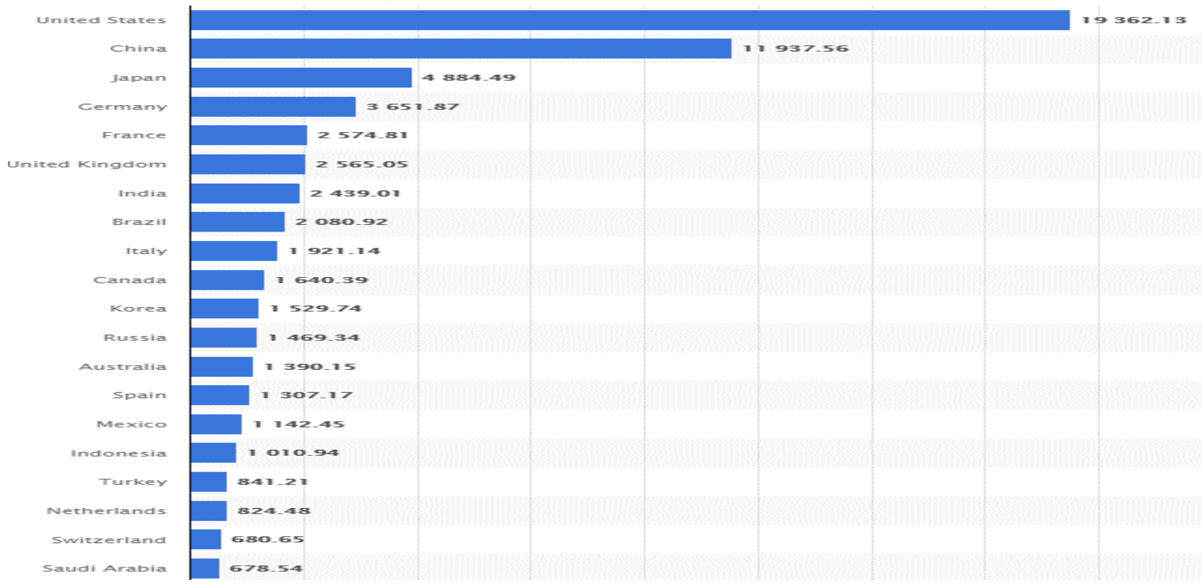
The Navigator

COVENANT CAPITAL

August 2018

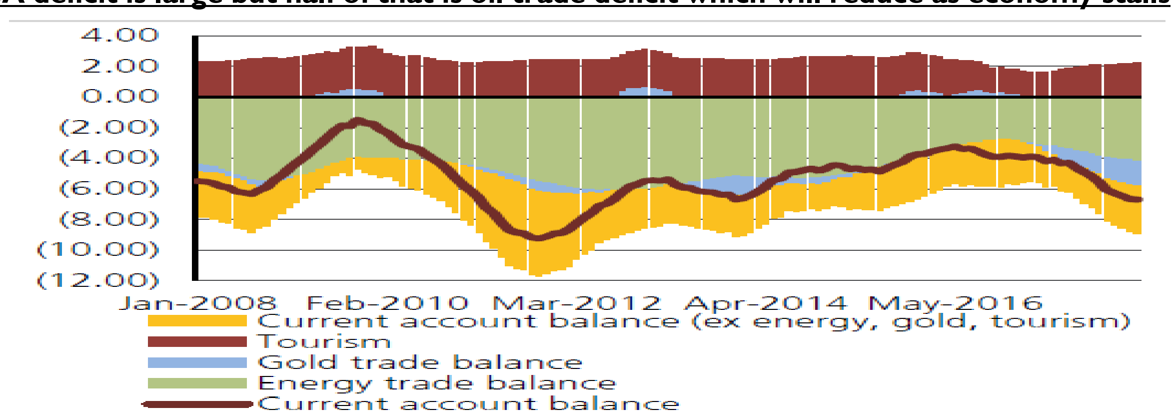
Quick Take – Turkey is a delicious bird if cooked correctly

1. **Size of Turkey GDP**: US$841.1bn; 17th largest economy in the world but is only 1.1% of world GDP and less than 1% of MSC EM Equity Index or 83% of Apple's market cap



