BARINGS VIEWPOINTS

October 2018

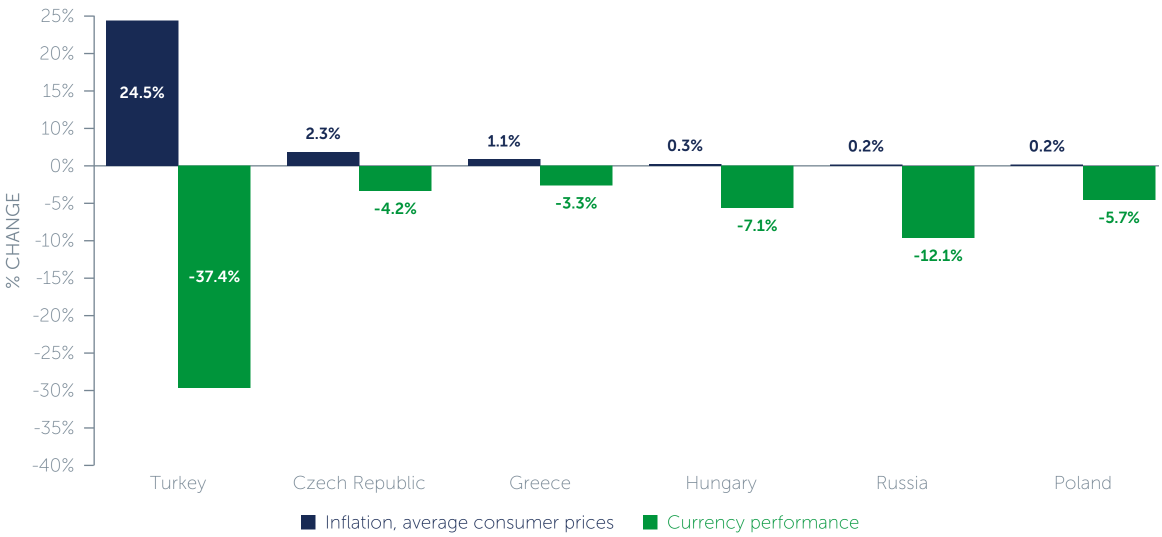
TURKEY: WHERE FROM HERE?

ON THE BACK OF DEVELOPMENTS IN RECENT MONTHS, BARINGS' EMERGING EUROPE EQUITIES TEAM TAKES A LOOK AT HOW TURKEY IS POSITIONED.

Turkey's financial system has suffered a tumultuous year which has seen the country's lira fall by more than 35% since the start of 2018 and the stock market nearly halve.[1] The prioritization of high economic growth rates by President Erdogan, in addition to elevated energy prices, saw the country's current account deficit expand to approximately 6% of GDP, the highest of any emerging market (EM). Investor confidence remains subdued following the combination of creeping fiscal indiscipline and excessively loose monetary policy. Additionally, serious questions are being asked of the central bank's ability to conduct independent monetary policy under the shadow of Erdogan, despite a rapid increase in inflation. In our view, Turkey now needs to enact strong measures to anchor these severe inflationary pressures, which should help to build a more solid foundation for sustainable growth going forward.

"Turkish policy makers and politicians recognize that the successful stabilization of the lira will enable the country to rebuild trust with markets and curb inflation from spiraling out of control."

FIGURE 1: TURKEY'S FINANCIAL SYSTEM HAS COME UNDER SUSTAINED PRESSURE THIS YEAR



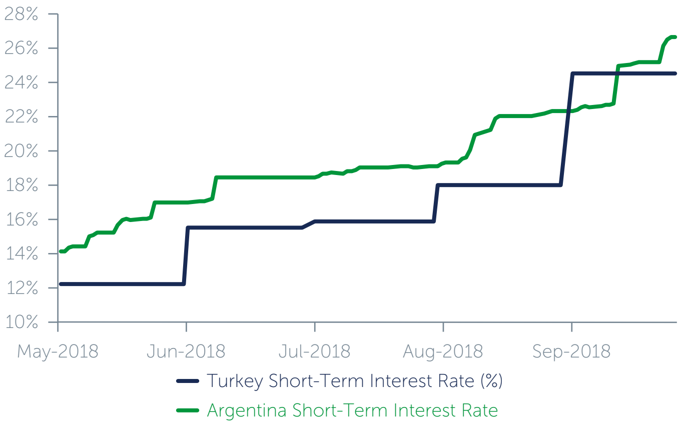
SOURCES: *BARINGS, FACTSET. SEPTEMBER 30, 2018.*

Stability builds trust

Turkish policy makers and politicians recognize that the successful stabilization of the lira will enable the country to rebuild trust with markets and curb inflation from spiraling out of control, in our view. Since May, there has been a synchronized monetary and fiscal response through significant rate hikes (FIGURE 2), which is a departure from previous growth-oriented, fiscally expansive plans.

