Turkey's tailspin

The following NYT article was sent by a client. While probably not intended, it is an excellent example of why you better get the timing right if you are going to attempt to time the market:

Turkey's Financial Crisis Surprised Many. Except This Analyst.

By **Landon Thomas Jr.**

Aug. 11, 2018

For the past seven years, Tim Lee has been warning that a financial crisis in Turkey would set off a wider calamity in global markets.

Just about nobody listened — until now.

A plunge in the Turkish lira and the prospect that the country might soon need a bailout has spurred an investor exodus in Turkey, one that gathered steam on Friday as the currency dropped as much as 16 percent. Relative to the dollar, the lira is now down 70 percent this year; one dollar buys 6.4 lira, the most ever.

There are signs of the rout spreading beyond Turkey. The stock prices of European banks, which have been big lenders to their Turkish counterparts, dropped sharply on Friday, with investors worried that a wave of corporate bankruptcies in Turkey would lead to a banking bust in the country. The currencies of China, Brazil and Mexico also weakened. And in the United States, major stock-market indexes fell more than 1 percent before recovering slightly.

Suddenly, Mr. Lee's largely ignored prophecy — that a decade of Turkish companies and real estate developers gorging on cheap foreign debt would end badly, not just for Turkey but for the world — does not seem so outlandish.

"Turkey is the canary in the coal mine," Mr. Lee said on Friday. "We are going have another crash that will be worse than 2008 in certain ways."

This is not a widely held view. Despite Friday's weakness, United States stock markets remain near their highs. Anxiety about trade wars with China and Europe has been largely cast aside. Even financial markets in developing countries, which tend to swoon in unison when one of their peers implodes, recently have been doing well.

Mr. Lee, 58, made his initial call — that Turkey was in deep financial trouble — in 2011.

A soft-spoken Englishman who eschews financial television and social media, Mr. Lee started writing an investment newsletter in 2003 after two decades working as an economist for the British mutual fund company GT Management.

He writes the newsletter, called piEconomics, from a Greenwich, Conn., office where he now works alone. The publication is simple: 10 pages of dense text supplemented with the occasional chart. His subscribers are a small cluster of European investment funds.

Toward the end of 2011, Mr. Lee published an installment of the newsletter in which he predicted that Turkey would need a $100 billion bailout.

At the time, central banks all over the world were pumping money into their economies, which were struggling to recuperate from the financial crisis.

Mr. Lee noticed that Turkish banks were borrowing in dollars to make other loans to fast-growing Turkish companies. He also saw that, over all, Turkey's economy was growing more reliant on financing from foreign investors. It struck him as similar to what had happened to Thailand in the years before the Asian financial crisis in 1997.

In his monthly notes to investors, he kept returning to the topic of Turkey and the risks there.

In a 2013 newsletter, he got more specific: The lira, then trading at 1.9 to the dollar, would crater to 7.2.

At the time, the Turkish economy was humming. The odds of a blowup looked remote. The idea of the lira ever trading at 7.2 seemed ludicrous. It was easy for people to ignore Mr. Lee's fantastical-sounding warning.

But Mr. Lee was on to something, even if his prediction was a half-decade premature. Over the next five years, the economic situation in Turkey deteriorated, as he had anticipated.

One side effect of having trillions of dollars of new money sloshing around courtesy of central banks was that it became much easier for governments and companies in hot economies like Turkey's to borrow money in dollars — as opposed to their own currencies — to finance their investments or other growth plans.

Today, according to the Institute of International Finance, a banking trade group, corporate debt in foreign currencies is $5.5 trillion, the most ever.

And Turkey relies on such foreign-currency debt more than any other major emerging market. Corporate, financial and other debt denominated in foreign currencies, mostly dollars, represents about 70 percent of Turkey's economy, according to the I.I.F. Turkish companies and real estate developers used borrowed dollars to pay for new factories, shopping malls and the skyscrapers that now define the Istanbul skyline.

The threat is that as the lira loses value, it becomes more expensive for Turkish companies to repay their dollar-denominated loans. Indeed, a growing number of companies in Turkey already have said they cannot repay these loans.

"Companies there just ignored all the risks and kept borrowing in dollars," Mr. Lee said.

And that has the potential to spread far and wide. American investors, for example, own nearly 25 percent of outstanding Turkish bonds and more than half of publicly traded Turkish stocks, according to the I.I.F.

Mr. Lee these days is far from the only one warning about the Turkish economy and financial system. The thing that really worries him and other bearish investors is that Turkey could be a signal for what lies ahead for assets and economies that were inflated by cheap debt.