2. **What kind of deficit matters.**
   a. Turkey C/A deficit is high at -8% but much lower than Greece; which was -15% at height of 2008.
   b. Half of Turkey C/A deficit is due to its oil deficit. Once we exclude energy, gold, its C/A deficit is only -3 to -4%. In other words, as its economy slows, its deficit will reduce as its oil demand reduces.
   c. Turkey is not Greece. Turkey has lira, Greece has Euros.
      i. Turkey can devalue its debt
      ii. Lira can devalue to re-establish competitiveness; Greece can't it has Euro.
      iii. But the big difference Greece has ECB backstop, Turkey has nobody.

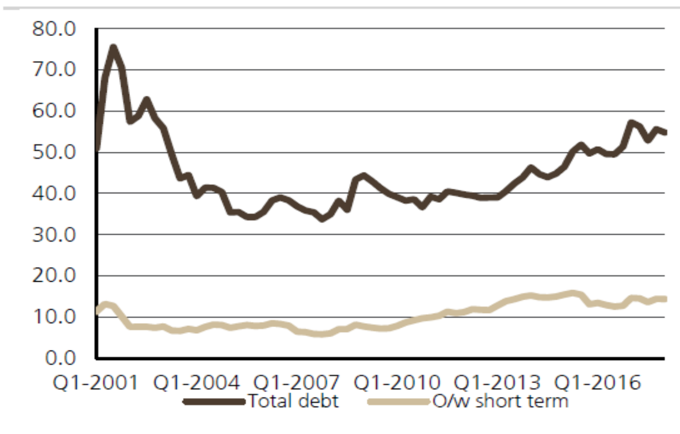
<u>CA deficit is large but half of that is oil trade deficit which will reduce as economy stalls</u>



Source: CBT, Haver, UBS

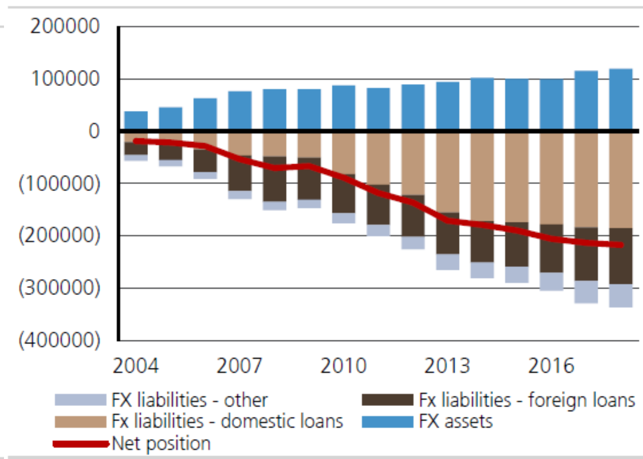
3. **What kind of indebtedness matters.**
    a. Turkey's debt is largely longer-term debt. 73% of total foreign and local debt are long-term debt.
    b. Largely domestic liabilities 2/3. Which means most of Turkey's total debt are held by locals rather than flighty foreign debt holders.
    c. The acute pain is with the foreign liabilities of which 36% is due within one year.
    d. Private sector holds bulk of the foreign debt, 55% of it

