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Trigger points

Last week, in Turkey, yields lurched higher, the exchange rate lower. Bearish enough in their own right, the moves were extra concerning in concert. Now in progress is a survey of what might go wrong in the Third World branch of the everything bull market of 2017.

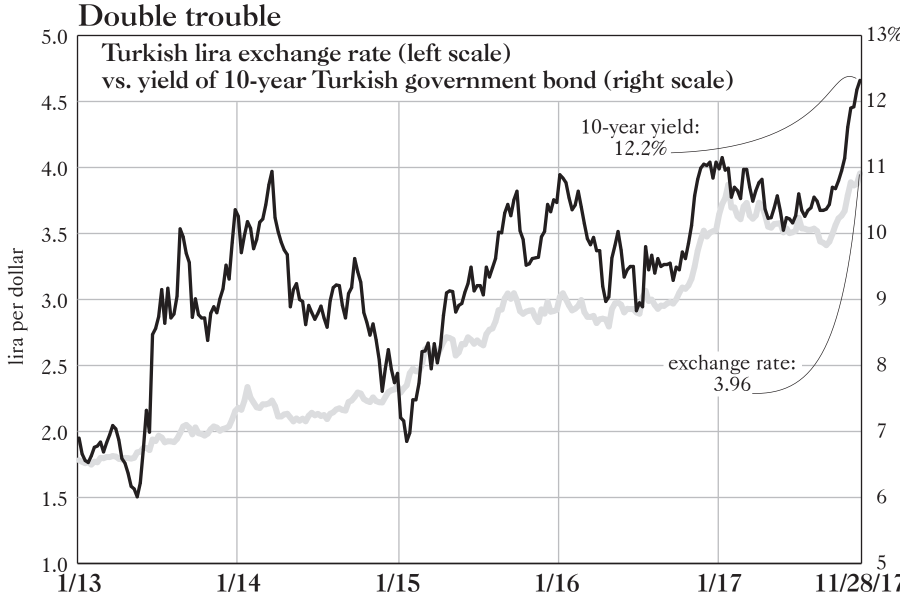
No mystery as to what's gone right. So far this year, local-pay emerging-markets debt has rallied by 11.5% to arrive at an average price to deliver an average yield of 6%. We measure performance by reference to a listed exchange-traded fund. LEMB, on NYSE Arca, is the wieldy ticker. The iShares J.P. Morgan EM Local Currency Bond ETF is the unwieldy name. The LEMB owns $315 million of local-currency-denominated sovereign bonds. Top index constituents include Brazil (15% of total), Mexico (11.8%) and Indonesia (8.3%). Turkey accounts for 4.4%.

As to what might interrupt the rally—might, indeed, touch off an electrified move to the downside—the sheer supply of debt makes a handy starting point. The Bank for International Settlements counted $11.7 trillion worth at year-end 2016, more than twice the amount outstanding at the close of 2007. Up to 80% of the grand total takes the shape of marketable bonds, not illiquid bank debt. Whether or not you can actually sell a bond, you mark it to market. On the cyclical upswing, rising marks build confidence. On the downside, falling ones sow disquiet, or, in the extreme, panic. In the next EM downdraft, we'll learn more about the dynamics of theoretically liquid bond markets.

Political risk is another source of potential trouble. Bloomberg observes that elections loom in the next 12 months for more than 50% of the constituent countries in the Bloomberg Barclays EM Local Currency Government Bond Index. The trouble with elections, of course, is that somebody wins them. In South Africa, if that someone is Dr. Nkosazana Dlamini Zuma, divorced wife of the incumbent South African president, bond investors should reconsider their commitments. So contends Francis Daniels, co-founder and director of Africa Opportunity Partners and two-time *Grant's* conference speaker. Elections to decide the top leadership of the African National Congress, South Africa's dominant party (the winner is regarded as the de facto choice for president), take place from Dec. 16 to Dec. 20.

