SPECTRUM
Asset Management

Special Note on Turkey and European Banks

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The ongoing financial crisis in Turkey is causing market nervousness. The country's economy has been growing rapidly with runaway inflation, high debt and a high cost of funding. The price of Turkey's 10-year government bond has been declining with a current yield of about 20%. The weak Turkish lira declined 30% this month, peaking at over seven liras to one US dollar, a historic low. And Turkish corporate bonds have been the worst performer among emerging market (EM) debt, according to Bloomberg. Turkey is getting no support from President Erdogan who is opposed to rate hikes. He has been undermining a path of prudent monetary policy responses including the central bank's recently stated goal of stabilizing the economy and financial markets. The president's erratic behavior, autocratic leadership and worsening relationship with the US (which has imposed tariffs and sanctions), exacerbates Turkey's dire situation. Rate hikes would help retain domestic savings, but Turkey could pursue other options to prevent money leaving the country including capital controls and/or IMF aid.

Several European countries have Turkish exposure. The short list of institutions with meaningful Turkish bank investments include Banco Bilbao (BBVA), Unicredit, BNP and ING. The equity price declines of these European banks this month have outpaced that of the STOXX Europe 600 Banks Index. However, the group's existing exposures to Turkey should not have a material credit impact even if an impairment takes place. Turkish banks have sound capital, liquidity and asset quality which could weaken considerably under more stressed economic conditions, like what Greek banks experienced after the Great Financial Crisis. Weakening bank fundamentals could prompt a European bank to add funding and/or equity to help recapitalize its Turkish investment. This could be construed as a negative credit event.

Turkey's eroding macro and political environment has fueled foreign investor worries, while markets are discounting trade wars and more appealing returns elsewhere. The lira's global linkage to other EM currencies also does not help. Under a stressed scenario whereby European banks write down their entire Turkish investment, we believe the reduction in capital and earnings would be manageable. **Comprising less than 1% of the world economy, a financial meltdown in Turkey should not lead to an increase in global systemic risk. Spectrum is cautiously optimistic that European banks will remain stable in the long term.**

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