Largely long-term debt



Source: CBT, Haver, UBS

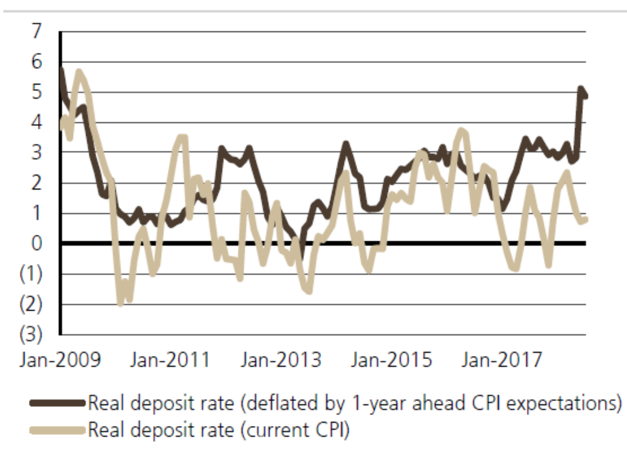
Largely local debt and not foreign debt



Source: CBT, Haver, UBS

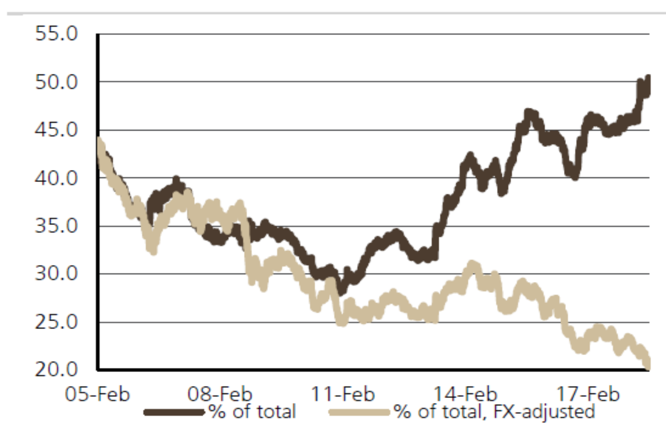
4. **Don't scoff on nationalistic clarion call**. Real deposit rate is 1% higher based on current CPI and 4% higher based on future CPI expectations. So why not sell USD and gold and keep lira

Unlike Greece, real rates are positive



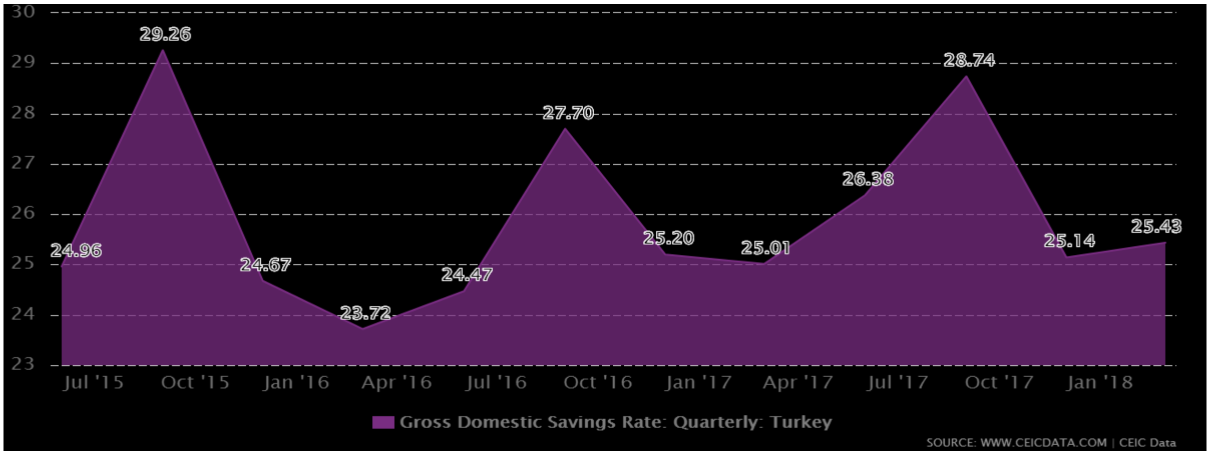
Source: CBT, Haver, UBS

Banking system deposit is rising despite USD outflows



Source: CBT, Haver, UBS

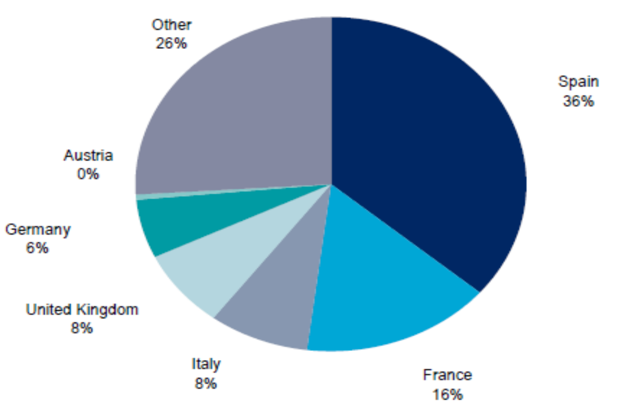
5. Turkey are larger savers than the PIGS. Household saving rates above 20% vs Greece less than 10%, Italy 8%, Portgual 5%, Spain is -ve.



