Turkey's Problems Different From Other Emerging Markets'

To say 2013 has been an *annus horribilis* for emerging markets would be something of an understatement. The MSCI Emerging Market Free index, the underlying asset for the popular iShares ETF (EEM) is down 10.08% in U.S. dollar terms. Turkey, our subject here today, has taken it on the chin and quite possibly elsewhere; it is down 25.7% year-to-date.

To re-pose the old question, "Why did Constantinople get the works?" (The old answer, "That's nobody's business but the Turks'" seems oddly inappropriate and therefore unworthy of repetition here.)

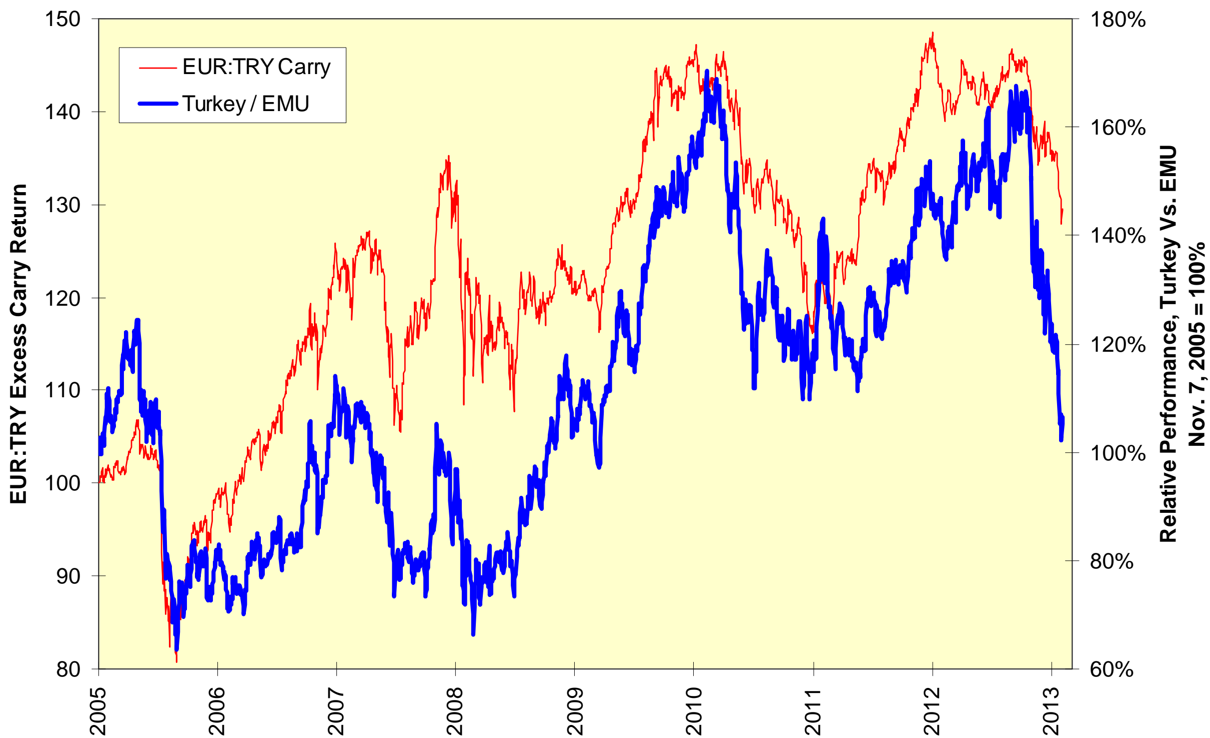
More Of A Euro Affair

Markets are forward-looking, which is why those who chase the latest backward-looking economic report or corporate announcement often find themselves frustrated. Two of the principal drivers of emerging market performance have been the dual U.S. dollar and Japanese yen carry trades. Both yen- and dollar-domiciled seized on emerging market rallies to sell-high and repatriate their QE-fueled gains into their cheaper domestic currencies well before all of the palavering about Federal Reserve tapering began in May.

Turkish markets, much to the discomfort of their European neighbors whose liberalism ends when it comes to including an Islamic state in their club, are linked far more to the euro than to either the yen or the dollar. If we measure from the May 22, 2013 start of what I call the "policy confusion era," we find correlations of returns of 0.62 for Turkish stocks against the carry return between the euro and Turkish lira versus comparable measures of 0.49 for the dollar and 0.55 for the yen.

