

EM Cross Asset Strategy

Turkey: why lower oil prices aren't helping the TRY

Emerging Markets

Global

TRY reaches fresh lows, despite favourable tailwinds

Everyone acknowledged Turkey's challenges but equally investors have been keen to play lower oil prices and a looser ECB through overweight positions in Turkish assets. Things haven't gone to script in the currency markets and they've begun to infect other asset classes. Why is this happening, and what may the catalysts for change be?

FX refinancing requirements, weaker FDI, and CBT stance dampen oil positives

While lower oil prices should on balance lead to a substantial narrowing in the trade deficit ahead, we think investors have been wrong-footed by a few considerations that blunt its relevance for the FX market. First, the rapid accumulation of private external debt will keep gross external financing requirements high relative to 2012/13 and high by EM standards. Second, the trend slowdown in net FDI inflows makes external financing less predictable, and the lira thus more susceptible to any slowing of portfolio inflows. Third, statistical evidence shows that changes in Turkey's trade balance have historically been practically irrelevant for the TRY. Meanwhile, CBT's dovish stance and reasonably strong portfolio inflows (especially into stocks) have compromised the carry/vol on the TRY – which is below the likes of the CNH, BRL, INR, and IDR, and pretty low relative to its own history.

Near term call on TRY boils down to the CBT's stance on liquidity

In the near term we think the call on the TRY boils down to the willingness of the CBT to tighten liquidity, thereby offering FX investors higher carry and shoring up foreign confidence in its inflation targeting credibility. With about 50bps of easing priced over the coming month, this should take the form of avoiding rate cuts, keeping the ceiling of the rates corridor unchanged and tightening interbank liquidity. There should be tactical opportunities to get more upbeat on the TRY if and when this happens.

Medium term faultlines for the currency are more severe

We remain long India vs. Turkey in FX and local rates, and long Turkey 5y CDS vs. short Indonesia as structural trades. We have long expressed our concerns about a fundamental credit misallocation/FX mismatch problem in Turkey's corporate sector. 60% of corporate debt is denominated in FX (mostly dollars), FX lending has flowed rapidly into sectors which we believe are not adequately hedged (most notably to the construction sector, which is supported by current double-digit house price growth), and the bulk of corporate TRY debt is floating rate and of short-term maturity which means shocks can be transmitted quickly to the real economy. Risks from US rates, less attractive valuations in local markets, and uncertainties in Russia and the Middle East are other clear risks over the medium term.

Not speaking the language of reform

We are disappointed to still find limited progress in reforms related to controlling unit labour costs, and limited discussion on real interest rates and savings rates which we think could help to mitigate macro and FX risks. The worry then is that things can get a lot worse yet for the TRY over the long haul, which can infect local rates markets too. Note that our unit labour cost adjusted REER still shows the TRY trading substantially above its medium term averages: don't be fooled, this currency is not fundamentally cheap.

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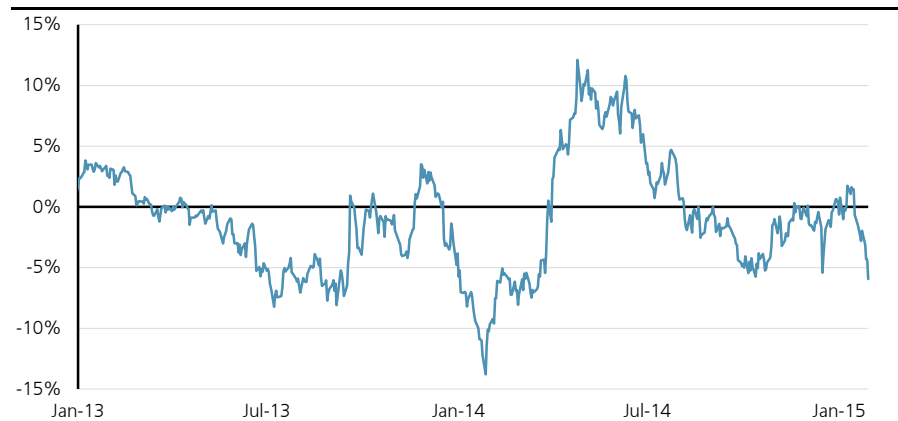
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Lower oil prices, a surprisingly aggressive ECB QE programme, US rates falling even faster than those in Europe, strong peripheral European debt markets....if you weren't an EM watcher you'd be forgiven for thinking the Turkish lira might be trading near record highs amid these tailwinds. Instead, the TRY is trading at record lows vs. the USD, underperforming its peers, and failing to match its forwards (Figure 1). What explains this highly indifferent performance? What can we expect from here, and what might be resultant implications for local markets?