"I think that most people have not thought through the broader implications of what is happening in Turkey," said Justin Leverenz, who manages the Oppenheimer Developing Markets Fund, the largest of its kind in the United States. "I could see global growth being much weaker than people think." Bracing for stressful times ahead, Mr. Leverenz recently reduced the fund's exposure to Turkey to nearly zero.

If Mr. Lee's 2011 call now looks prescient, it hasn't won him much new business.

Lately, just as Turkey began its crackup, a number of his clients have left him.

Yes, he might have been right on Turkey. But his persistent gloom was wearing thin, especially as the markets continued to soar.

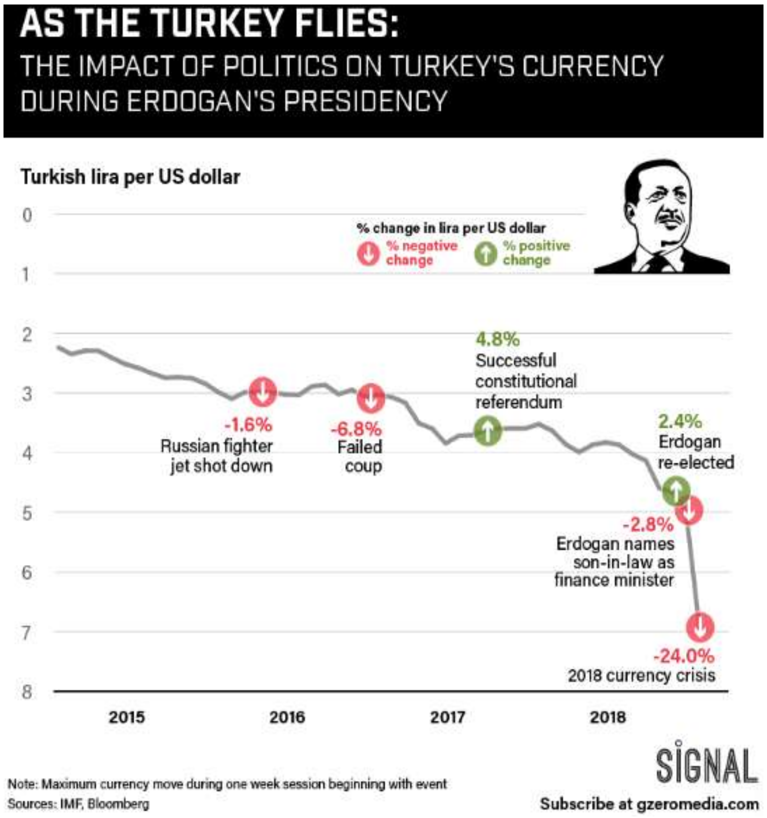
“It has been some hard sledding,” Mr. Lee admitted. “I have lost a lot of clients because I have been too bearish.”

Yet he is doubling down on his doomsday message: The river of global cash will dry up, the dollar will spike and there will be a series of financial seizures. Investors, he thinks, will flee developing economies, then Europe and eventually the American stock and bond markets.

