Research Note: Turkey

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NORTHWEST PASSAGE
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Wanting to be Bullish on Turkey:

Assessing the Turkey Credit Rating Saga

Since the failed coup of July 15th, emerging market investors have been kept on the edge of their seats awaiting a potential downgrade of Turkey's credit rating. With Standard and Poor's already rating Turkish sovereign debt non-investment grade (from BB+ to now BB), a downgrade by either Fitch or Moody's will have major implications. JP Morgan estimates institutional investors would have to sell off nearly $10 billion worth of investments if Turkey goes to junk status.[1] Additionally, the rating agencies' actions may have tangible negative consequences in driving up borrowing costs, steering away foreign investors, and depressing economic activity. While Moody's delayed their determination until sometime this fall, Fitch is scheduled to report on August 19th.

Plainly, any coup, successful or not, presents a political risk scenario worthy of reevaluating a country's creditworthiness. Nonetheless, it appears that perceptions of the post-coup political situation are outpacing reality when evaluating Turkey's creditworthiness. Political risk has been a prevailing theme of late when investors think of Turkey, yet post-coup politics arguably depict lessening risk. The economic vulnerabilities cited by the agencies are not new and, so far, have not been further aggravated by the recent turmoil. Moreover, given the agencies' treatment of other recent coups, the question arises of why does Turkey's situation warrant a downgrade?

Dissecting Moody's Non-Call

Moody's statement issued on August 5th claims its evaluation of Turkey would be "ongoing" indicating a final decision would come by mid-fall.[2] It also refers to its far more extensive July 18th memorandum which first warned of a reevaluation. In that statement, Moody's specified three primary drivers for its reassessment:

- Prospect that medium-term growth will weaken.
- Governability and risk of policy inertia in the coming years.
- Continued access to external liquidity.[3]

Despite possibly quibbling as to the breadth of scope and time horizon ("coming years"?), these criteria look sensible enough while sounding very much like pre-coup concerns about Turkey's economic prospects. As it stands now, four weeks after the coup, none of these drivers have weakened to merit a credit downgrade.

In paraphrasing Moody's, the coup has not significantly affected the country's growth trajectory negatively. While growth is projected to be lower year-over-year, forecasts still suggest 3% to 3.2% GDP growth. As for investor confidence, both the Turkish stock market and Lira have already recaptured over half of the immediate post-coup losses. Turkish stocks and bonds continue to be some of the best performing investments in the global economy.[4] The central bank pledged to backstop the banking system to allay investors' concerns. Additionally, while history can be a fickle predictor, it is notable that after the successful 1997 coup, the BIST 100 index fell 15% over the next three trading days to then rally, gaining 250% by year's end.[56]

Several negative factors do overhang the Turkish economy, however. Turkey continues to have near- and longer-term structural issues. Despite pre-coup projections of 3.5% plus growth, the economy is slowing from previous years. Foreign Direct Investment is also trailing from past years. For the first five months of this year, foreign investment totaled $3.5bn, down nearly 41.5% from the same period in 2015.[7] Inflation continues to tick upwards, well exceeding the central bank's target range. This data coupled with the central bank's long-held dovish stance on rates amplify investors' concerns. Lastly, government spending continues to rise, which to a great extent is supported by foreign investment.

Despite the overwhelming rejection of the coup by the public and all major political parties, the ensuing government crackdown has intensified fears over political risk. Nevertheless, there are signs of inter-party unity across the major political parties that would have seemed unimaginable in the days preceding the failed coup.[8] At recent joint public appearances, leaders from the Justice and Development Party (AKP), including President Erdogan, along with two of the three major opposition parties, the Republican People's Party (CHP) and the National Movement Party (MHP), have taken to the podium calling for political unity and easing of prior political polarization.[9] Rather than relying on the AKP's parliamentary majority status, Erdogan is cultivating a broader base of support. With the backing of the major opposition parties, a constitutional referendum will likely be put to the voters yet this year transforming Turkey into a US-styled executive presidential system.

A Coup by Any Other Name

Interesting is the differing treatment of coups by the rating agencies. Thailand experienced two coups over the past decade, in 2006 and 2014, yet in neither instance was the country's long-term credit rating downgraded. Notably, the 2006 coup was pronounced as only a "temporary disturbance."[10] Fitch even went so far as to suggest the coup might prove a positive event if leading to a resolution of the country's long-running political crisis.[11] It did not, hence the 2014 coup.

After the successful 2014 spring coup, Fitch issued a press release, entitled "Thailand's Coup not an Immediate Ratings Trigger," asserting that "The military takeover of Thailand's government on 22 May is not in itself a negative sovereign ratings trigger."[12] They further stated, "The political reaction to the coup is a short-term wild card. Broad acquiescence to a new military (or military-backed) government, followed by a transparent process towards fresh elections, could ultimately be positive for political and economic stability."[13] Similarly, Moody's noted, "The stable rating outlook reflects the expectation that the recent military coup and the lingering political uncertainty will not undermine Thailand's credit strengths to a material degree over the next 12 to 18 months."[14] Just this past week the military junta finally promised to hold national elections at the end of 2017 as part of a national referendum of dubious legitimacy.

Conversely, just three days after the failed Turkish coup Fitch reported that the event "highlights the country's turbulent political environment."[15] Arguably, the defeat of the coup demonstrates there being little political uncertainty as to the leadership of the country. The recent rallies point in the direction of greater political unity, improving governability and reducing policy inertia. Despite evolving political continuity, the rating agencies perceive the July 15th coup attempt as ramping up political risk and potentially causing significant economic disruption going forward. A recent academic study, however, finds that failed coups in democratic states have little discernable effects on economic growth.[16] Rather, it suggests that situations like the 2006 and 2014 Thai coups are more likely to produce mixed or detrimental economic impacts.

Assessment: Tilting at Windmills

Despite the (strong) case to be made in opposition of a downgrade, the safe money is on Moody's downgrading Turkey to Ba1, and an equivalent downgrade by Fitch coming even sooner. We judge it as nearly certain that at least one will downgrade and highly probable that both do so. Accordingly, investors should expect a near-term deterioration of the Turkish economy. The very sensitivities highlighted by the rating agencies will manifest as a result of the downgrades. Most notably the flight of foreign investor and creditors which help grease the wheels of the Turkish economy.

Expectantly, the Turkish economy may labor to regain traction following this political disruption. We believe that the displays of political unity suggest a potentially speedy resumption of pre-coup economic activity and resolution of any political uncertainty in the near-term. Though in light of an inevitable downgrade by at least two of the three major credit rating agencies, we continue an underweight position regarding Turkey. Our internal modeling suggests Turkey as a continuing investment grade credit, holding at a comparable BBB+ rating. Accordingly, a credit downgrade may offer the potential opportunity to add and move to overweight if circumstances warrant.

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[6] BIST 100 stands for the Borsa Istanbul 100 index, a capitalization-weighted index tracking the performance of 100 companies selected on the basis of pre-determined criteria by the Istanbul Stock Exchange.
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[11] “Rating Agencies are monitoring situations in Thailand.” The Nation. September 20, 2006.
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