Figure 1: Net gain on short USD/TRY (relative to 3m forwards)



Source: Bloomberg, UBS

The trade balance will start improving from here. But so what?!

No discussion on the lira these days begins without reference to how Turkey's trade data prints will benefit tremendously from lower oil prices. So let's consider this more closely.

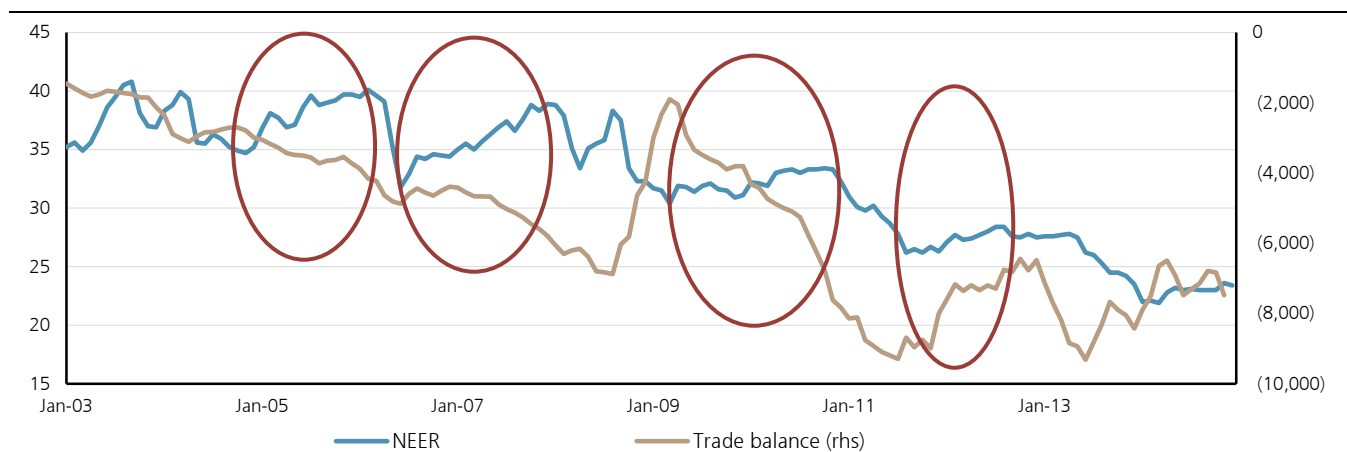
Turkey's trade deficit has been sticky in recent months, owing to weak exports and 'lumpy' precious metals imports. However the deficit is widely expected to narrow swiftly from here – in fact December trade data is expected to start showing this more clearly. After all, oil accounts for 25% of imports, and Turkey's main export destination - the Euro area – is starting to show some signs of a cyclical growth recovery. A crude rule of thumb suggests that, should Brent oil prices settle around \$53/bl this year as UBS analysts forecast, about \$24bn or 3%/GDP could be shaved off the annual energy import bill.

Even allowing for offsetting factors - such as weaker exports to/tourism receipts from oil exporting trade partners (note Iran, Iraq, Russia, Saudi Arabia and the UAE account for nearly ¼ of Turkish exports), slower petrodollar speculative flows, and stronger domestic demand on monetary loosening, - it still seems reasonable expect a roughly 2-2.5%/GDP improvement in the current account deficit (to around 3.5%/GDP), making it easier in theory for the TRY to appreciate.