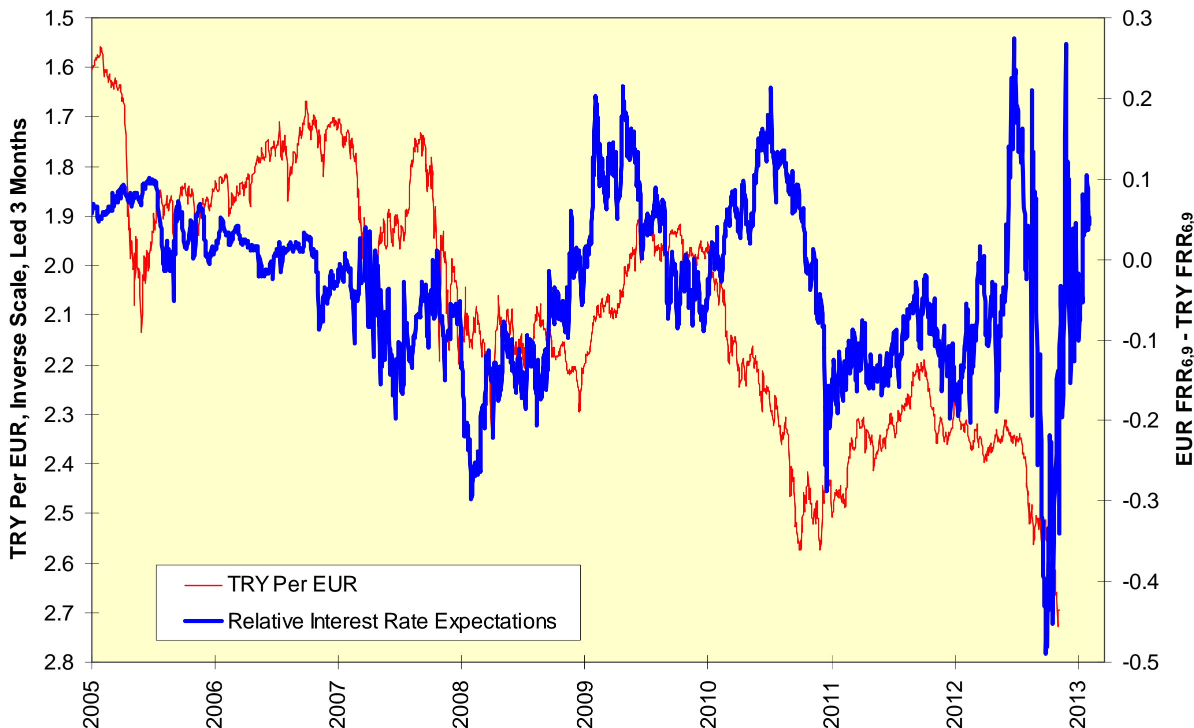
As in the case of preemptive selling of equities leading the currency lower seen for both the yen and the dollar, Turkish underperformance vis-à-vis the Eurozone weakened the lira against the euro. I must emphasize this is not a long-term causal relationship but rather a special case for 2013. The name of the game is repatriate funds from emerging markets before someone, somewhere actually stops printing so much money; the funding currency itself is somewhat irrelevant.

Relative Equity Performance Leading Lira Lower Against Euro



Light At End Of Tunnel

All trends, including preemptive selling, come to an end. In the Turkish case, the expected relative interest rate gap should start to shift by the end of this month. This can be measured by the difference in yield curve slopes as measured by the forward rate ratio between six and nine months ($FRR_{6,9}$) for the euro and the lira. This is the rate at which we can lock in borrowing for three months starting six months from now divided by the nine-month rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is.



Rising short-term interest rates in Turkey and a continued loose monetary policy in the Eurozone are combining to expand this gap. As it leads the cross-rate by three months on average, the lira should firm against the euro and put a stop to outflows from Turkey.

I expect this phenomenon to be repeated in other major emerging markets this fall. Remember, markets are discounting mechanisms and returns will go to those who look forward to relative value and not backward at the shellacking markets such as Turkey have taken recently.