HORSEMAN
CAPITAL MANAGEMENT

COMING OFF THE DOLLARS COLD TURKEY

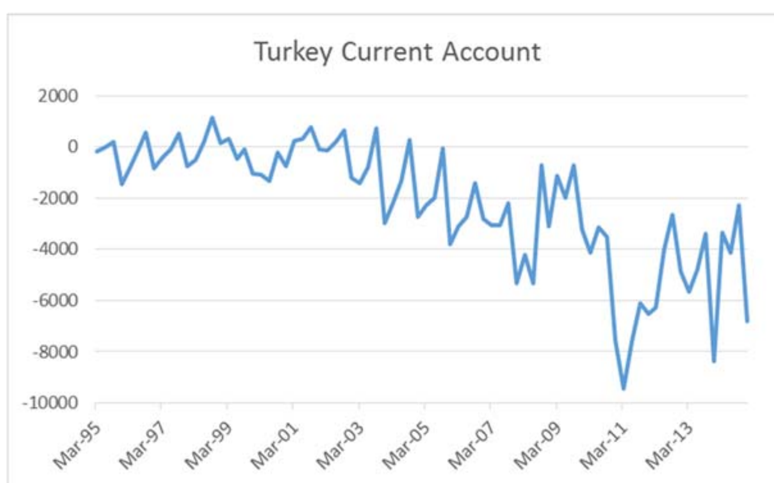
John-Paul Burke's
Market Views

"A great deal of capital has flowed into Turkey in recent years, much of it in US dollars. The largest single destination for the capital was non-financial corporate balance sheets, a large portion of which still sits in USD form. The 'original sin' of overseas borrowing at low rates makes company balance sheets vulnerable to currency fluctuation."

A great deal of capital has flowed into Turkey in recent years, much of it in US dollars. The largest single destination for the capital was non-financial corporate balance sheets, a large portion of which still sits in USD form. The 'original sin' of overseas borrowing at low rates makes company balance sheets vulnerable to currency fluctuation. As Turkish bond yields have fallen and the supply of available dollars globally declines, the fact that corporate balance sheets are dollar indebted will only add stress to the exchange rate.

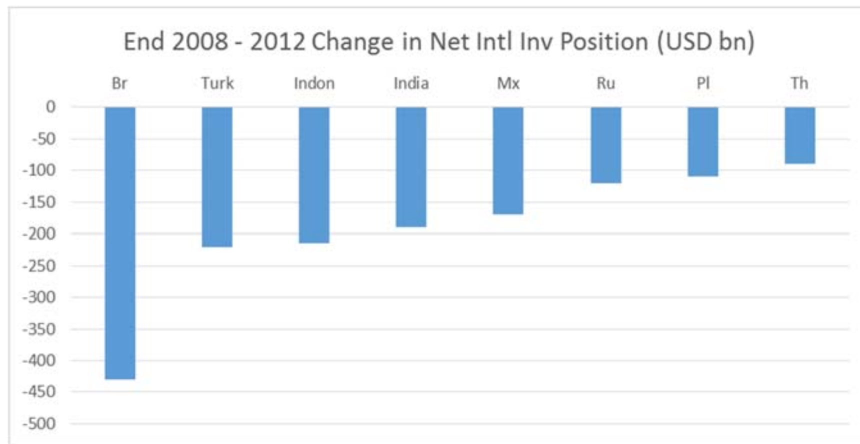
In the absence of very high interest rates to prevent capital outflow, central bank credibility is the linchpin of currency stability. Unfortunately recent statements by senior politicians are decimating any perception of central bank independence. Turkey could very quickly face a currency induced liquidity crisis which at its worst could morph into a problem of solvency as dollars become scarce; either way the lira looks extremely vulnerable to me as it is it sits at the fulcrum of Turkey's imbalances.

Turkey has had a persistent current account deficit for over a decade. From 2010 it ballooned as QE induced low interest rates resulted in USD liquidity seeking high returns.