So shouldn't investors use the recent weakness in the TRY to position for this big improvement in the external balance? We see two flaws with this argument.

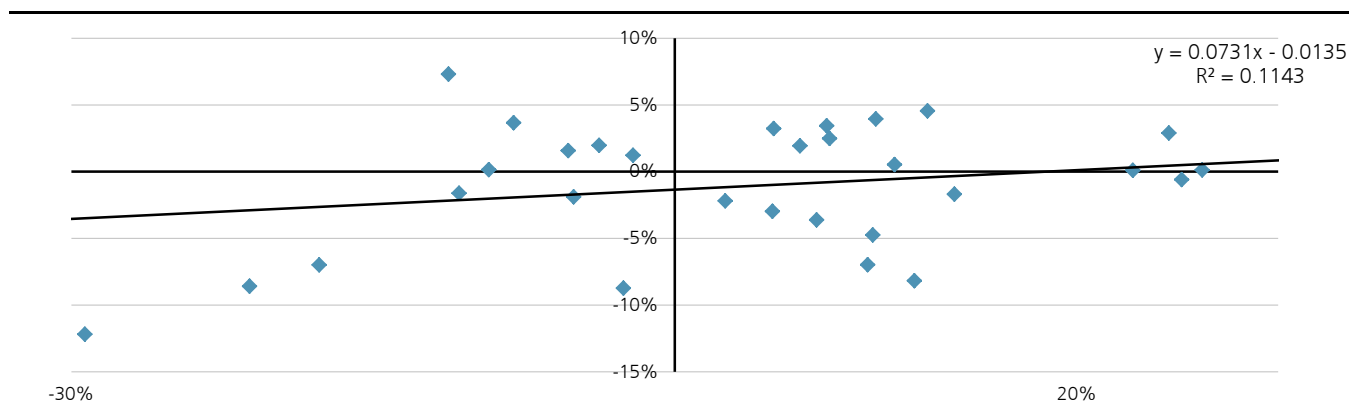
First, **contrary to popular perception, there simply hasn't been any meaningful relationship between changes in the TRY and the trade balance** historically speaking. Figure 2 shows that there have been 4 phases of TRY NEER appreciation in the past decade and that, in 3 out of these 4 instances, Turkey's trade balance was significantly *deteriorating at the time*. Simple regressions confirm an extremely weak – call it irrelevant – relationship between changes in the TRY NEER and Turkey's trade balance (Figure 3). This implies that other variables such as real rates, FDI inflows, valuations in local debt and equities, global risk appetites, and so on have tended to play a much more significant role in driving the lira than the trade balance per se.

Figure 2: The best phases of TRY appreciation have been when the trade balance actually deteriorated



Source: Haver, UBS. Note: Higher values of NEER denote TRY appreciation vs. trading partners. Red circles denote phases of TRY appreciation.

Figure 3: Regression of quarterly % changes in TRY NEER vs. the trade balance – a very weak relationship indeed



Source: Haver, UBS estimates

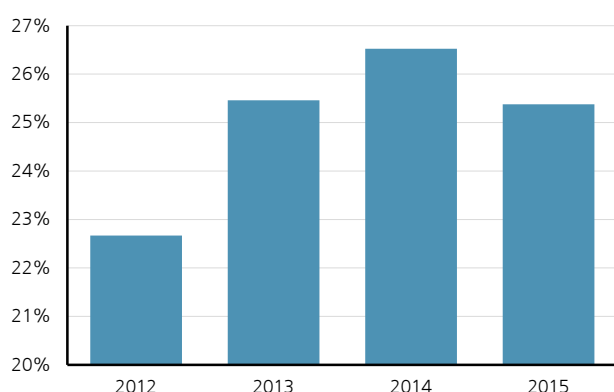
The elephant in the room: external debt matters more than the trade deficit

Second, **while Turkey's trade deficit should shrink notably in the coming quarters, its gross external financing requirement is likely to do so at a slower pace, and will remain very high by EM standards.**

Gross external financing requirements are defined as the current account balance + short-term debt amortisation + medium/long term debt falling due over the next coming year. As explained earlier, we think Turkey could see roughly \$20bn knocked off its current account deficit over the coming quarters thanks to lower oil prices. However, about \$7bn of this will be negated by higher external debt refinancing requirements. Turkey's external financing requirement relative to GDP will thus be lower than was seen in 2014, certainly, but substantially higher than in 2012 and about the same as in 2013 when the TRY weakened substantially (Figure 4). This is not necessarily cause for imminent concern, but it does go to show that obsession with the shrinking trade deficit may be misguided.