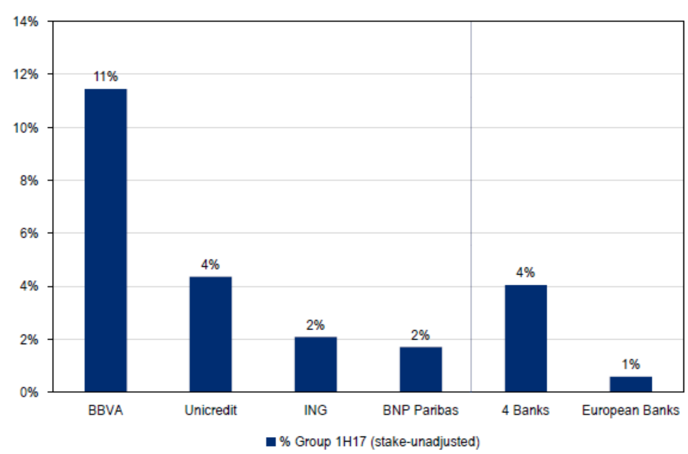
6. **Doesn't mean it wouldn't hurt** but do you know Turkey GDP grew 7.4% last quarter and for what is worth current forecast is 4.1% 2018 and 3.4% 2019.

   a. Foreign bank exposure is large for Spain, but overall European banks are small.
   b. Non-lira debt is almost entirely held by corporates. This is a corporate debt crisis.
   c. Stay away from their banks and banks with big exposures. Corporate debt crisis means lenders take the hit first.
   d. BBVA is largest exposed and accounts for 30% of total foreign banks exposure. It owns the 2nd largest bank in Turkey, Garanti Group. Turkey contributed to 26% of its 2017 NP and 13% of its total loan exposure. Saving graces: 1) No apparent intra-group funding (2) LDR is 114% and Deposit franchise is largely retail with good CASA mix (3) 70% of its capital exposure is FX-hedged and 50% of its FX PNL is hedged (4) so far most analysts model a less than 1% hit to CET1 which now stands at 11.4%, which means worse case BBVA CET1 still above EBC minimum and 0.6% lower than management desired level.

