Make no bones about it: The Turkish lira has collapsed, and several other emerging market currencies are under pressure. How much should investors care?

It depends on where we are investing. Countries like Turkey with deep current account deficits are under close observation. But the emerging market dynamo, China, has a current account surplus, perhaps sheltering that nation if this summer’s squall metastasizes. Granted, East Asia has its own problems—witness fears of a housing bear market in Hong Kong right now as an example—but runaway inflation and currency collapse are not among them at this stage in the cycle.

We do not wish to minimize the potential for the classic butterfly wing flapping to cause a tsunami on another continent. But when it comes to the question of who is holding Turkish debt, the answer is not China or South Korea or Malaysia. The answer is the Southern European banks.

Figure 1 shows the varying degrees of exposure to the financials sector in WisdomTree’s European equity Indexes that have ETF trackers.

Sources: WisdomTree, as of 6/30/18, MSCI, as of 7/31/18. ETF sector weights may differ slightly from index-level weights. EMU = European Monetary Union. You cannot invest directly in an index. Weights subject to change.

1 Inflation: Characterized by rising price levels.
A PRIMER ON THE TURKISH CRISIS

This summer, the Turkish lira fell to nearly TRY7 to the dollar from TRY3.73 in February, recently trading at TRY6.09. Five major influences drove the panic:

+ A yawning current account deficit equal to 6.5% of GDP, with the Street estimating -6.3% and -5.0% deficits in 2018 and 2019, respectively
+ A budget deficit that will be 2.8% of GDP this year, despite Turkey actually experiencing economic expansion
  - The deficit would seemingly expand deeper should the country’s economy recess, which is now a distinct possibility, if not a probability.
+ Turkish President Recep Tayyip Erdogan’s market-unfriendly antics, primarily his attempts to keep the central bank from fighting inflation
+ A strong bull rally for the U.S. dollar in general, not just against the lira specifically
+ U.S. sanctions from a solvable diplomatic dispute with Ankara

ERDOGAN’S ACTIONS

The Turkish president is not a new face; he’s been in office since 2014 and was prime minister in the 11 years prior. However, the Erdogan of 2018 is a twisted distortion of the image he presented to the world at the turn of the century.

Erdogan a generation ago was looking westward. A NATO member strategically positioned at the crossroads of the Middle East and Eastern Europe, Turkey appeared set to continue with Ataturk’s vision of a moderate, secular society that wanted to be seen as European.

But things evolved. Generally speaking, Erdogan found popular support among rural voters, who tend to favor more hardline interpretations of Islam. But many voters in Istanbul, which is a very European city, are frustrated with Erdogan and the government’s assault on cultural liberalism. His tiffs with ostensible Western allies and his voodoo economic theories, such as his belief that raising interest rates exacerbates inflation, frighten investors who just witnessed Argentina and Venezuela take nosedives.

With the lira sliding, U.S. President Donald Trump put a twist in the plot, sending a painful message to Erdogan in the form of sanctions, at a time when the Turkish president was already up against the wall. Part of the Trump-Erdogan conflict can be traced back to the question of what to do with Fethullah Gulen, who is exiled in Pennsylvania and whom Erdogan accuses of plotting a coup with his many followers, the Gulenists. The U.S. has no plans to give the dissident back.

However, Trump does want Erdogan to send someone back to the U.S.: Pastor Andrew Brunson, whom Turkey put under house arrest after accusing him of plotting the 2016 coup, which enraged and scared the regime. As punishment for not returning Brunson, Trump doubled up the notorious steel and aluminum tariffs that he levied on friends and enemies earlier this year, with a 50% and 20% special rate just for Turkey. These amounts are particularly problematic for Ankara because at one time the primary destination for Turkish steel was the U.S.

2 DAs of 9/13/18.
3 Gross domestic product (GDP): The sum total of all goods and services produced across an economy.
This all comes amid the market’s laser focus on the “BIITS,” if we can resurrect the 2013–2014 acronym describing Brazil, India, Indonesia, Turkey and South Africa—the current account deficit nations that some refer to as the “Fragile Five.” All of them have experienced currency depreciation in 2018, and some have been forced to hike interest rates to stave off capital flight, with Indonesia joining the ranks of policytighteners in August.

But unlike the Indonesian central bank, the Central Bank of Turkey (CBRT) had been reluctant to raise interest rates to stem capital flight, solely because Erdogan castrated it, taking away much of its independence. Markets didn’t appreciate the May and June hikes, even though the policy rate went to 17.75% from 13.50%; the CBRT needed to be even more aggressive given the rapid accumulation of U.S. dollars in panicked Turkish hands. But with Erdogan breathing down the central bank’s neck, the CBRT had to sit out July, impotent, acting only in mid-August when the collapse in the lira went parabolic. Overnight rates were then hiked and margin requirements on lira short sellers were suddenly raised, the latter tactic a classic riff from the Lehman days. With markets on edge, the central bank had to act boldly in September, ratcheting up its policy rate to 24%, a move that blew out the Wall Street consensus expectation of a three percentage point move. The lira was pleased with that action, but question marks remain with respect to the value of the country’s foreign currency-denominated debt.

