FX Monthly Report

Turkey – Bad To Worse
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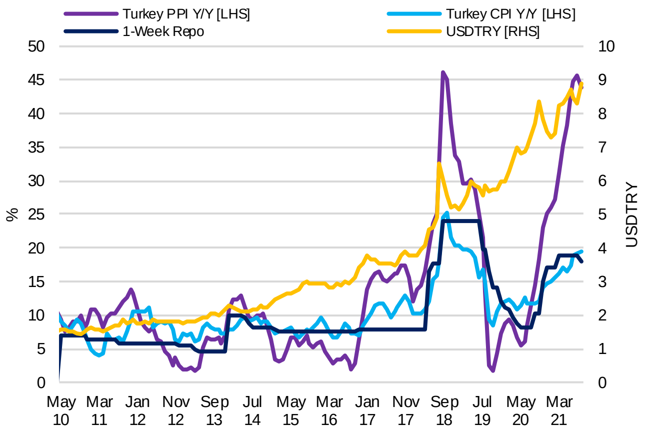
Turkey –Bad to Worse

Turkey PPI vs CPI vs 1-Week Repo vs USDTRY

Inflationary pressure persists as the CB cut rates, and USDTRY weakens.



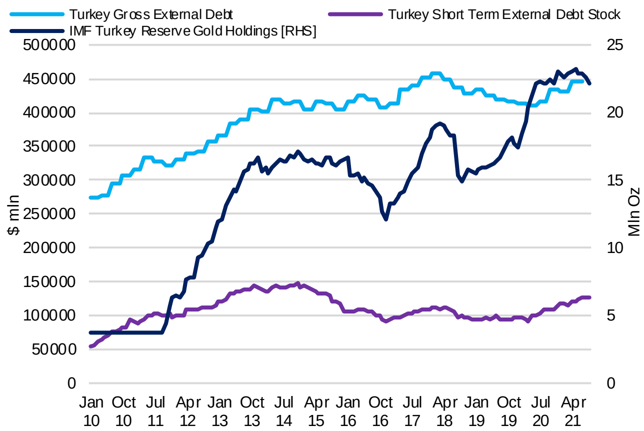
Source: Central Bank of Turkey

Tukey has continued to suffer from the political risk, declining 27% YTD, but when we look at the currency on a 4-year time scale, Lira has depreciated 169%. The central bank has tried to grapple with the inflationary environment due to the depreciating currency for years. However, they are unable to do due to the political risk from their President Recep Erdogan. The latest episode was Erdogan threatening to expel 10 Western Ambassadors after they requested the release of a philanthropist in prison; he has since gone back on this threat. The economic impact of this would have been catastrophic, not to mention the effect on the Nato alliance. The ambassadors were from Germany, France, Denmark, Netherlands, Norway, Sweden, Canada, New Zealand, and the U.S. it is thought that the U.S. was the driving force behind the letter. As a result, this would have stoked the fire between the two countries, which had been come in recent months, following the previous escalations over Turkey's relations with Russia.

Turkey's inflation is at 19.58% Y/Y, with the core index at 16.98% Y/Y. The central bank raised its end-year inflation estimate at 18.4%. The inflation target is 5%, which turkey has not been close to since 2012 or 2013. The CBRT repo rate is 18%. However, Turkey's issue is again directed at the President, whose animosity towards high-interest rates can never be underestimated. The President again removed the CB governor and two deputies following as they voted against the rate cut. There is now only one MPC member there in March, and Erdogan has been his fourth governor since 2019. PPI in Turkey has reached 43.96% as of September Y/Y, and this is due to the higher commodity prices. Turkey inflation will continue to worsen while the MPC cut rates, commodity prices rise, and the dollar strengthens. We saw a 200pp cut in interest rates in the latest meeting and the 1-week repo rate at 16% as of October 15th.

Turkey External Debt vs External Debt Stock vs Gold Reserves

Gold reserves have edged lower in recent months but external debt is high.

