

MARKET COMMENTARY

EM – No Turkish contagion

Author: Guillaume Tresca, Martin Pohl

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- Turkey has been back at the forefront of EM concerns as the TRY has been depreciating rapidly. The pace of depreciation has accelerated after the last CBRT rate cut, and risks are skewed for more TRY depreciation.
- Like in Q121, we expect the Turkish developments to have a limited impact on other EMs countries and EM assets. Risks have been well flagged, and investors' positioning is close to lows.
- If any contagion, the channel could be via portfolio adjustments. It would be temporary and limited. EMEA FX yielders would be the most vulnerable.
- We do not see value in Turkish assets yet. The main difference from previous market stress episodes is the limited push-back from authorities. There is a clear will for a weaker FX.
- The sovereign is not the most vulnerable link. However, the situation is still fluid, and we keep our negative view on Turkish sovereign credit before reassessing our position. The market reaction should be more limited than on March 21.

Limited contagion to other EMs

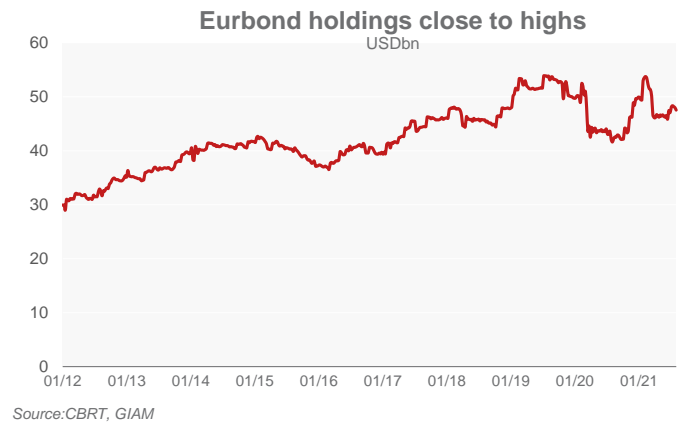
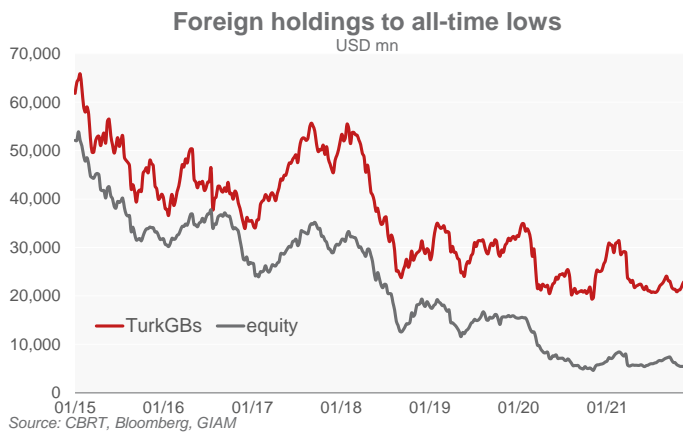
In our view, the recent significant depreciation of the TRY and the uncertainties related to the future monetary policy should have limited and manageable impacts on global EM assets.

Indeed, the CBRT has kept cutting its policy rate with a 100bp rate cut to 15.00%, and the communiqué leaves the door open for further easing in December. The TRY has been depreciating by 34% YTD, and the pace of depreciation has accelerated post the CBRT decision. Uncertainty is high, but risks are skewed for more depreciation. Unlike the other episodes of market stress, there has been no push-back from authorities to cap the TRY depreciation.

On the contrary, ahead of the 2023 presidential election, President Erdogan seems to try to support growth via looser financial and monetary conditions. Real interest rates are already negative, which has not been sufficient to lure investors or reduce inflation in the past. However, the Turkish financial system has been so far surprisingly resilient to the recent turmoil with gross international reserves stable. Moreover, the banks' FX position has been little affected with stable FX deposits.