ERDOGAN’S CREDITORS

J. Paul Getty famously said, “If you owe the bank $100, that’s your problem. If you owe the bank $100 million, that’s the bank’s problem.”

Fortunately, Turkey makes up only 1% of global GDP, although we must respect the cumulative economic heft when we sum it with its BIITS counterparts. Among those five nations, there are at least a couple billion residents (although we would argue that one of the “Fragile Five,” India, just spent the last half decade rectifying its current account, so maybe it has escaped peak fragility).

Regardless of other nations’ problems, the situation in Turkey is no doubt perilous, with some of the worst debt dynamics in the emerging world. According to Credit Suisse and Thomson Reuters Datastream, Turkish nonfinancial corporations have non-TRY debt equal to more than 35% of GDP, while Turkish financial institutions have another 20% of GDP in hard currency debt, the sum of which puts the country in first place on this dangerous metric.

A bailout is needed. But from whom, exactly? We don’t think the IMF is going to be too happy to jump on this one. The U.S. is the largest contributor, Trump wants Brunson back, Erdogan doesn’t want to give him back and Trump has Twitter. Nevertheless, the IMF is the most likely candidate because the usual suspects have their hands tied.

Which usual suspects? For example, China. It is doubtful that Beijing can come through for the Turks this go round, because it has its own problems to worry about, namely its woeful trade discussions with the U.S. Helping Turkey in a time of need would be a masterful strategic move given China’s aggressive multitrillion-dollar Belt and Road Initiative ambitions, but right now is not opportune for Beijing politically.

Russia could bail Erdogan out, but what an awful time for Moscow to pull such a trigger. Vladimir Putin himself is watching the ruble take the same directional path as the lira, the Brazilian real and other currencies, while he is under sanctions for the Ukrainian conflict. He’s also duking it out with Washington on Nord Stream 2, the gas pipeline to Germany that Trump wants quashed so that Europe can purchase liquefied natural gas from the U.S. As much as Putin may want to pull NATO’s easternmost member into its orbit, it would be a real gamble to snub Trump on the Turkish situation.
So if it’s not one of these nations, and if the IMF balks—or even if the IMF doesn’t balk—that still leaves an actor that will come to Turkey’s rescue, via the backdoor.

That actor will do it not to save the Turks, but to save a treasured political experiment, and if it takes fire hoses to do it, he may just turn them on. That person is European Central Bank President Mario Draghi, and the political experiment in question is Common Europe. He no doubt has spent many a sleepless night thinking about Southern European bank balance sheets. And who owns the Turkish debt? You guessed it.

**ERDOGAN’S KNIGHT IN SHINING ARMOR: MARIO DRAGHI**

According to the Bank for International Settlements, Spanish, French and Italian banks own $83.3 billion, $38.4 billion and $17 billion, respectively, of Turkish debt. Much of that is in foreign currency, so that fraction could be at risk of haircuts as euros and dollars become scarce. The rest of it, the TRY debt, is more likely to be paid than foreign currency-denominated debt, but the value of the paper has halved for European owners. This threatens to take large chunks out of bank capital at the likes of BBVA and UniCredit, the large Spanish and Italian lenders.

And Europe is really in no position to play hardball with Erdogan right now, for two reasons.

First, the European economic data in 2018 is not nearly as robust as it was in 2017, although Germany recently posted healthy Q2 GDP figures. The second reason is the migrant crisis.

**ERDOGAN’S REFUGEES**

Turkey maintains a very large, porous border with Syria and has already taken in 3.5 million refugees, with another 1,000 coming every day.

Erdogan’s strategists can read the newspaper. They’ve seen the rise of players like Matteo Salvini, the strongest politician in Italy, who rose to power on a stalwart anti-immigration platform. But Eastern Europe’s nativists make Southern European populists like Salvini look like open borders liberals.

Consider the path Syrian immigrants, seemingly expelled by an angry Erdogan who needs leverage, would take to get to Germany or Scandinavia from Turkey: They would wend their way through Bulgaria, then into either Romania to the north or Serbia to the west, nations that haven’t taken many asylum seekers because the refugees haven’t wanted to stay there. The next stop in their journey would be on Viktor Orbán’s doorstep, with the Hungarian president, perhaps the most staunch nativist in the region, so incensed at that occurrence that the Hungarian border wall along the south would then be extended even farther. That would infuriate Brussels.

And next to Hungary is Austria, where the Freedom Party rose to prominence from nothingness, solely on its vows to halt immigration. Next to Austria is Germany, where Angela Merkel, generational leader of the mainstream right, is facing career death unless she corrals her party’s Bavarian allies. But Merkel’s right-of-center partners have adopted a platform of greater hostility to migration in an attempt to stem support for the Alternativ für Deutschland (AfD), which flanks it on the right.

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4 **Source:** Kemal Kirisci, Jessica Brandt and M. Murat Erdogan, “Syrian Refugees in Turkey: Beyond the Numbers,” Brookings Institution, 6/19/18.
In other words, Erdogan’s 3.5 million Syrians, ready to be escorted westward by the Turkish army’s 350,000 active personnel, are the Sword of Damocles for traditional European parties.