Spain is most exposed, followed by France

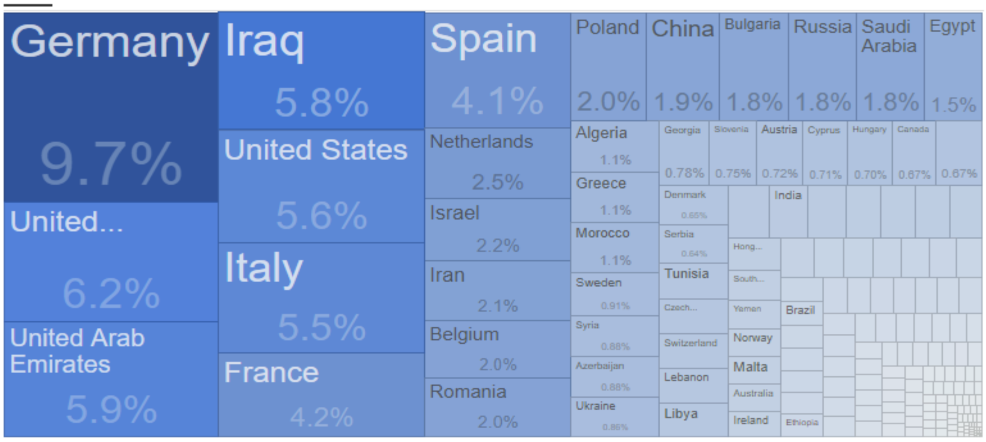


BBVA is largest foreign bank exposure



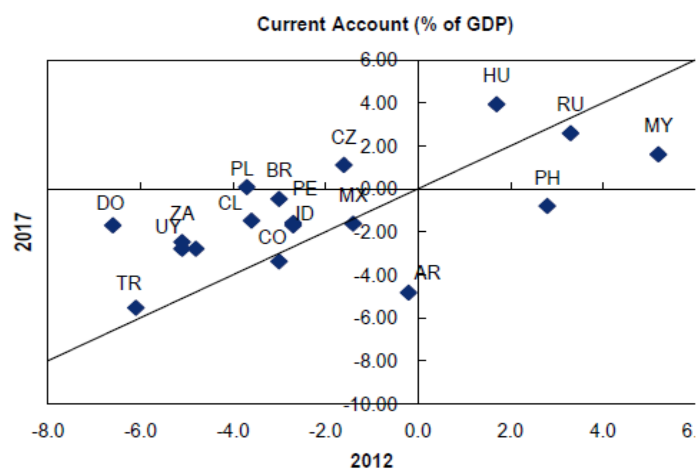
Source: Citi Research, BIS link * BIS reports The Netherlands as zero / Source: Citi Research, EBA * Unadjusted for stakes

7. **Remember the links.** Financial linkage vs trade linkage vs cruising for a bruising linkage
   a. Financial linkages – Mostly a local problem, concentred at Spain particularly at BBVA followed by UniCredit.
   b. Trade linkages – Services (Tourism is big part): 23% of GDP, Manufacturing 25%, Argi is 7%. 55% of economy will benefit from cheaper lira. Export is 25% of GDP.
   Exports: Ger, US, UAE, Iraq Imports: China 11%, Ger 10%, Russia 9%.



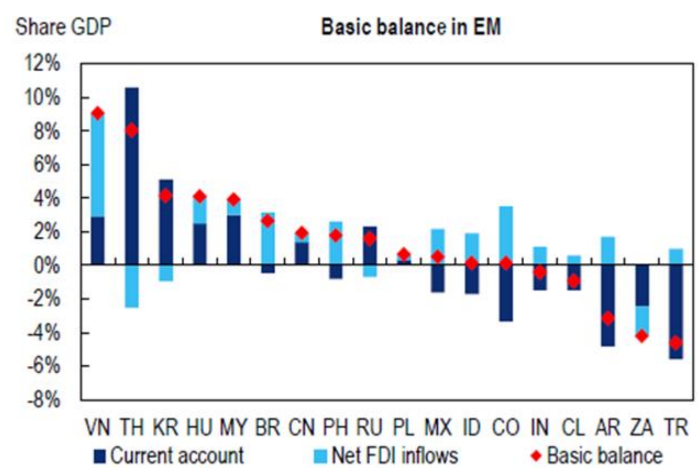
C. Cruising for a bruising linkage. Remember we analysed this 2 months ago when Argentina broker and Turkey was cracking. Read [The Navigator June 2018: Memories fade but the scars still linger](). The end conclusion: Argentina and Turkey are clear outliners. Possible risk markets are South Africa and Colombia. Russian isn't one, neither should India and Indonesia be viewed in the same view as Argentina and Turkey!