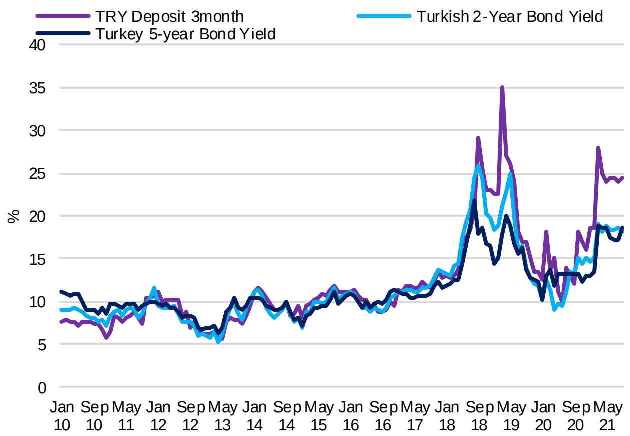


Source: Central Bank of Turkey, IMF

We do not expect much change in the currency with the inflationary trend continuing. The reduced interest rate will compound the issue. Indeed, as the western central banks start to become hawkish and interest rates in the U.S. start to rise, emerging market currencies tend to weaken. This will remain the case for Turkey; the increased cost of their external debt will be a significant headwind to the currency. Turkey's short term external debt stock has increased in recent months, with gross external also increasing back towards levels seen in 2017. Short-term Turkish bond yields are high with the 1-year at 21.34%, 2-year at 20.94%, 10-years at 19.08%, the steepness in the curve in the near term outlines the significant risk to the economy and lack of appetite for Turkish assets from foreign investors and domestic investors. Investor sentiment for the Lira and Turkish assets is low, and we do not expect much change in the near term. Non-resident holdings net Government Domestic Debt has declined every week since September 17th with a total decline of $794m. Central bank gold reserves reached 23.22m ounces in May 2021, and reserves have started to fall and now stand at 22.16m ounces.

Turkey 2yr Yield vs 10yr Yield vs 3-month Deposit Rate

Turkish bonds have sold off as the yield rises, there is little appetite for Turkish assets.



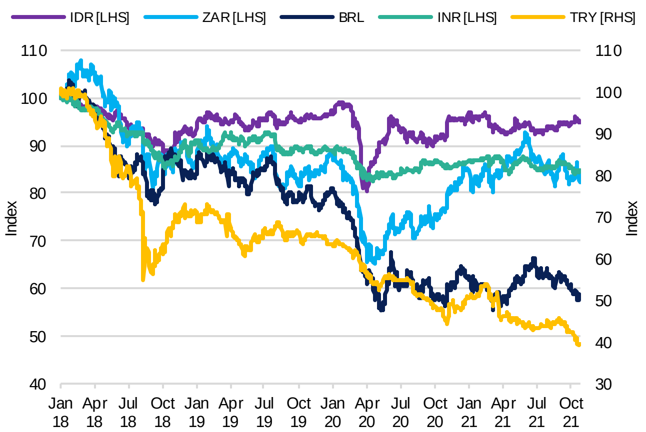
Source: Central Bank of Turkey

Currency View

We hold a bearish view on the Lira basis the stronger U.S. dollar, high Turkish inflation, and a hawkish Fed coupled with a dovish Turkish central bank. Cost-push inflation is likely to persevere for months to come, and we expect high freight prices to persist also, but Turkey continues to prioritise growth over inflation which has not worked before, and that will not change. We do not expect these inflationary pressures to be as severe in 2022 as they are today, but the persistent depreciation of the Lira, in conjunction with a lack of appetite for Turkish assets from foreign investors, is expected to remain a severe headwind to the currency. The political risk associated with President Erdogan will also cause weakness, especially with his involvement with the central bank. This is not dissimilar to Brazil, which will also suffer from a stronger dollar, hawkish Fed, and heightened political risk. While the carry trade will be an important one for EM currencies, here is little appetite to hold cash in Turkey at this time. Turkey has historical yielded strong returns for the carry trade. We also expect the BRL to suffer a similar fate than the Lira, with a weak economic outlook, loss of credibility for the President and Central Bank, and importing inflation.

EM Currencies Indexed to January 2018

TRY and BRL are the worst performing EM currencies in the index.



Source: Sucden Financial

Desk Comments

Among major currencies the broader theme currently is rising inflation vs slowing growth rates. The US, EUR area and the UK GDP all remain below pre covid level expectations. The rising inflation and concerns it may not just be transitory has seen large shifts in central bank stances causing a shift in short OIS rates across most majors. This has disrupted conventional FX /rates relationship, countries tightening monetary policy before their economies are ready is likely to have a negative impact on their currency. Adding more fuel to growth uncertainty in coming months is supply disruptions which are not likely to ease anytime soon especially in UK and Europe and as covid-19 cases remain a lot higher than many expected back in March and are only likely to become worse as winter brings for favourable conditions for the virus.