Again, how does a Europhile like Draghi counter what would then seemingly be a rise in popularity of the eurozone’s euroskeptic League (Italy), National Rally (formerly France’s National Front of Marine Le Pen), AfD (Germany) and others? Ease monetary policy to jolt the economy, and do it as if the sky is falling.

THE STREET’S AMBITIOUS HAWKISH PROGNOSTICATIONS

With the ECB set to end its €30 billion-per-month bond purchase program (down from €60 billion) at year-end, the sell-side Wall Street consensus is positioning a 1-in-3 chance that the central bank starts to ratchet higher its -0.40% policy rate, the eurozone overnight indexed swap. We just don’t see the rationale for a hawkish swing, not with the very banks that have been the question mark over Europe for the last decade serving as the largest holders of Erdogan’s debt.

ACTION PLAN INSIDE WISDOMTREE’S ETF SUITE

For an idea of the market’s perception of risk across Europe, the credit default swaps (CDS) market prices risk at the sovereign bond market level. In Figure 2, Switzerland is considered the safest domicile, with 5-year CDS priced at 0.09%, meaning that it costs about $9,000 per year, every year, to insure $10 million of government bonds. In contrast, risky Greek debt costs $412,000 per year for the same quantity.

For investors concerned about the Turkish problem ricocheting through Europe, a response may be to ratchet up exposures to countries on the left of the bar chart, while minimizing the Southern European countries on the other side.

FIGURE 2: 5-Year Credit Default Swaps, Sovereign Debt, USD

Sources: WisdomTree, Bloomberg, as of 8/17/18.

5 Source: Global Firepower, for 2018. Active military personnel are considered “ready to fight.”

6 Credit default swap: A swap designed to transfer the credit exposure of fixed income products between parties. The purchaser of the swap makes payments until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third-party debt if this party defaults on the loan.
Figure 3 shows the country exposures of the seven WisdomTree European equity Indexes, along with MSCI EMU (European Monetary Union). At the bottom, we also calculated the weighted-average credit default swaps prices of the nations in each Index to gauge country risk. The equity Indexes that are tracked by the WisdomTree Germany Hedged Equity Fund (DXGE), the WisdomTree Europe Quality Dividend Growth Fund (EUDG) and the WisdomTree Europe Hedged Equity Fund (HEDJ) have low weighted-average CDS prices of 0.11%, 0.25% and 0.30% at the sovereign bond level, respectively. For comparison, MSCI EMU's component nations’ CDS are a riskier 0.41%.

<table>
<thead>
<tr>
<th>Country</th>
<th>WisdomTree Germany Hedged Equity Index (ETF = DXGE)</th>
<th>WisdomTree Europe Quality Dividend Growth Index (ETF = EUDG)</th>
<th>WisdomTree Europe Hedged Equity Index (ETF = HEDJ)</th>
<th>MSCI EMU</th>
<th>WisdomTree Europe SmallCap Dividend Index (ETF = DFE)</th>
<th>WisdomTree Dynamic Currency Hedged Europe Equity Index (ETF = DDEZ)</th>
<th>WisdomTree Europe Domestic Economy Index (ETF = EDOM)</th>
<th>WisdomTree Europe Hedged SmallCap Equity Index (ETF = EUSC)</th>
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<td>--</td>
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<td>3.6%</td>
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<td>4.4%</td>
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<td>3.1%</td>
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<td>Finland</td>
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<td>5.3%</td>
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<td>Other</td>
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<tr>
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<td>Weighted-Average Credit Default Swaps</td>
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<td>0.48%</td>
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<td>0.63%</td>
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Sources: WisdomTree, as of 6/30/18, MSCI, as of 7/31/18. CDS data as of 8/17/2018. ETF sector weights may differ slightly from index-level weights. Totals may not add to 100% due to rounding. EMU = European Monetary Union. CDS takes the weighted average of each component nation’s 5-year USD CDS. You cannot invest directly in an index.

**OUR VIEW**

In a recent blog post, we pointed out the advantages of DXGE, WisdomTree’s German equity tracker, amid our concerns about Roman fiscal policy compared to Berlin’s more responsible stewardship. Our Germany ETF can be combined with EUDG, although we point out that the latter contains a heavy degree of Brexit risk due to the near-26% exposure to the UK.7

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7 Source: WisdomTree, as of 6/30/18.
Perhaps a more opportune approach comes from combining DXGE with our flagship European tracker, HEDJ, capitalizing on three concepts:

- The strategy ratchets up exposure to “core Europe,” minimizing the effect the Turkish crisis may have on the continent’s troubled southern periphery.
- Both ETFs have lower financials sector weights than MSCI EMU.
- Perhaps more importantly, both DXGE and HEDJ hedge\(^8\) the euro, mitigating the risk of currency contagion.

In essence, combining DXGE with HEDJ in perhaps a 50/50 mix can cut down on the countries, the specific sector (financials) and the currency that may be the main ingredients of portfolio pain if Erdogan plays the fool.

\(8\) Hedge: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.
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