Turkey had its election in 2015, and the winner embodies the No. 1 EM political risk of 2018. His name is Recep Tayyip Erdogan. If Dr. Zuma poses a risk to the creditors of South Africa, Erdogan presents a threat to EM bondholders the world over. Not that the market is unaware that the lira sits near an all-time low or that the lira-denominated Turkish sovereign 10½s of 2027 change hands at a price to deliver 12.2%, one of the EM's highest yields (for context, also at the 10-year point of the local-pay sovereign yield curve, Ukraine fetches 7.2%, Russia 7.6% and Brazil 10.1%). Subtract the 11.9% year-over-year rise in the Turkish inflation rate, and that nominal return dissolves into an 0.3% real one. It's less, even, than what the 10-year U.S. Treasury provides.

Double trouble



source: The Bloomberg

That Turkey is a kind of financial pariah would not, ordinarily, clinch the case against bullish consideration around here. It might suggest opportunity. (The issue of *Grant's* dated Jan. 13, 2017 identified four beaten-down Turkish equities for possible purchase. We're glad it did, and we're glad that the issue dated May 19, 2017 nominated the very same stocks as candidates for sale.) In the case at hand, we see the potential for a case of systemic jitters.

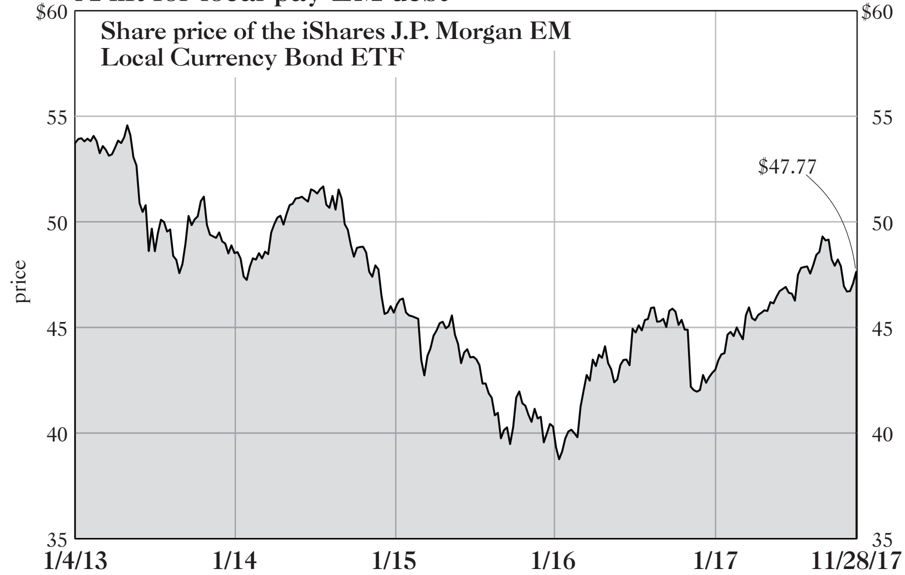
Russell Napier, independent strategist, co-founder of Electronic Research Interchange and longtime bear on Turkey, makes a case which proceeds from the changing composition of emerging-market borrowings. More bonds and fewer bank loans offer scope for quicker trigger fingers.

"The Asian Financial Crisis was basically bank debt," Napier tells colleague Evan Lorenz. "The Mexico crisis of 1982 was bank debt. This is not a bank-debt problem, this is a bond problem. It manifests itself in a different way. Banks aren't liquid, they find it difficult to get out. They come out of their loans as they mature.

"With bonds, you can have a sudden dumping of bonds and a significant capital exodus," Napier continues. "The Asian crisis may have been about structurally excessive debt, but what caused it was people trying to liquidate their portfolio investments and head for the exit at the same time. It put huge downward pressure on the currency, and huge upward pressure on domestic interest rates, because the currencies were managed and that was the trigger for that crisis. Well, portfolio investments in emerging markets are factors bigger than they were then, and that is primarily because the bond markets are relatively large and held by foreigners."