Arg, Turkey CA worsen, Russian and Indo little change



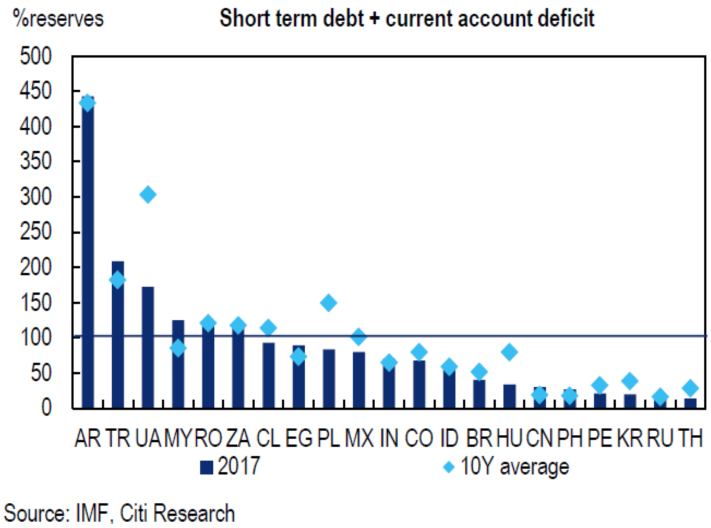
Source: Bloomberg, Citi Research

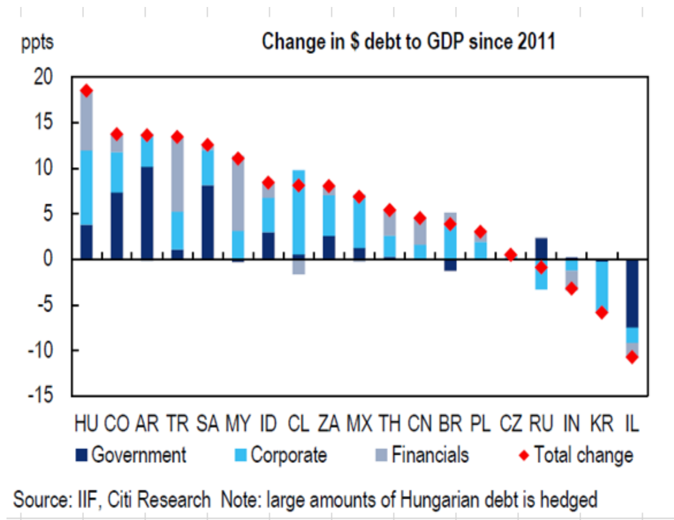
Russia,India, Indon healthy balance of FDI and CA



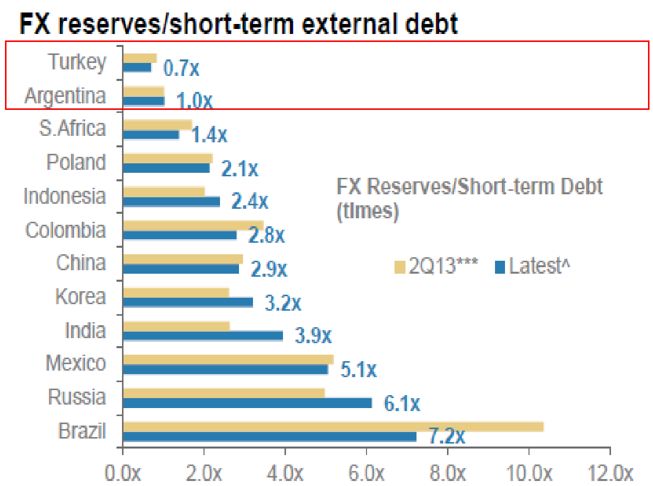
Source: Citi Research

Again AR, Tur stands out short of liquidity but Rus,Indo and India more than covers and didn't see a surge in debt/GDP like Hu, CO, Arg and Tur