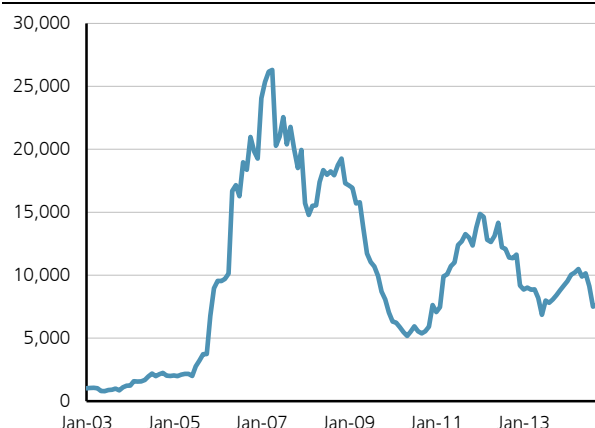
Meanwhile there has been a trend slowdown in net FDI inflows, which have slowed to annual \$5.5bn from an average \$10.7bn between 2011-13 (Figure 5). This reduces the predictability of external financing, and could make the currency more susceptible to external risk gyrations.

Figure 4: Gross external financing requirements (%/GDP)



Source: UBS estimates, Haver. 2015 figure assumes a current account deficit of -3.8%/GDP and unchanged dollar GDP. We think these are generous assumptions

Figure 5: Net FDI inflows (\$mn, 12m rolling)



Source: Haver, UBS

CBT easing: eroding the carry...

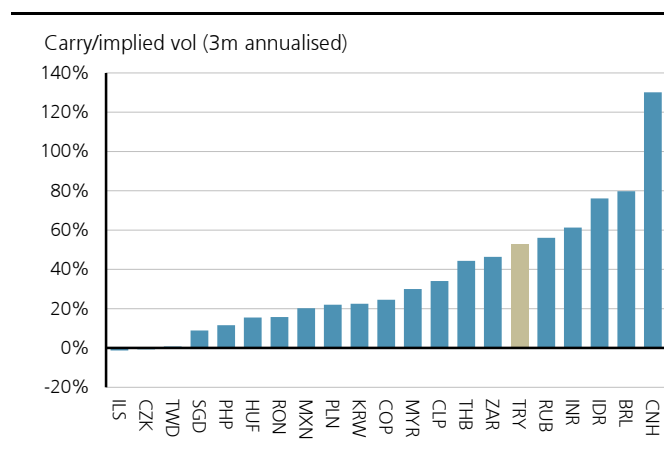
That other factors besides the trade balance adjustment tend to have a dominating influence on the TRY leads us neatly into an investigation of the CBT's policy actions.

In response to the improvement in inflation expectations and sequential core inflation momentum, CBT cut the overnight borrowing rate by 50bps on January 20th, and has signalled it could hold an unscheduled meeting on February 4th to review rates should CPI data (to be released a day earlier) show a 1pp decline or more. While the CBT likes to emphasise that it retains flexibility on funding rates

through its wide interest rates corridor, rate cuts have not just been symbolic: as of yesterday the weighted average cost of funding for the banking system declined to 7.8% from an average 8.5% in December.