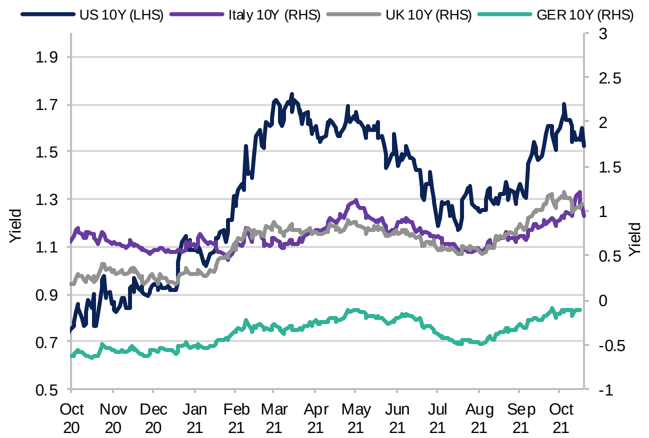
So, the key for all central banks is trying to find the balance of finding the right time to start tapering/raising rates to get a handle on inflation, whilst ensuring economies still continue growing at reasonable rates.

Euro Desk Comments

We expect Euro to remain subdued as despite higher-than-expected inflation readings we expect the ECB to remain patient. Unlike the US we believe tightening of the purse in the eurozone would be detrimental to the Euro. We expect the euro to continue trading in the range between 1.1250/90 and 1.1909 over the next few months, before depreciating against GBP and USD in the longer term once conventional FX / rates relationship is restored.

Developed Economy 10yr Yields

Developed economies' yields have rallied, but the BoE held rates and the market reacted similarly to a rate cut.



Source: Bloomberg

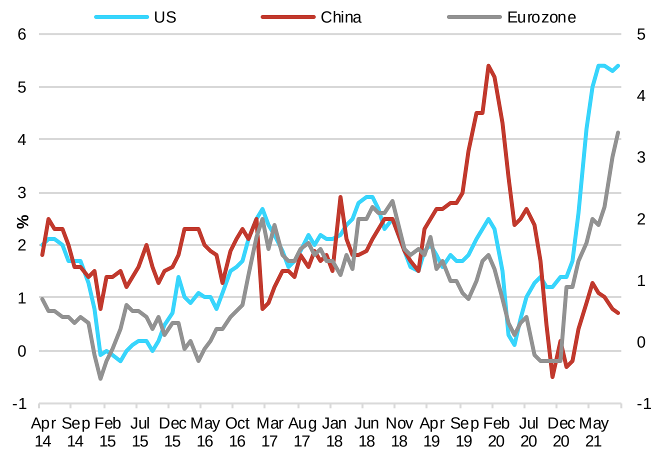
USD Desk Comments

The FOMC announced $15bn asset purchase reduction in line with expectations and will adjust pace based on economic outlook, which gives a hawkish bias given the record highs posted in the ISM services index.

We expect the USD to continue appreciating over the next few months and into 2022, as we believe the US growth is stable and believe the Fed unlike others are not being forced to act prematurely.

US vs China vs EU Inflation

Central Banks want to see the confirmation of unemployment data before raising rates.



Source: Bloomberg

GBP Desk Comments

GBP sentiment has been hit recently as inflation expectation have been revised up significantly, simultaneously growth rates have been reduced. This has forced BOE's hand to act sooner than it had hoped (Market had probability of circa 59% chance of a 15-basis point increase), however BOE voted 7-2 to keep on hold, which further reduced the probability of a hike at DEC meeting. 146% chance of a hike down to 37% post meet. Leaving rates on hold in addition to supply related disruptions and covid cases remaining high will not provide the pound with much support before year end.

Technical Analysis

GBPUSD

Technically GBPUSD has consolidated between 1.3572 – 1.4248 before a break to the downside of the triangle pattern reaffirmed our view of a negative bias, only to see the pair test the upside of the declining trendline before heading south. With rates kept on hold we expect the market to test 1.3400 opening a deeper correction to 1.3165. On the upside 1.3790 (trendline) offers resistance followed by psychological 1.40 and recent highs at 1.4248.

EURUSD

EURUSD closed below our previously stated support at 1.1702, opening the way towards our first target 1.1490 (50% fibo). If broken, we expect the pair to test our longer-term target of 1.1292 (61.8% fibo) and target area of head and shoulders pattern. On the upside, the market tested and failed to break back above 1.1702 at the end of Oct but if broken could open the way to 1.1909 (double top).

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