Two Steps Back in Turkey

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Our assessment of the Turkish lira (TRY) has substantially changed in a short period of time. The credibility of the TRY, which had been won back at great expense during the past few years, has again been crushed by Turkish President Recep Tayyip Erdoğan. And we cannot conclude that this time the credibility can be again restored.

Fundamental Value Foundational

The foundational investment thesis for all of our currency opportunities is fundamental value, and this thesis is very hard to violate because fundamental value is longer term in its orientation, very stable over time, and ultimately a robust indicator of long-term currency movements.

But for a currency and its fundamental value to be viable, certain characteristics must hold true: store of value, medium of exchange, and unit of account. These characteristics can be threatened by the nature of a country's institutions and, if trust in these attributes gets eroded enough, then fundamental value as an investment thesis can indeed be violated.

We believe that Turkey has moved in this direction. This is something that has long been possible but that we—and the market—had discounted to a very low probability until last weekend.

A Game of Chicken

The primary issue the TRY has episodically experienced during the past few years has been that the central bank—at the direction of Erdoğan—has left policy too loose in the face of high inflation or has lowered rates prematurely after raising them. The central bank is officially independent, but that isn't actually the case if the central bank head is replaced every six months for not doing what Erdoğan wants.

This issue has happened before and we have likened it to a game of chicken: Erdoğan wants low interest rates despite high inflation, the market responds by weakening the TRY, and Erdoğan eventually capitulates under market pressure to more orthodox monetary policy (raising interest rates to fight high inflation).

This backing down—chickening out—has happened twice recently, once in late 2018 and again last November. In both instances, our response to a weakening TRY was to increase (long) exposure to take advantage of a forward-looking fundamental opportunity whose thesis we still felt had not been violated. There was certainly elevated risk associated with the TRY, but we felt it was adequately compensated given how far price had declined below value and given the "game of chicken" dynamic at play. That is, until now.

Last weekend, Erdoğan fired the head of The Central Bank of Turkey, Naci Ağbal, whom he had only recently appointed, back in November, and had publicly pledged to support.

Ağbal's appointment signaled a return to orthodox monetary policy that the market took favorably. Indeed, under his leadership the central bank did raise rates aggressively, including just last week, when it raised rates by more than the market expected, driving TRY close to its recent high. But Erdoğan has taken an about-face and has brought in a replacement governor that is almost undoubtedly going to be soft on interest rates.

Credibility Crushed

The credibility of the TRY—which had been won back at great expense during the past few years—has again been crushed by Erdoğan. We cannot conclude that this time the credibility can be again restored, even if Erdoğan wants to.

So, if the TRY is threatened as a store of value, as a unit of account and a medium of exchange, then we must react by significantly suppressing the investment thesis of fundamental value versus price. We no longer have enough conviction that the opportunity about which we were optimistic is adequately compensated to justify a significant long exposure. We have therefore reduced TRY exposure in our portfolios during the past several days.

This is another manifestation of the importance of the "G" in the application of ESG principles in macro investing. Governance institutions (and indeed social institutions) can have huge importance and influence on macro investing, as the developments in Turkey have demonstrated.

While our investment philosophy is grounded in fundamentals, our process incorporates a number of ESG-oriented considerations from both a valuation (longer-term) and a navigation (shorter-term) perspective. In this case, both the social and governance aspects of ESG have seen a rapid deterioration and have already influenced our navigation; the degree of influence on our valuation is likely to play out over the next few weeks.

Developments Idiosyncratic to Turkey

It is worthy to note that we continue to believe that this development and market reaction is idiosyncratic to Turkey, and additional risk to other emerging currencies as a result of the TRY episode appears very marginal.

There is some knock-on volatility to other emerging currency and debt markets, but Turkey is doing strange things and no other countries seem keen to follow suit at this point.

In fact, other emerging markets—such as Brazil and Russia—have recently raised interest rates and the central bank heads have remained firmly in place. This does not mean that this kind of episode is not possible elsewhere, but we do not feel that possibility has increased nor we need to adjust our other long emerging currency exposures at this time.

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