Source: Bloomberg.

According to BIS data, Turkey's non-financial private sector was one of the largest recipients of flows among emerging market between the end of 2008 and 2012.



Source: BIS Qtly Review Sept 2014

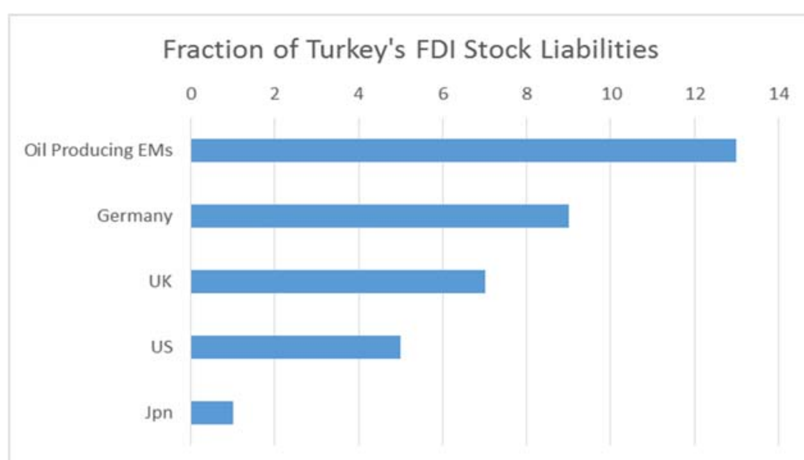
Over time this persistent capital inflow results in a large stock of debt, illustrated by a country's Net International Investment Position (NIIP). As a percentage of GDP, Turkey's NIIP (ex FDI) is larger than all emerging markets bar Hungary (who has received a good portion of its funding from the IMF).

Oil accounts for 25% of Turkey's imports, the price decline of which helps to reduce the current account deficit. However the benefit is partially offset by the increase in servicing costs on the growing aggregate debt pile. Taken together the total servicing costs as a percentage of GDP (which incorporates the reduced current account deficit) is forecast to be only marginally lower in 2015 versus 2014. In short therefore, the oil price decline is no game changer.

In terms of global dollar supply, current account surpluses of the Middle Eastern countries are set to fall with the oil price. IMF estimates of aggregate surpluses in 2014 amount to $422bn in 2014. Goldman Sachs see the supply of petrodollars falling by up to USD24bn per month in coming years due to the oil price decline.

Turkey, in particular, looks set to suffer from an oil price induced slow-down of the Middle East. One quarter of Turkish exports go to Iran, Iraq, Russia, Saudi Arabia and the UAE. Furthermore it has also been an outsized beneficiary of petrodollar supply in recent years. 11% of all oil producing emerging market's total FDI assets has been to Turkey, not an insignificant fraction and the largest single country outside the region.

Demonstrated another way, the fraction of Turkeys stock of FDI from oil producing emerging markets is 13%. Against the other capital-hungry emerging markets of India, Brazil and South Africa, this is huge, the three countries combined have a stock of FDI from the middle east of less than 1%.



Source: Goldman Sachs Global Inv Research, UNCTAD

Given that high dollar demand in Turkey coincides with tightening dollar supply globally, this would suggest that Turkish rates should increase. Instead the central bank has recently been in cutting mode as headline inflation has dipped. Given Turkey's unenviable historic record of price stability, markets are rightly cautious. In addition, the recent heterodox declarations about inflation and interest rates expressed by influential politicians has caused FX inflow to slow. As a result the lira has weakened notably, in turn this puts pressure on company debt servicing and reverberates back onto the lira. In the short term this concern amounts to one of liquidity, however given the substantial capital allocation from overseas into Turkey, the problem could potentially morph into one of corporate solvency.

What seems clear to me is that the lira is vulnerable to Turkey's imbalances and capital flight as it sits at the nexus of both.

INFORMATION

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