Subject: EM Special publication: Turkey – What to look out for in local markets
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Date: Wed, 15 Aug 2018 09:13:39 -0400
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Paul – this was written by Christian overnight, but BEFORE the FX funding squeeze.

EM Special publication: Turkey – What to look out for in local markets

https://research.db.com/Research/Article?-rid=GDPBD00000323684&kid=RP0001&documentType=R

Please note that this report was written prior to today's FX funding squeeze

Overview: If anyone had thought that after months of high volatility and primarily negative price action, it cannot get worse, the last few days would have proven him wrong. On the back of increased geopolitical tension between the US and Turkey, Turkish assets have come under even more pressure. While 5Y bonds have sold off by almost 500bp to above 25% since early August, the TRY (vs USD) has weakened 30% over the same period and reached a new high at slightly above 7.20. In fact, despite reasonably high carry for most of the year, Turkish local bonds (FX unhedged vs USD) are now at -60% the worst-performing EM local asset market YTD.

In this strategy note, we provide an update on important recent developments for local markets. This said, rather than commenting on potential outcome scenarios (covered by our DB Economics team here), implications for the Turkish economy or high conviction trade recommendations (too much uncertainty as of now), we focus on important market relevant variables.

We find that:

n The market is now pricing 600bp of hikes to the effective funding rate over the next couple weeks

n Current levels in short-end rates imply upcoming inflation closer to 25% rather than the current 16.0%

n Real-rates (based on inflation linked-bonds) have reached record highs, and B/Es imply already a lot of inflation premium priced into fixed income markets

n Term-premium further declined in recent weeks and is now at historically low levels, particularly in the long-end of the curve. This suggests positioning in local bonds is more favorable in the belly of the curve.

n Positioning – neither in FI nor in FX, is crowded anymore, and therefore not the marginal driver of further weakness

n Our fair valuation model for rates sees 5Y local bonds closer to 23% rather than the current 25%. The 200bp spread relative to our models, is the most extreme dislocation seen in recent years.

n FX looks (for obvious reasons) attractive on various matrixes and particularly our long-term valuation model, however, despite the sharp move, our short-term fair value model does not see any clear undervaluation relative to what is implied by financial variables.

FI/FX Strategy: Despite the ongoing re-tracement, the fact that our models clearly imply an overshooting in both FX and fixed income, and from a risk-reward perspective once again attractive opportunities to re-enter cross-asset trades (long FX vs short rates) - as preferred by us over the recent few months, we remain on the side-line for now. As we type, the international incident has not been solved and a clear path is not yet in sight. Further, upcoming developments are uncertain given rising inflation, an economy most likely in recession and ongoing concerns around external financing requirements, and the fragile banking and more importantly corporate sectors. To stabilize FX, beyond some technical retracement, we believe that an aggressive response from the CBT – in line with what is priced or even beyond this – has to go hand in hand with de-escalation on the geopolitical front.

Kind regards,

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