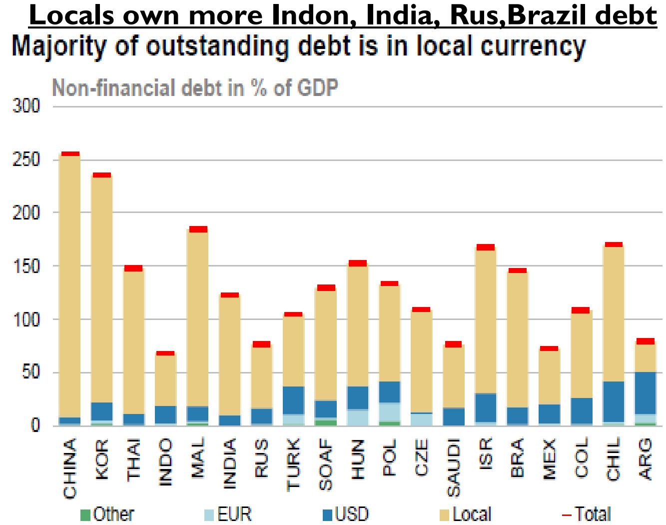




Look at Brazil, Russ, India and Indon cover

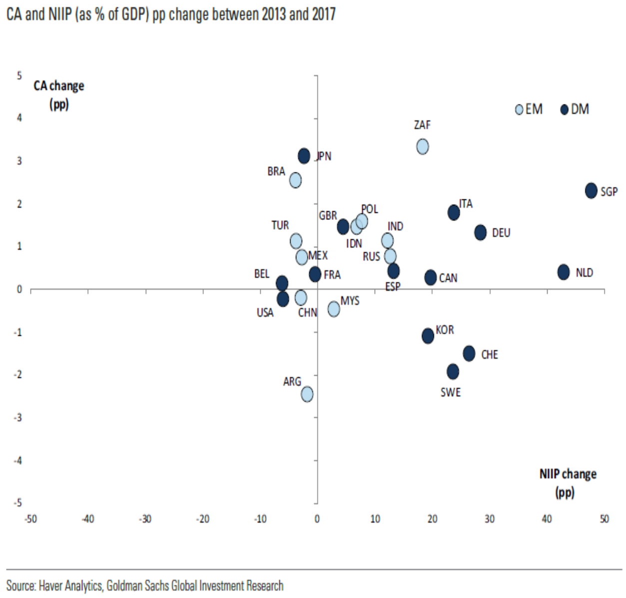


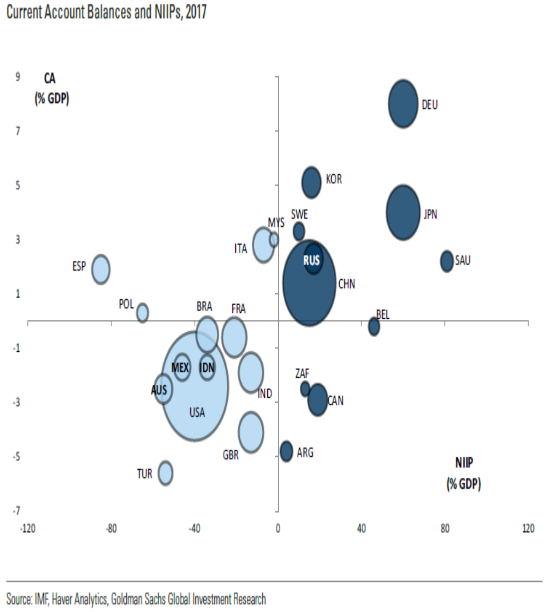
Locals own more Indon, India, Rus,Brazil debt



Who has been naughty? More has been good than bad. Prior GFC, CA for the world rose to 6%, now is 3.25% globally according to IMF

More have seen improvement in CA and NIIP since 2013. Arg, China and USA didn't





Is there a who's next? Colombia and South Africa are at risk.
Not Russia, India less so Brazil and Indonesia.

EM Exposure to Higher US Rates (0 = very low exposure, 4 = very high exposure)

	EM Scorecard	China*	Russia	Korea	India	Poland	Mexico	Brazil	Indonesia	S.Africa	Argentina	Colombia	Turkey
External Exposure	Current account balance	1	0	0	2	1	2	2	2	3	4	3	4
	FX reserve/external debt	0	3	2	2	4	3	3	4	3	4	4	4
	Foreign holdings of gov. bonds	0	1	1	0	2	2	2	2	4	0	2	1
	USD-denominated corporate debt	1	2	3	1	0	2	2	1	1	1	2	3
Monetary Policy Flexibility	Inflation	2	2	2	2	2	2	2	2	2	3	3	3
	Real rate differential	2	1	4	1	4	0	2	2	1	0	3	0
	Overall Score	1.0	1.1	1.4	1.5	1.8	1.9	2.1	2.1	2.5	2.6	2.9	2.9

EM Exposure to Higher Oil Price & Political Events

	China	Russia	Korea^	India	Poland	Mexico	Brazil	Indonesia	S.Africa	Argentina	Colombia	Turkey
Impact of Higher Oil Price	-	+	-	-	-	-	+	-	-	-	+	-
Major Elections Over Next 6M						X	X				X	X

Conclusion: We do not subscribe to the view that Turkey problems should not lead to a contagion to whole of EM. Recent downward moves in EM equities and bonds prices have presented an opportunity to buy not sell. We prefer to focus on Asia related names such as Indon, China issuers, long/short Asia credit fund manager, Income Partners and EM Equities call options.

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