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Turkey: political noise but investment opportunity

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This set of comments is a prelude to a more substantial piece about the developing relationship between the United States (and the US dollar) and emerging markets.

The US and Turkey: a long history

We have had an increasingly positive view on Turkish assets, despite some stark news headlines covering the deteriorating relationship between the US and Turkey, and we felt this deserved some timely comment. Before discussing the market opportunity, we feel it is important to understand how Turkey came to the current situation.

Turkey was a key ally of the US for the second half of the 20th century. It was even more important to the US before 1973: it underpinned the southern flank of NATO, defanged the Soviet/Russian Black Sea fleet and provided a jumping-off point for US operations in the Middle East and, later, Central Asia. This relationship endured through a wide variety of Turkish domestic political conditions and brought great advantage to both sides. An example of this would be the enormous Incirlik Air Base in southern Turkey, which the US used as a base for spy-planes during the Cold War and where it is generally understood that a material part of the US overseas nuclear deterrent has been housed. Another example would be the US intelligence assistance provided to Turkish forces for their capture of Ocalan, the leader of the PKK Kurdish terrorist movement, in Kenya in 1999.

The deterioration in this relationship began in 2003. Popular Turkish opposition to the Iraq War coincided with the election as prime minister of current president Recep Tayyip Erdogan on an Islamist political platform. Flashpoints around Turkish intervention in northern Iraq combined with a collapse of the relationship with previously-close US ally Israel to lead to increasing tensions. These then took a turn for the worse with the Arab Spring of 2011-12.

Erdogan and his government saw the Arab Spring as the opportunity for Islamic political movements to replace Western-aligned autocracies in the region. Turkey was particularly supportive of the Muslim Brotherhood in Egypt (who overthrew US ally Hosni Mubarak) and Hamas in Palestine (who remain at war with US ally Israel). The situation deteriorated further in 2013, when the US-backed Egyptian military overthrew the Muslim Brotherhood and installed military chief Abdel Fattah el-Sisi as an autocratic president in the style of Hosni Mubarak.

2016 saw an unsuccessful coup attempt against the Turkish government. The Erdogan regime were vocal in their belief that the US had co-operated with US-based Turkish opponents of the regime to organise the coup. This led to tit-for-tat charges against a US citizen in Turkey and the first real sanctions against Turkey by the US government. Significantly, it also saw the first splits within NATO, with Turkey closing the airspace around Incirlik Air Base, and Germany responding by withdrawing all its NATO forces from Turkey.

The next leg down was in 2017, when the crisis between most of the Arab world and Qatar (because of the Qatari regime's growing closeness with Iran) saw Turkey come to Qatar's aid, and Turkey begin a de facto alignment with Iran and a developing tension with the regime in Saudi Arabia. This latter part then blew up in 2018 with the assassination of Jamal Khashoggi, a Saudi dissident and journalist for the Washington Post. Khashoggi was murdered at the Saudi consulate in Istanbul by Saudi agents, with the US forced to choose sides. The Trump administration's statement that 'it could very well be that [Saudi Crown Prince Mohammed bin Salman] had knowledge of this tragic event — maybe he did and maybe he didn't… In any case, our relationship is with the Kingdom of Saudi Arabia' was a decisive step.

The developing alignment between Turkey and Iran grew to include Russia, with Turkey and Russia managing to look past the conflict in Syria between the Russian-backed Syrian government of Bashar al-Assad and various Turkish-backed Islamic groups in the country.

The final collapse in the Turkish relationship with the US and NATO was the Turkish acquisition this year of the Russian S-400 air defence missile system, in clear contravention of the internal rules of NATO. There is no mechanism to remove a country from NATO, nor any official list of US allies, but the relationship, to us, looks finished. The West and the US are effectively, in our opinion, in a form of cold war with Turkey, which in turn now sits in the loose anti-US coalition that variously includes Iran, Russia, Qatar, China, Syria and Venezuela. The role of the EU in this conflict is more uncertain, because president Erdogan has explicitly threatened to allow millions of Middle Eastern refugees to travel to Europe, with both social and security implications for the EU.