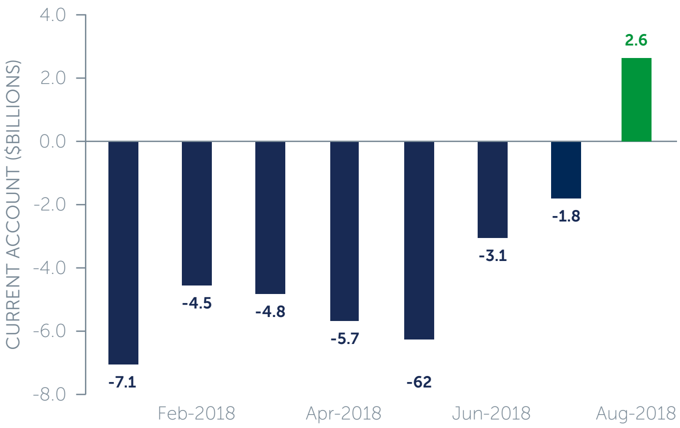
1. September 30, 2018, based on MSCI Turkey

FIGURE 2: THERE HAS BEEN A SYNCHRONIZED MONETARY POLICY RESPONSE SINCE MAY



SOURCES: *BARINGS, FACTSET. SEPTEMBER 30, 2018.*

FIGURE 3: TURKEY POSTS ITS FIRST MONTHLY CURRENT ACCOUNT SURPLUS SINCE 2015



SOURCES: *BARINGS, CBRT. SEPTEMBER 30, 2018.*

MATTHIAS SILLER, CFA
HEAD OF EMEA EQUITIES TEAM

Matthias joined Barings in 2006 and was appointed Head of EMEA Equities Team in 2016. Matthias is also lead manager for the Baring Emerging Europe Plc. He began his career in fund management at Raiffeisen Zentralbank Austria in 1997 as a Market Maker/ Proprietary Trader in Central & Eastern European Equities and Derivatives. He joined Bawag – PSK Invest as an EMEA equity portfolio manager in 2001 and moved to Raiffeisen Capital Management in 2003, where he was a portfolio manager for Central & Eastern European Equities. Matthias has a Masters degree from Vienna University in Economics & Business Administration. Matthias was awarded the CFA designation in 2006 and speaks fluent German.

September's interest rate increase exceeded economists' expectations and was met favorably by investors, who interpreted the move as a strong demonstration of central bank independence from President Erdogan, a widely acknowledged critic of high rates.

By increasing interest rates, Turkey has provided itself with an opportunity to ease the pressure on its banking system. It's very encouraging to see government officials acting swiftly in the past month to provide relief to banks' balance sheets, which have been stretched by holding liabilities in stressed industries such as construction and energy. This has been evidenced through Turkey's state-owned Halkbank, which has sold non-performing loans (NPLs) to the Savings Deposit Insurance Fund (TMSF), the Turkish state's fund and insurance management body. Furthermore, another state-run lender, Vakifbank, sold $300 million of subordinated debt to the country's unemployment fund. Such assistance should free up the desperately needed capital and act as a catalyst for the eventual thawing of credit markets, in our view. Additionally, despite the lira's weak position, we believe the banking sector is adequately capitalized to contend with the potential for deteriorating credit quality and an inevitable increase in NPLs as a result of the recession.

Improving current account

Economists have long been concerned that Turkey's current account deficit was a sign that foreign inflows of capital have funded the country's rapid economic growth in recent years. A higher deficit can indicate the country is more vulnerable to external macro shocks, which are extremely prevalent during this period of elevated investor concerns toward emerging markets. While Turkey now finds itself in a recession, it's encouraging to note that the country's deficit is showing tentative signs of rapid rebalancing, as the lira's slump has drastically reduced imports and prompted a first monthly surplus since 2015. The weak currency has also reduced the Turkish economy's dependence on foreign funding, providing a measure of support through the rise in net exports. This is also commensurate with Turkey's traditional surplus in services, which is especially prevalent in summer months when tourism is at its height.

As Turkey takes its first steps in restoring confidence, a pronounced recovery may take time, and any prolonged period of negative sentiment is likely to impact confidence and investment in the country. Inflation will remain a concern in the near term as Turkey is heavily reliant on imported oil and has been impacted by the elevated crude prices, which are priced in dollars, adding additional pressure to businesses and consumers. In our view, the recent fiscal and monetary policies implemented should dampen inflation, which will set a foundation on which investor confidence can grow. Despite recent events, there remain considerable investment opportunities in the Turkish market, in our view, especially in companies that have pricing power and strong balance sheets. Many of these now trade at attractive valuations, providing a compelling entry point for investors who are willing to take a medium-term view.

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**As of September 30, 2018*

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