The situation is still fluid, but the impact on other EMs will be limited and temporary. The main contagion channel, if any, is portfolio adjustment. To this extent, EMEA high-yielders, like the RUB and the ZAR, would be the most affected. The current episode is not similar to August 2018, when the fears of US sanctions triggered the sell-off. At that time, the Fed was tightening, and large EMs like Argentina defaulted. The Turkish risk has now been well identified, and the TRY has been on a gradual depreciation trend since January. Moreover, the foreigners positioning is close to multi-year lows in the equity and local debt spaces.

The impact could be a bit more pronounced on external debt. Turkey's weight in the EMBIG is 3.4%, and Eurobond holdings have declined only modestly over the past months. That said, the market reaction has been limited so far. The CDS only widened by 46bp, but less brutally than in March. It is still below its highs. The EMBIG Turkey index spread only increased by 40bp, below its October level. It is worth highlighting that the risk is not stemming from the sovereign profile but more from the corporate sector that holds a large FX debt.



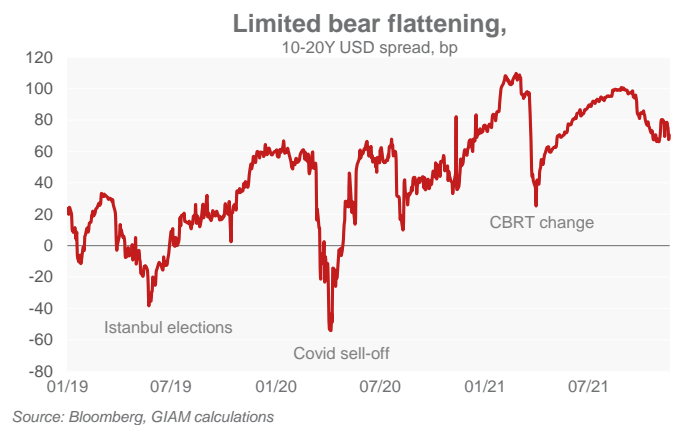
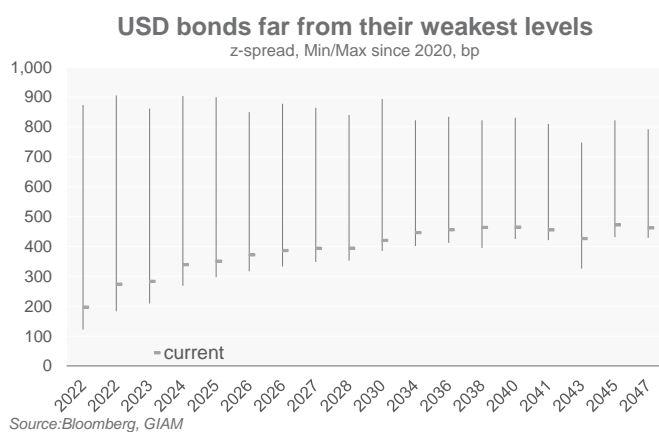
Strategy: still negative on Turkey debt

We hold our negative view on the local and external debt, but we prefer external over local debt. The market reaction has been more contained than in March so far. Positioning is lower, and we sense market fatigue. The Turkish risk has been flagged, and external/local debt recouped their losses during the latest market stress episodes. Since 2013, Turkey has been able to muddle through and has proved surprisingly resilient despite a high political risk, unorthodox monetary policy, and low FX reserves. Turkey has managed to extend the maturity of its hard currency bonds, and there are only USD 8.7bn due in the upcoming twelve months.

That said, the current levels are not attractive yet, and the situation is too fluid to change our stance now. Indeed, there is no clear sign for push-back from the authorities. Therefore, the TRY can depreciate further, the prospects of higher UST will weigh on the large external refinancing needs.

In terms of relative value, Turkey continues to trade cheap vs. its rating peers, more like a B country. However, relative-value opportunities are currently limited in our view, given the downside risks.

Curve-wise, we see limited room for bear flattening on the EM USD curve. Unlike on March 20 and March 21, the move has been limited so far. If any, it will be more in the 10-20Y segment of the curve. On local debt, the potential is more significant, and we will expect the CCS curve to flatten significantly.



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