Analysis

Turkey – Not a Debt Crisis

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Despite rising international tensions and concerns of high levels of corporate debt, the country's geographical location and NATO membership could prove the key to ensuring the country's long-term stability

Warren Hyland – Portfolio Manager

Warren joined Muzinich in 2013. Prior to that he was the Senior Portfolio Manager for Global Emerging Markets at Schroders where he managed $2 billion and helped develop the firm's EM corporate capabilities. Warren has a B.Sc. in Mathematics for Business from Middlesex University London and an M.Sc. in Shipping Trade and Finance from CASS Business School. He holds the Chartered Financial Analyst designation.

Recent currency crises in Argentina and Turkey have turned the spotlight firmly on emerging markets (EM). Although the effects have largely been felt within the EM local currency space, it has raised fears of the spread of contagion across the emerging world and a wider sell off within EM fixed income.

While the broader market has shown herd mentality, it is important to highlight that the situation in each country is very different. Argentina's woes are underlined by fears that the country is unable to service its debt levels.

Turkey's was about the collapse of confidence in the country's political leadership, rising international tensions and concerns around corporate indebtedness.

Recep Tayyip Erdogan's self-appointment as Executive President has given both the market and wider international community cause for concern.

The Central Bank of Turkey's (the, "central bank") seeming lack of independence and unwillingness to increase interest rates against a backdrop of rising inflation has also set alarm bells ringing. As has Erdogan's apparently nepotistic appointment of his son-in-law as Finance Minister.

Turkey's international relationships meanwhile have deteriorated, most notably with the US. Turkey continues to detain US evangelical pastor Andrew Brunson on charges of espionage, and has risked international criticism by buying Russian armaments.

The US continues to hold one of the chief perpetrators of the 2016 failed Turkish coup, has charged the CEO of one of Turkey's major banks with money laundering for Iran and is supporting Kurdish militants.

The strength of the sovereign is not, in our view, up for debate. Turkey's government has largely shown itself to be fiscally responsible, having kept the fiscal deficit around 1% for some years. [1]

The country's external sovereign debt is only 13.2% and, unlike Argentina who are struggling to remain solvent after next year, on the face of it, Turkey appears able to cover its external liabilities until the end of 2020.[2]

However, what has garnered closer attention is the indebtedness of the corporate sector, as Turkish companies have taken advantage of lower international borrowing rates to avoid higher interest rates at home. Combining corporate and sovereign debt, the total gross external debt is closer to 60% and investors are beginning to question the corporates' ability to roll over debt, especially against a backdrop of a weakening currency.[3]

Turkish regulations require all companies – including financials – to hedge their exposure. Therefore, in the short term (i.e. over the next 12 months) we believe Turkish companies can comfortably make their repayments (because the currency hedges prevent debt levels from rising as the lira falls). It is when these hedges come off that problems could arise.

In our view, a combination of a degradation of trust in the political leadership, central bank inaction and declining international relationships combined to result in the recent sudden and rapid selloff in the lira, which has fallen around 40% year to date.[4]

With investors and the international community relatively bearish on Turkey, what is needed to turn the tide and restore confidence?

In our view there are three key issues that need to be addressed: currency stabilisation, evidence of central bank independence and a government that can show it is in control.

Over the past week, the currency has shown more stability, and is currently trading around the 6 – 6.5 range.[5] The central bank has also made some headway, by raising rates to 24% in a bold move to lower inflation and highlight its independence from Erdogan's influence.

In addition, while there have been many negative headlines around Finance Minister Albayrak's appointment, Erdogan's son-in-law is already a seasoned and highly experienced politician and we believe his entreaties to the broader international community are being well received.

The government also needs to ensure it secures international support. Qatar has already stepped in and provided US$15bn of financing. Later in September Turkey is due to meet Germany, who are also likely to offer support.

The elephant in the room is the US. Although diplomatic relations appear to have reached an impasse, we believe it is important that they do not deteriorate further.

However, in our view the international community is unlikely to let the country spiral out of control.

Turkey plays a key role as NATO's sole presence in the Middle East as well as being a custodian of 3 million Syrian refugees. If the country collapsed, refugees would flood into Europe, which could have dire consequences for the eurozone's future. Meanwhile, without Turkey, NATO becomes ineffective.

Looking ahead, Turkey appears to be making inroads into stabilising its economy, although Erdogan continues to remain something of a wild card.

In our view, the road to recovery is also likely to be painful as higher rates, a weaker currency and high inflation will inevitably lead to recession.

However, as with all credit cycles, recession ultimately has cleansing effect and resets economic imbalances which, over the long term, could be positive for the country.

1. Source: Muzinich & Co. internal calculations as of 18 September 2018
2. Source: Muzinich & Co. internal calculations as of 18 September 2018
3. Source: Muzinich & Co. internal calculations as of 18 September 2018
4. Source: Bloomberg, as of 17 September 2018
5. Source: Bloomberg, as of 17 September 2018

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