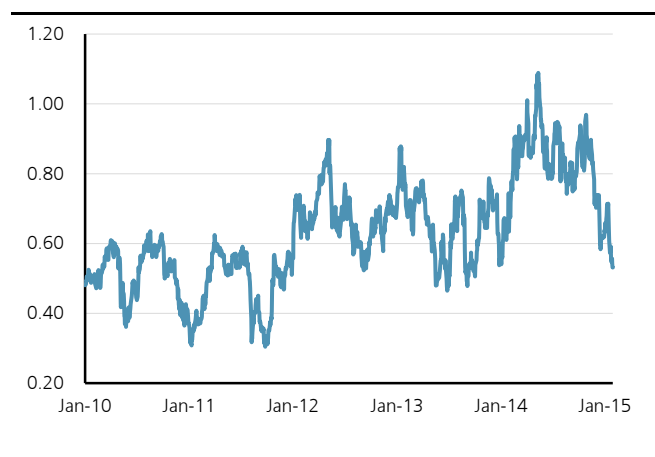
This easing policy stance is already being felt visibly in the FX forward market. 3m forward FX implied yields on USD/TRY have declined from about 8.3% annualised in late December/early January to 7.2% at the time of writing, and the decline is somewhat steeper at the 6m and 12m tenors. **Relative to implied volatility, carry on the TRY has also fallen, and stands behind the CNY/CNH, BRL, INR, IDR and RUB.** TRY carry/vol now stands at about 25% of its percentile since January 2010. While this admittedly is a backward looking indicator and volatility could come lower again as positioning adjusts/the CBT tightens its liquidity stance, we think it helps illustrate why tighter rates will probably be a prerequisite for the TRY to sta

Figure 6: TRY carry/implied vol – not particularly attractive



Source: Bloomberg, UBS

Figure 7: TRY carry/realised vol since 2010



Source: Bloomberg, UBS

...and bringing back uncomfortable memories

More fundamentally, while the CBT's moves to ease policy are not unique in the current environment, we think many investors may be especially mindful of CBT easing given the Bank's inflation fighting track record. The CBT over-eased policy in 2009/10 and in 2012 when the chance to entrench structurally lower inflation was there for the taking. In fact it has missed its inflation target seven out of ten times in the past decade, and missed badly – in these years inflation overshot the target by an average 384bps, or 293bps under Governor Basci's reign since 2011.

Moreover other high-inflation EMs such as Brazil, South Africa, India and Indonesia have either kept policy on hold or waited for clearer signs of disinflation before easing, which accentuates the relative dovishness of the CBT's actions.

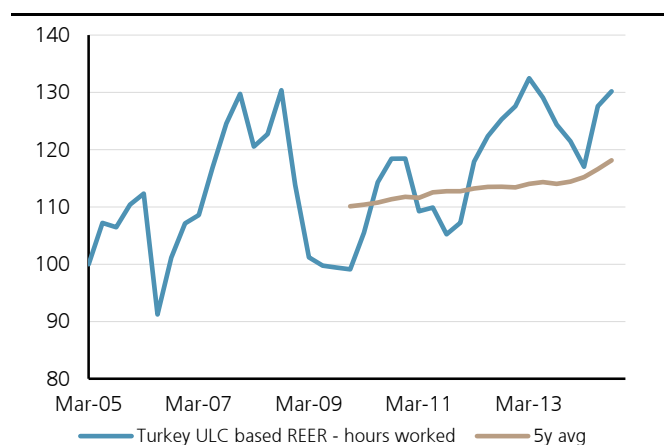
Investors will also be mindful that there are reasonably important general elections scheduled for June; President Erdogan is keen to push for constitutional amendments which will almost certainly require greater parliamentary representation for the AKP).

Part of the erosion in TRY carry is also due to portfolio inflows, which have been particularly strong into equities in recent weeks (the local debt market has rallied, but CBT data suggests that move has been primarily driven by local investors). With Turkish equities now trading around 15% above their forward P/E average, it seems very plausible that these inflows can slow from here. We also believe the local rates market is pricing in a very benign outlook for inflation already, with real rates net of CDS well below the EM average and Turkish debt ranking in the lower range of our fundamental valuation scorecard (please click [here](#) for details).

