credits in foreign currency weigh heavily

With a debt ratio of 28% of GDP, the Turkish state has an unusually low level of debt. But at the end of March, the cumulative amount of public-/private-sector debt denominated in foreign currency stood at the equivalent of USD 466 billion (58% of GDP); and in the meantime, this figure most likely has risen to more than 100% due to the currency collapse. 122 billion of that are short-term borrowings, mainly owed by Turkish banks and companies. So if just one European bank were to cancel its credit lines to those borrowers, the Lehman Brothers effect could kick in. This would not only be disastrous for the debtors but also for the lending European banks, which would have to write off at least part of those loans. To make things worse, the global economy would also be affected because everyone sits in the same boat when it comes to international commerce: many major European financial institutions have outstanding claims against the Turkish banking sector, and at the end of the day it matters little who the biggest direct lender is because the European financial sector is networked – so even US and Asian banks would be affected at least to a certain extent by more severe turbulence in Turkey.

Chart 2: External indebtedness (in USD millions)



Where do things go from here?

Even if individual loans were no longer repaid, this would not threaten the entire system. In terms of the real economy, Turkey could leave certain skid marks in Germany: after all, Turkey ranks 16th amongst Germany's most important trading partners (in 2017, goods with a cumulative value of EUR 21 billion left Germany in the direction of the Bosporus).

But before things reach the boiling point, there are still other options available. Initial measures aimed at stabilising the lira were announced already on Monday (e.g. banks' liquidity requirements were eased). Should the lira stabilisation efforts fail, a nationalisation of distressed banks would be an option. The low government debt ratio is certainly helpful in this regard. Moreover, the International Monetary Fund (IMF) has stood by Turkey in the past. But it goes almost without saying that the threat of defaults cannot be ignored – especially if the Turkish central bank fails to react in an appropriate way.

That said, the ECB is primed and ready if the creditor banks are faced with loan defaults.

Effects on the equity markets

The economic difficulties in Turkey are essentially homegrown and have been cropping up for months. The escalating situation now poses key questions for investors:

- Will Turkey experience an isolated crisis or will the problem spill over to other countries?
- Are European banks careening towards yet another debt crisis?
- Does the low fundamental valuation of Turkey present an investment opportunity?

No systemic crisis

Although it is highly likely that the situation will deteriorate further, even a possible bankruptcy will not shake the world markets to any significant degree. The economic stress will be felt mainly by individual companies with heightened exposure and lead to generally lower valuations of Turkish assets. The syndrome will persist until investor confidence is restored – a development that is impeded at present by the behaviour of the autocratic government. Emerging markets in general are heavily dependent on external investors and the corresponding grant of foreign credits. In this regard, trust in the given country’s legal framework and steadily improving economic stability are very important. Turkey's particular situation is one in which those foreign liabilities are largely concentrated in the private sector. Given its low level of government debt, the country has plenty of scope to defuse short-term tensions.

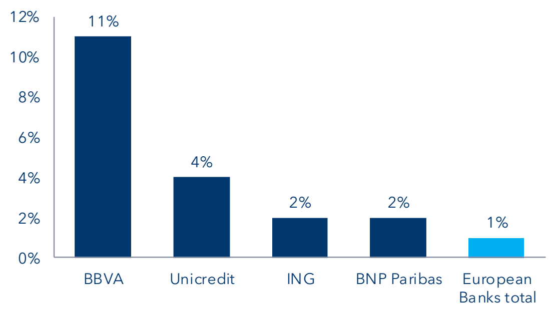
Thus a hypothetical systemic crisis triggered by Turkey in the emerging nations or beyond is not to be expected. The current crisis merely constitutes one dimension of the general increase in capital market risks we have been drawing your attention to since the beginning of the year.

Consolidation in the European banking sector continues

Risk migration of long-term debts is an important factor for fundamental valuations of financial institutes. At the equivalent of USD 111 billion, the lendings by European financial institutions account for almost half of Turkey's total longer term foreign currency liabilities (USD 223 billion). Spain is the largest creditor country with 36%, followed by France (16%) and then Italy, England and Germany each with 8% of the total debt.

The credit exposure of European banks in terms of Turkey amounts to roughly 1% of their collective net receivables, whereas the lending volume for which they are co-responsible is largely attributable to the engagements of Spain’s BBVA and Italy’s Unicredit in the Turkish banking sector. However, it must be noted here that these loans are also backed by assets in not insignificant amounts, and a considerable proportion of the loans are invoiced in domestic currency. As shown in the following chart, net exposure is much lower.

Chart 3: Net credit position vis-à-vis Turkey



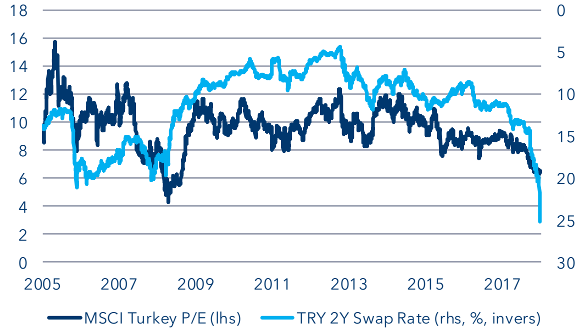
Nevertheless, it is highly likely that the current turbulence will trigger valuation adjustments on those investments, as well as write-offs on a certain amount of the loan volume. For the European banks concerned, the current crisis is therefore a problem of profitability. Should the supply of liquidity to European banks be threatened by a further escalation, the ECB has already assured that strong support will be provided.

Of the banks involved, only ING is on VP Bank’s recommendation list. The company started its activities in Turkey in 1991 with a primary focus on commercial clients. Retail banking activities were commenced in 2007 with the acquisition of Oyak Bank. ING ranks amongst the top 10 Turkish banks with a market share of roughly 3%. Its loan commitments in Turkey amount to some EUR 15 billion, equal to approximately 2.5% of the company's total outstanding loans. Like any other bank, ING conducts active currency hedging. The crisis will therefore crimp the bank's profit outlook but not trigger a stress test. We will continue to monitor the further developments and put our view of ING to the test.

Turkish crisis opens up no investment opportunities

Valuations in Turkey have declined significantly, but this does not represent a buying opportunity. The emerging equity markets are highly dependent on the foreign exchange and credit markets. The following chart shows the strong correlation between P/Es and short-term interest rates.

Chart 4: Credit market dependency



The P/E ratio of the reference MSCI Turkey benchmark index presently stands at 6.8 (compared to 8.8 at the beginning of the year) and has been trading at a discount to the other emerging markets for two years now. The current malaise is therefore country-specific and is unlikely to improve anytime soon in light of the latest developments. For the Turkish stock market, this could well mean further price losses of 15 to 20%, which would take the index back to the low end of its 2015-2016 consolidation range.
For European banks, this means a continuation of the structural adjustment phase. Given the indebtedness of their respective home countries, Spanish, Italian and French banks' sizeable credit exposure in crisis-prone emerging countries certainly gives rise to questions.

Summary

If the situation on the Bosporus continues to deteriorate, the euro is also likely to suffer further losses against USD. However, the Swiss franc should remain in demand as a safe haven. We reserve the right to reassess the EUR/USD and EUR/CHF currency pairs, depending on the further developments in Turkey.

Within our present equity strategy, we are taking a neutral stance on both, the European banking industry and the emerging markets. However, their high correlation to credit risks cannot be dismissed out of hand. Any further worsening of overall credit risks in the market will most likely lead to negative market responses and the need to revise our assessments.

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