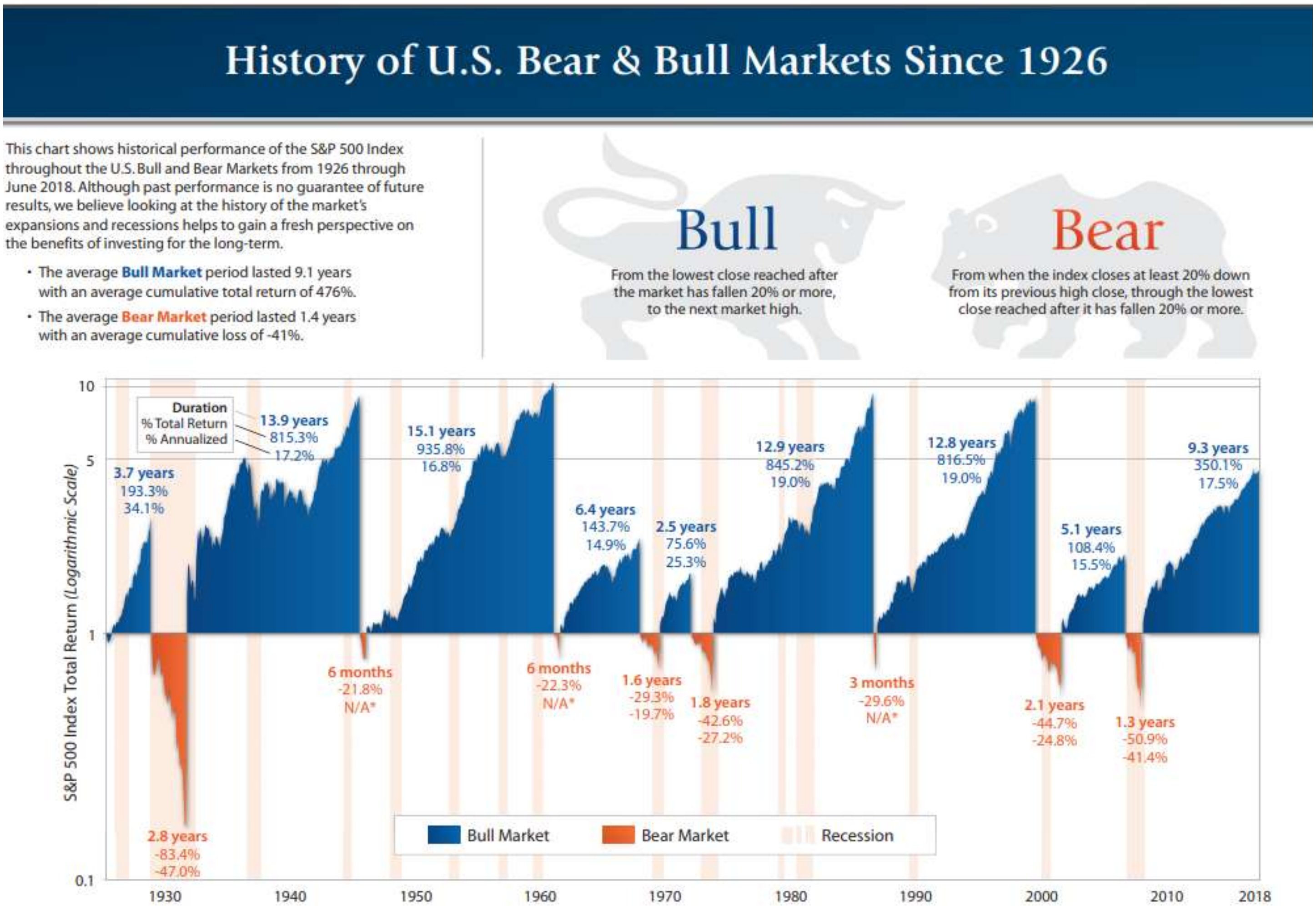
“It won’t be a banking crisis this time around — it will be a financial market crisis,” Mr. Lee said. “And I am very confident that it will happen.”

Our thoughts

The problem with Mr. Lee's "prescient" call wasn't being bearish on Turkey. We have repeatedly shared our concerns about a number of EMs, including Turkey, for geopolitical reasons, and EMs in general in a rising interest rate environment. Mr. Lee's problem was/is believing that what he foresaw unfolding in Turkey would spread. The last time this occurred was the **Asian financial crisis** which, according to Wikipedia, "was a period of financial crisis that gripped much of East Asia beginning in July 1997 and raised fears of a worldwide economic meltdown due to financial contagion. The crisis started in Thailand ... with the financial collapse of the Thai baht .... At the time, Thailand had acquired a burden of foreign debt that made the country effectively bankrupt even before the collapse of its currency. As the crisis spread, most of Southeast Asia and Japan saw slumping currencies, devalued stock markets and other asset prices ...." The crisis culminated in the global **October 27, 1997, mini-crash**. The S&P 500 fell 6.9%. "U.S. stock markets were widely expected to open lower for October 28, due to the Asian markets falling even more than they did on the 27th. Hong Kong's Hang Seng Index declined a staggering 14%." However, after initially falling, stocks rallied. The "Dow finished with a then-record 337.17 point gain (recovering 61% of the previous day's loss) to close at 7,498.32. ... One billion shares were traded on the New York Stock Exchange for the first time ever ...." For all the "weeping and gnashing of teeth" the **Asian financial crisis** resulted in a S&P 500 10.8% correction. For comparison, the current correction has, so far, resulted in a 10.2% Maximum Drawdown. In terms of the 12.8 year Bull Market that ended with the bursting of the **Dot-com Bubble** beginning on March 11, 2000, the Asian financial crisis barely registers. While Turkey's current crisis may get a footnote as another example of Populism's economic



consequences (As noted by the Signal on 8/14, "the effects of Erdogan's politically-motivated policy of pumping loads of cash through the economy – while dismissing inflation as a conspiracy rather than a consequence – began to spook ... creditors, making Turkey's economy increasingly fragile."), the odds of contagion are very low, and the odds of it bringing the current Bull Market to an end even lower.



Source: First Trust Advisors L.P., Morningstar. Returns from 1926 - 6/29/18. *Not applicable since duration is less than one year.

The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results.

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