AB BERNSTEIN

TURKEY'S TENSIONS

After a year of calm, we expected volatility to increase this year. Yet, other than a short-lived spike in February amid worries of renewed inflationary pressures, markets have been relatively tranquil overall. However, volatility tends to have unpredictable catalysts; in August, that unexpected event was Turkey. Tensions with the US have exacerbated existing concerns over the country's vulnerabilities, stoking fears of contagion spreading to other emerging markets.

THE TRIGGERS

Turkey has been a tremendous growth story. But with their growth came fragilities. Over the last few years, the Turkish government has supported growth by keeping interest rates low and encouraging bank lending. This policy worked, with income per capita more than doubling. But it has also led to many of the issues facing Turkey today. The country is laboring under a high current account deficit, exacerbated by this year's rising cost of oil imports. They are also largely externally financed, meaning they pay for imports primarily through debt issued in non-lira currency. That is not necessarily a problem, unless the value of that foreign currency strengthens relative to your own—as it has for Turkey.

And those aren't the only concerns. The independence of Turkey's central bank was called into question when it failed to raise interest rates to stem accelerating inflation. Observers noted that Turkish President Erdogan is extremely opposed to higher interest rates. But just this week, Turkey's central bank stated it would adjust its monetary policy position. How, and to what degree, though, is still to be determined. This announcement came in response to its inflation rising to 18% in August, four times greater than its 5% target.

Further clouding the picture are the elevated geopolitical tensions between Turkey and the United States over the imprisonment of a US pastor accused of terrorism.

In protest, the US government placed sanctions on two Turkish officials and authorized a doubling of aluminum and steel tariffs in mid-August. These sanctions have renewed—and added to—already shaky confidence, which recently turned to full-blown concerns for Turkey's fundamentals.

In response to these issues and elevated inflation, the lira has tumbled 42% this year, putting pressure on debt-heavy corporations and banks. And the turmoil has prompted investors to cast their gaze beyond Turkey to other emerging markets,

Display 1

TURKEY IS LIKE NO OTHER COUNTRY IN THE WORLD—OTHER THAN ARGENTINA

	China	Korea	Taiwan	India	South Africa	Brazil	Russia	Mexico	Malaysia	Thailand	…	Turkey	Argentina
Current Account Balance (Percent of GDP)	1.2%	5.5%	13.6%	(2.3)%	(2.9)%	(1.6)%	4.5%	(1.9)%	2.4%	9.3%		(5.4)%	(5.1)%
External Financing (Percent of GDP)	14.0%	27.3%	31.8%	20.5%	49.6%	26.5%	32.8%	38.0%	65.0%	35.4%		53.3%	37.0%
Inflation	2.1%	1.5%	1.8%	4.2%	5.1%	4.5%	2.5%	4.8%	0.8%	1.5%		15.9%	31.2%
Currency Percent Change vs. USD (YTD)	(5.0)%	(4.6)%	(3.0)%	(8.5)%	(13.4)%	(17.1)%	(14.2)%	4.5%	(1.2)%	(0.4)%		(37.0)%	(37.9)%
Percent of EM Equity Index	**31.2%**	**14.1%**	**11.8%**	**9.0%**	**6.8%**	**6.4%**	**3.5%**	**3.1%**	**2.4%**	**2.3%**		**0.7%**	**0.0%**

Total Top 10: 91% of Index

Past performance is not necessarily indicative of future results. There is no guarantee that any estimates or forecasts will be realized.
Current Account Balance is from the IMF's April 2018 World Economic Outlook. External Financing is as of 2017 from CEIC, except for India and Thailand, which are as of 2018. Inflation is the year-over-year change in CPI as of the most recently announced month. Currency returns YTD are as of August 21, 2018. Percent of EM Equity Index is as of July 31, 2018.
Note that the color coding is relative to each other country for each metric, at present.
Source: Bloomberg, CEIC, Individual country statistics, International Monetary Fund, and AB

in the hopes of sidestepping similar issues elsewhere. But we believe investors may be missing the bigger picture.

STRONGER TODAY

Most other emerging markets are in far better shape than Turkey or even they themselves were just five years ago. Inflation is under control in many countries, which promotes low domestic interest rates. EM currencies are more competitive and external balances, or the amount they import relative to their exports, are healthier. In fact, very few countries are running current account deficits above 3% (**Display 1, previous page**). Additionally, foreign direct investment has increased, providing a more stable source of funding.

EMERGING MARKET HEADWINDS

On the face of it, Turkey's unique issues are unlikely to have significant fundamental implications for other emerging markets. But they may add to the short-term volatility for emerging-market (EM) equities, as investors remain nervous about the US dollar's strength, higher US interest rates, and risks of a trade war.

The MSCI Emerging Markets Index fell by 7% in US-dollar terms this year through August 31, after surging by a cumulative 53% in 2016 and 2017. Investors, worried about market declines, pulled nearly $170 million from EM funds in June, reversing what had been more than a year-long trend of positive inflows.

LOOKING THROUGH A KALEIDOSCOPE

Turkey's risks are real, and in the process of playing out. Yet, there are vast differences among countries and companies today. Discerning the impact these risks may pose further underscores the value that global research can add.

To be sure, we are carefully watching developments and stand ready to adjust our positioning if we start to see signs of broader contagion related to the events in Turkey. All told, we would expect volatility to remain elevated until the Turkish issue is resolved, but in the meantime, the risk of meaningful contagion is fairly limited.

Capital Markets Update

US EQUITIES–STILL IN THE LEAD

Stocks	August 2018	YTD
US	3.3%	9.9%
Int'l Developed Markets	(1.9)	(2.3)
Emerging Markets	(2.7)	(7.2)
Bonds		
Municipal	0.1%	0.5%
Taxable	0.6	(1.0)
Alternatives		
Hedge Funds	0.2%*	0.9%*
Commodities	(4.2)	1.7
Real Estate	1.0	2.2

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US stocks are represented by the S&P 500 Index; international developed-market stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of developed markets in Europe, Australasia, and the Far East; emerging-market stocks by the MSCI Emerging Markets Index; municipal bonds by the Lipper Short/Intermediate Blended Municipal Fund Average; taxable bonds by the Bloomberg Barclays US Aggregate Bond Index; hedge funds by the Hedge Fund Research Inc.'s (HFRI) Fund of Funds Composite Index; commodities by the MSCI ACWI Commodity Producers Index; global real estate by the FTSE EPRA/NAREIT Developed Index. An investor cannot invest in an index. These figures do not reflect the deduction of management fees and other expenses an investor would incur when investing in a fund or separately managed portfolio. See "Information About MSCI" at the end of this report.

*July 31, 2018
Source: Bloomberg Barclays, FTSE, HFRI, Lipper, MSCI, S&P, and AB

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