Emerging market sympathies? Yes. Crisis? Hardly.

Turkey is facing a currency crisis. The temptation is to treat the emerging markets (EM) asset class as homogenous and dump emerging currencies, bonds and stocks when trouble hits a big EM nation. Although EM assets are under pressure, markets are showing differentiated stress levels, with some barely down since the Turkey crisis erupted. Investors should be sanguine as the country is too small to affect the outlook of for global growth.

What is the importance of Turkey?

Turkey, which links Europe and Asia, is of key geopolitical significance as a member of the North American Treaty Organisation (NATO). Both Erdogan and Russian President Putin have strengthened political relations which risks souring Turkey's ties with alliance members.

An insufficient policy response to a weakening lira, a diplomatic dispute and sanctions from the US triggered a sharp drop in the lira last week. This led to a crisis of confidence amid Turkey's backdrop of high dependence on short-term foreign currency borrowings and a large current account deficit.

What kind of economic conditions precipitated this?

During his time in power, President Recep Tayyip Erdogan drove the economy on speed accelerators fuelled by excessive foreign currency borrowings. He remains impervious to Western orthodox economic policy which calls for higher interest rates and slowing of the country's consumption and construction oriented economy. Instead, he promises the benefits of "growth at all costs" to his voter base. Investment and growth are persistently stoked with burdens of budget imbalances, external borrowing, surging inflation (now at over 15%) and overheating.

How does this affect the markets?

Turkey's problems are containable. It accounts for around 3% of European exports and the impact to European banks are kept likely minimal even in the worst scenario. Spanish banks have less than 3% of exposure to Turkish loans while the figure drops to about 1% for French and Italian banks. In a nutshell, if the gross domestic product (GDP) of Turkey were to shrink by 20%, the dent to Europe's growth is estimated to be less than 0.2% of its GDP.

Within EM, Turkey comprises 0.6% of the equity market capitalisation and 3.7% of the bond indices. Investors are closely monitoring other EM countries including Brazil, India, Russia, South Africa and even China. EM fundamentals are generally in good shape as they have employed an arsenal of policy tools such as currency depreciation, interest rates and fiscal measures.

Additionally, EM countries have fortified their balance sheets (debt in China has been declining), accumulated significant foreign exchange reserves and largely pursued responsible fiscal measures (reduced budget deficits, casting off costly subsidised) to build up resiliency to external pressures.

Unlike Turkey, most EM countries mainly borrow in local currency, which buffers them against the effect of a stronger dollar and higher interest rates. These same countries have also learnt lessons from prior crisis- the Latin American debt crisis around 1980 and the Asian financial crisis in the in the late 1990s and have reoriented their finances accordingly. The woes from Turkey aren't enough for a wider crisis, and fears of contagion are likely to be limited.

What is likely to play out next?

Turkey's deepening woes will hurt risk appetite and sentiment, and drive investors to safer assets in the short term. However, Turkey will be forced to respond to the markets' concerns at some point. When that happens, a buying opportunity will likely emerge for bonds and currencies of countries that don't face challenges as deep as Turkey. During past crises, the markets have only become a clear buy once the current account turns into a surplus.

We believe sound EM fundamentals will re-assert themselves, supported by cheap valuations, once Turkey's problems no longer make headlines.

Positioning on Turkey

The impact from Turkey to UOBAM is minimal. Our EM bond portfolio allocation is less than 1% against the benchmark's 3.4% weight. Moreover, our exposures into contingent convertibles (CoCos) within European banks are small and manageable.

House view

We remain overweight on equities over fixed income in our global strategies. We prefer developed market to emerging market equities, although we acknowledge the relative attraction of EM valuations. The risks from Turkey combined with other risks (trade spats, China growth data), makes it difficult to neutralise our underweight.

Within fixed income, we advocate a neutral position for EM bonds (USD denominated), with their cheap valuations and largely sound fundamentals compensating to some extent for geopolitical risks.

The weaker lira should make imports into Turkey more expensive and exports more competitive. Consequently, for next year, Turkey is likely to turn in a current account surplus that can help fix the first part of their twin deficits. However, this may imply a near term hit to growth. Additionally, a weakening economy would subside inflation tempers. Though a scenario of accepting financial support from the International Monetary Fund (IMF) is remote with Erdogan in power, this could stabilise help stabilise the currency and public external finances should it occur.

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