

## Flash Note 02/08/2018

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### **Bad Omens (even more) for Turkish assets**

#### ***The Facts***

- The U.S. has prepared a list of Turkish entities and individuals once Washington has decided to impose sanctions on Recep Tayyip Erdogan's government.
- White House spokeswoman Sarah Huckabee Sanders said yesterday that the sanctions by the U.S. Department of Treasury would target Turkey's justice and interior ministers, whose agencies she said were responsible for the evangelical Pastor Andrew Brunson arrest and detention.
- Brunson, who has lived in Turkey for more than two decades, was indicted on charges of having links with the outlawed Kurdistan Workers' Party (PKK) and FETÖ, which Ankara blames for the failed coup in 2016.
- The U.S. had extended deadlines to release Brunson or face sanctions, according to Turkish officials, but their application represent unprecedented penalties against a NATO ally, being such sanctions modeled on those imposed against the Russian government and oligarchs close to President Putin.
- The sanctions are being prepared under the Global Magnitsky Act of 2016, which allows the U.S. government to target individuals, companies or other entities involved in corruption or human-rights abuses anywhere in the world. Sanctions under the act allow for the seizure of assets in the U.S., travel bans and prohibitions on doing business with U.S. entities.
- As of last week, the Americans thought they had a deal that would bring Brunson home. According to officials on both sides of the matter, in return for the release of evangelical pastor, the U.S. administration would recommend a lenient fine on Halkbank (as for its role in evading U.S. sanctions targeting Iran's nuclear program), and the U.S. also offered to send Mehmet Hakan Atilla (a former executive at the bank who's been jailed in the U.S.), back to Turkey to serve out the rest of his term. As a final sweetener to the Turks, U.S. President said he'd get Israeli Prime Minister Benjamin Netanyahu to release a Turkish citizen, Ebru Ozkan, who'd been arrested in Israel on accusations of abetting Hamas. Netanyahu did it, and Ozkan was sent back to Turkey on July 16. The Americans waited for Erdogan to deliver on his side of the deal and Brunson had to be released and then deported on July 18.

***The reaction from Turkish agents does not allow to foresee anything good***

- The two Turkish ministers who were targeted by United States sanctions have shrugged off the threat. Justice Minister Abdulhamit Gül vowed that he has “not even a single cent in the United States”, and that “I did not have any dream but living in my country,”
- By its part, the (in principle moderate) Turkey's main opposition CHP have asked the government to retaliate against US sanctions.

### **Market reaction**

- Bonds, Fx and Equities plunged.
- Yields on 10Y local government bond raised by +70bps to 18.50%. The USD denominated 10year bond also experienced a sharp rise in yields (+15bps to 7.95%).
- Equity market plunged by 3%
- And the Lira continued its particular path to hell, plunging another 1% (and crossing the 5 mark against the USD), with a YTD performance of -33%.

### **Outlook**

- Diplomatic spat with the US is a serious problem, tough it is not a structural one. Political crises can be solved when you change the parameters. Turkey and the U.S. have had crises before, as serious as the current one, but they were eventually solved.
- The economic outlook is alarming too. The Central Bank increased its inflation forecast from 8.4 percent to 13.4 percent on July 31, a dramatic 5 percentage point increase. But early in July, inflation hit its 14-year high at 15.4 percent.
- Only hours later, Turkey’s state natural gas grid BOTAŞ increased the price of the gas it provides to gas-operated power plants by 49.5 percent and indexed the prices to the U.S. dollar rate, which is gaining value against the Turkish Lira.
- Soon after, the Energy Market Regulatory Authority (EPDK) increased the residential electricity prices by 9.57 percent and industrial by 9.26 percent. Then BOTAŞ again announced that it increased gas prices by 9 percent for residents and 14 for industry.
- In parallel to those developments, the interest rates of commercial credits kept rising, exceeding 20 percent, while the Central Bank’s main interest rate is kept steady at 17.75 percent.
- Additionally, the head of the Turkish Industry and Business Association (TÜSİAD), representing more than 80 percent of the entire production, said that high inflation rate were harming the industry and trade.
- **Our outlook remains NEGATIVE for Turkish assets until we see a remarkable turnaround in Erdogan's policies, and redirect them so that he stops fighting the market.**
- **That requires three steps:**
  1. **External political stability**

2. **Commitment to fiscal discipline (probably the best way is through lower military spending)**
3. **Monetary policy that clearly signals fight against inflation (last week Turkey lost a great opportunity by not raising interest rates).**

I just hope that this will be resolved soon, given the relative size of the Turkish economy and the capacity of this issue to destabilize the EU.

Best regards