Investment implications

That's a lot of geopolitics and not a lot of financial market commentary, so, what does it mean for investors?

Turkey is an emerging market very much at the high beta/current account deficit/liquidity-sensitive end of the asset class. Turkey has had an average current account deficit of 4.1% of GDP since 1999, and Turkish assets have historically done very well in periods of abundant global liquidity and correspondingly poorly when liquidity has been tight. That means that the feedback of international and domestic politics into financial markets is particularly strong in Turkey.

The primary and direct feedback of international politics into capital flows is through sanctions. The US has an unparalleled ability to punish opponents by restricting access to the global US dollar payment system, cutting targeted institutions in any such country off from, for example, the half of global trade or the two-thirds of EM external debt issuance that are denominated in US dollars.[1] It is the most direct expression of the 'exorbitant privilege' that the US enjoys by being the issuer of the global reserve currency. The US can, of course, also impose other sanctions such as travel and trade restrictions.

[1]See Mark Carney's speech at the 2019 Jackson Hole Symposium 2019, https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/the-growing-challenges-for-monetary-policy-speech-by-mark-carney.pdf.

One key part of this power is the US-controlled network SWIFT (Society for Worldwide Interbank Financial Telecommunications). Launched in 1973, SWIFT lets financial institutions transmit financial transaction information securely and reliably. Nearly 12,000 financial institutions in more than 200 countries use SWIFT, allowing the US government a near-immediate and global reach in denying the dollar payments system to targeted individuals and institutions.

In the course of the deterioration in the US-Turkish relationship, there have been various sanctions on Turkish individuals and institutions, including on the Turkish state-owned bank Halkbank (for violating US sanctions on Iran), on Turkish ministers (related to Turkish charges against a US citizen), and short-lived sanctions on the energy and defence sectors in October 2019 (in response to the Turkish incursion into Syria). Overall, these create the sense of a negative political environment for investors in Turkey.

In addition, these have occurred in a period of generally tight US dollar liquidity that has been ongoing since the US Federal Reserve ended the quantitative easing programme in 2013. This has generally been a difficult period for liquidity dependent emerging markets like Turkey, which amplifies the concerns that investors might have regarding potential sanctions.

Turning more positive on Turkey

And yet, despite all this, we have been turning more positive on Turkey. The stabilisation of the economy is clear, with credit growth dropping to a more sustainable level, a huge improvement in the current account balance and policy interest rates being cut substantially on falling inflation. Likewise, the incredibly cheap valuation of Turkish equities, both against history and peers is clear.

How, then, are we comfortable with the political situation? On the domestic political front, the Erdogan administration's illiberal nationalism does create challenges, but in an EM context this is effectively the norm, and we have seen other emerging markets do well under similar governments.

The external political environment matters less when US dollar liquidity improves, which we believe will be the result of the Federal Reserve's growing realisation that increased intervention is needed in US dollar money markets. This change will be slow, but, we believe, steady and absolutely already underway.

In addition, the US's ability to use the dollar as a geopolitical weapon is finite. Countries and companies use the dollar because it is convenient. As the certainty of that convenience falls, alternatives will be adopted, whether by holding reserves and deposits in gold and other currencies, or by invoicing trade in other currencies, or by building alternative banking settlement systems to SWIFT (such as Russia's SPFS or China's CIPS). The US will have to pick its targets carefully, and we believe that, with the scale of the dispute with China, the history of tensions with Russia, and the priority afforded to countries linked to terrorism and nuclear proliferation (notably, at the moment, Iran), Turkey simply doesn't matter enough.

This, we believe, is why the US has moved as quickly as possible to remove the latest sanctions on Turkey. Halkbank falls under the Iran sanctions programme and is likely to be punished further, but we think the US government's desire, and even ability, to hurt the wider Turkish economy, is limited. There will be tweets, and headlines, but we choose to look through these, and focus on the wider opportunity Turkey offers with the economy reset and the currency and equity market cheap.