Turkey has serious problems, having borrowed large amounts in U.S. dollars while seeing its currency decline in value, which could prompt a vicious cycle of divestment for the country.

Turkey’s issues have prompted broad selling in emerging market debt (EMD), making it cheap relative to domestic high yield from a historical perspective. Though cheap tactically, problems for Turkey and EMD may persist for some time to come, leaving us still cautious on the sector.

Turkey is facing a serious financing problem, and investors in emerging market debt (EMD) have clearly taken note. Turkey has borrowed heavily in foreign currency markets, much of it in U.S. dollars. That, by itself, is not an issue; borrowing in foreign currencies can attract new investor sets and help emerging market (EM) countries raise capital they otherwise could not in their own currencies. The problem for Turkey, however, is that the value of its currency, the Turkish lira, has fallen steeply relative to other currencies, including the dollar. This makes its debt costlier to repay, prompting investors to question whether Turkey has the capacity to fulfill its financial obligations.

WHY INVESTORS ARE CONCERNED

Investor concern around Turkey has prompted selling in EMD, cheapening EMD broadly. This risk aversion may be warranted, as Turkey could fall into a downward, vicious cycle. If Turkish businesses default on their dollar-denominated debt, they may go bankrupt, further hurting the economic situation and leading to additional depreciation of the currency. This is similar to what has happened to other EM economies, such as Argentina, over the last few decades. Turkey’s large current account deficit is a problem as well. Turkey’s GDP growth, while ample, is viewed to be increasingly driven by borrowing and not outright increases in productivity.

The current risk aversion is evident when comparing EMD with the domestic high-yield bond market. High-yield debt historically yields more than dollar-denominated EMD, signaling that investors believe it is riskier. This is for good reason, as the credit ratings of EMD issuers is generally much higher than those of high-yield issuers. However, in periods of stress, investors sometimes sell first and ask questions later. Turkey’s currency crisis has led to a cheapening of EMD, regardless of the credit rating of the issuers. On August 13, the yield advantage of high yield over EMD fell to just 0.01%, its lowest level since 2005, indicating serious investor concern about mounting troubles in Turkey [Figure 1].
CONTAGION CONTAINED?

Despite Turkish troubles leading to a broad sell-off in EMD, there are no signs of actual contagion spilling into other countries yet. However, it’s difficult to discern different drivers of weakness, as EMD had already been under pressure this year due to mounting concerns over the threat of broadening global trade tensions. Earnings estimates for EM have also come down in recent months, prompting some investors to potentially anticipate lower growth rates. Federal Reserve (Fed) monetary policy tightening has also been a headwind, with ongoing rate hikes and balance sheet normalization removing some liquidity from markets.

Some other countries with large current account deficits, such as Argentina and South Africa, could become vulnerable to similar weakness.

The currencies of these countries have seen declines in sympathy with the lira, but on a much smaller scale. It will be important to watch the behavior of these and other EM currencies to gauge the spillover of negative sentiment from Turkey’s situation.

The spillover into other non-EMD market segments like high yield, both domestic and European, has been limited [Figure 2]. This is another positive indicator for market action moving forward.

Spreads in these other asset classes have notched somewhat higher, but not on the same magnitude as EMD.

WHAT NOW?

Despite the cheapening of EMD relative to high yield, we remain cautious on the asset class for various reasons. For the last several years, we have

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**Figure 2**

HIGH YIELD’S YIELD ADVANTAGE TO EMERGING MARKET DEBT (EMD) REACHED LOWEST LEVEL IN OVER A DECADE

- Yield Spread of High Yield over Dollar-Denominated EMD

Source: LPL Research, Bloomberg 08/15/18

Note: Chart represents the yield advantage of the Bloomberg Barclays U.S. Corporate High Yield Index over the Bloomberg Barclays EM USD Aggregate Index.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.
remained defensive regarding international fixed income exposure. This not only applied to high-quality sovereign debt, due to low yield levels, but to lower-quality EMD as well (though EMD has a broad range of quality ratings). Our defensiveness stemmed from our fairly similar return expectations within high yield, bank loans, and EMD. With EMD, however, there is the additional risk of currency fluctuations (and the potential for related headwinds, as in the case of Turkey), unless a currency-hedged product is used.

Additionally, we understood that, in line with President Trump’s campaign rhetoric, there was the potential for the Trump administration to favor protectionist trade policy. This posed a threat to stability within the EMD asset class for which, from our perspective, investors were not being adequately compensated. Those concerns have been validated lately, and we continue with our preference for domestically focused high and low quality fixed income for suitable portfolios.

CONCLUSION

Turkey is facing issues due to its weakening currency and the resulting higher cost of its heavy debt burden. Thus far, there has been limited contagion to other countries, but the broad EMD space has experienced some pressure and investors must remain vigilant against the potential for mounting risks. While EMD has cheapened relative to lower-quality alternatives such as high yield, we still remain cautious on the sector for its exposure to currency weakness, protectionist trade policy, and country-specific risks, for which we believe investors are still not sufficiently compensated. While the severity of the lira’s sell-off has unnerved many investors, we believe the crisis will pass with minimal damage to EM economies overall. EM economies are still in the early stages of economic recoveries and stand to potentially benefit more from robust consumer demand and dynamic global output changes.

GLOBAL HIGH-YIELD SPREADS HAVE BEEN WELL CONTAINED RELATIVE TO EMERGING MARKET DEBT (EMD)

Source: LPL Research, Bloomberg 08/15/18

Note: Chart represents option-adjusted spreads of the Bloomberg Barclays U.S. Corporate High Yield Index, the Bloomberg Barclays Pan-European High Yield Index and the Bloomberg Barclays EM USD Aggregate Index.

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IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

INDEX DESCRIPTIONS

The Bloomberg Barclays Emerging Markets USD Aggregate Index is a flagship hard currency emerging market (EM) debt benchmark that includes fixed- and floating-rate U.S. dollar–denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. Country eligibility and classification as emerging markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classifications.

The Bloomberg Barclays US Corporate High Yield Bond Index is composed of fixed-rate, publicly issued, non-investment grade debt.

The Bloomberg Barclays Pan-European High Yield Index measures the market of non-investment grade, fixed-rate corporate bonds denominated in the following currencies: euro, pounds sterling, Danish krone, Norwegian krone, Swedish krona, and Swiss franc. Inclusion is based on the currency of issue, and not the domicile of the issuer.