TRY is not fundamentally cheap

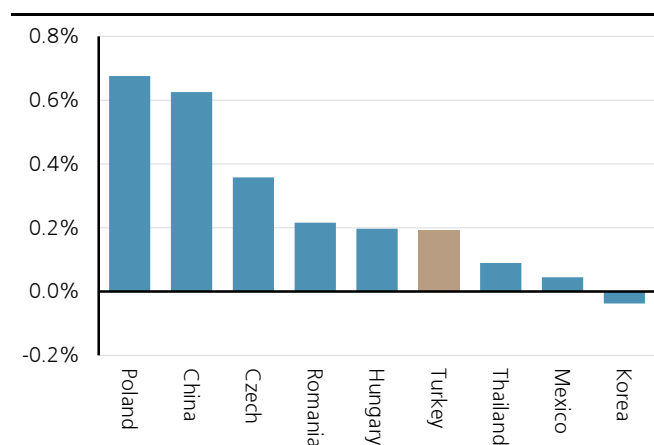
It is also worth mentioning briefly that in spite of recent weakness against the USD, the **TRY real effective exchange (adjusted for unit labour costs) has remained elevated** (Figure 8). Meanwhile, though Turkey's share of European imports is growing, it has not done so at an especially remarkable pace (Figure 9.) We are thus very reluctant to conclude that the TRY is undervalued.

Figure 8: TRY unit labour cost adjusted REER (UBS estimates)



Source: Haver, UBS estimates

Figure 9: Turkey is gaining share in EU imports, but not at a remarkable pace (share of EU imports, latest 3m, relative to 2011-2013 average)



Source: Haver, UBS estimates

FX (mostly USD) leverage a major medium term headwind

Over the longer term, our macro concerns in Turkey centre around leverage.

Private credit growth has grown rapidly post-crisis in Turkey, indeed faster than all other emerging markets bar China. FX leverage in the system has also picked up significantly, with about 60% of corporate debt now denominated in FX (roughly 70% of which is in US dollars). In our view this credit has not been allocated efficiently in that:

a) it has flowed rapidly into sectors such as electricity, gas, water, and construction companies, where FX hedges are unlikely to be complete and

b) there has been an alarming disconnect between (strong) private credit growth and (very weak) private investment/GDP for over three years now, which we think reflects a misallocation into areas like wages and servicing existing debts (click here for details: [Turkey Visit Notes: Structural faultlines deepening? Oct 3 2014](#)).

Note that within corporate loans, c.60% are in FX and of the remaining 40% in TRY, about half are short term (0-12m maturities) and about 60% are floating rate. Given how far the TRY has depreciated in recent years, and that commercial loan interest rates have thus far been unable to fall, it is not hard to see that corporate Turkey's balance sheet has been strained significantly. Moreover there are no signs that the corporate sector has begun to reduce its FX leverage – quite the reverse, in fact, with monthly balance of payments data showing continued accumulation of external borrowings. Meanwhile the housing market continues to boom, a factor that is likely underpinning growth in the construction industry more broadly. **It is only once this starts to slow down that the real external deleveraging by Turkey will begin – which could open a new wave of TRY depreciation.**

Concluding remarks

Overall, we see recent TRY weakness as largely a case of positioning over-exuberance stoked by falling oil prices and the ECB, which was subsequently damaged by the CBT's very dovish stance. While we would expect further inflows into local debt and stocks to be constrained by valuations, we think a change in CBT liquidity policy in the coming weeks could go a long way in creating tactical opportunities to fade TRY volatility. We would look to tactically get long the TRY if and when liquidity is tightened, against perhaps the ZAR or EUR for example. At current levels we still see the carry/vol on offer on TRY as unexciting, and recently added a long CNH position (vs. the AUD) to our model portfolio to gain some carry where we see a more attractive Sharpe ratio on offer.

Longer term, we continue to see India's policies bearing greater fruit on FDI, real rates, savings rates, and trend growth than Turkey. We remain long INR/TRY as a structural trade and long India 10y bonds against Turkey, and long Turkey 5y CDS vs. short Indonesia 5y CDS. We think FX as an asset class is more 'right' than local debt: we think FX weakness is likely to contaminate yields over the several months, rather than expecting strength in local rates to start benefitting the FX.

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