Borrowers don't default when the market is ready and willing to finance them. What, then, might spark the next emerging-markets crisis? The imposition of capital controls is Napier's once and present suggestion for a catalyst (*Grant's*, Aug. 12, 2016). In 2008, hedge funds, in extremis, closed "gates" in the face of partners who wished to withdraw money. Greece, Cyprus and Iceland implemented a version of that tactic in their own times of crisis. It was a moment in the history of the free movement of money across national boundaries when, in a speech at the University of Maryland on Feb. 4, 2016, Christine Lagarde, managing director of the International Monetary Fund, blessed the concept of capital controls.

A lift for local-pay EM debt



source: The Bloomberg

Last year, Napier identified Turkey as the country most likely to ignite the next panic. Observe, he tells Lorenz, how Erdogan, in his railing against the so-called high-interest-rate lobby, recalls Mahathir Mohamad, the former prime minister of Malaysia. It was Mohamad, you'll remember, who on Sept. 1, 1998 accelerated the Asian Financial Crisis by declaring the imposition of capital controls in Malaysia.

As for Erdogan, he seems more and more to be edging away from the West in favor of Russia and Iran, much to the discomfiture of NATO and the United States. To take but one example, a trial is set to begin in America this month concerning one Reza Zarrab. A dual Iranian/Turkish citizen, Zarrab fell afoul of U.S. law for his alleged circumvention of American sanctions against Iran. According to charges, Zarrab conspired with and/or bribed senior ministers of the Turkish government. Recent news reports have it that Zarrab may agree to plead guilty in exchange for a deal. Erdogan calls his arrest a "trap" and his detention a kind of hostage-taking. In Istanbul, some are said to worry that Zarrab will name senior associates of Erdogan as co-conspirators and that the U.S. may retaliate with penalties on Turkish banks that acted as conduits to Iran. Just to keep things on an even keel, Turkey has opened its own investigations into Preet Bharara, the U.S. attorney who initiated the case, and Joon H. Kim, the attorney overseeing the case now.

Could Turkish banks simply ignore U.S.-imposed fines, if matters came to that? Not if the banks want continued access to the world's premier reserve currency. "There are two numbers that are important for Turkey," Haydar Acun, CEO of Istanbul-based Marmara Capital Asset Management, tells Lorenz. "We have about $40 billion of current account deficits, and the private sector has about $200 billion of short FX positions. If you combine these, Turkey needs to refinance around $240 billion."

As noted, the lira is selling off (down 11% against the dollar so far this year) while inflation is rising (up 11.9% year over year in October). To restore order, Turkey's central bank has lifted its late liquidity-window lending rate (i.e., the one charged just before the market closes) to 12.25% from 10% at the end of 2016. Not that this pleases Erdogan, who damns the usurers and blames high interest rates for inflation, not the other way around. "Those who captured the Turkish economy with speculation of billions of dollars in the past now cannot get results with even bigger attacks, because this is not the old Turkey anymore," the president explained to the Ankara Chamber of Commerce on Monday.

Turk Telekomunikasyon A.S., a.k.a. Turk Telekom, defaulted on $4.75 billion in bank loans in September 2016, the largest default in the country's history; the crashing lira rendered local earnings inadequate to service the dollar-denominated debt. "Turkish banks have not put aside provisions for this loan yet," Acun relates. "Apparently the government is trying to either take back the company to the Treasury or they are trying to find a buyer, maybe some Qatari group, but there is a question mark there." The worry is that banks, if forced to take losses on the loan, will be unable to provide dollar financing to companies already struggling to cope with higher interest rates and the lower exchange rate.

"He is running out of rich foreign friends," says Napier of Erdogan. "When you have a large current-account deficit and you are trying to support your exchange rate and you are frightening capital out of your country, especially for anyone you consider an opponent, you need rich foreign friends. It is not difficult to default on your enemies. It is more difficult to default on your friends. The $405 billion of credit risk that Turkey has held with foreigners is really held by people that the president would have considered his friends. Now it is held by people the president seems to increasingly consider his enemy.

"I would argue," Napier sums up, "that this makes default significantly easier than it was before."

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