

Turkey crisis: Time to deleverage

The dramatic fall in the Turkish lira and broad-based sell-off in emerging markets is sending funds into the safe haven dollar. But at some point, President Trump's economic policies may come home to roost



Source: shutterstock

USD: Trump's economic wars stand to push risk assets over the edge

The broad-based sell-off in emerging market assets is so far sending funds into the safe-haven dollar – where 2% yields on the most liquid and safe (in theory) financial instrument – three-month US Treasury bills – look very attractive. So far US asset markets have managed to withstand the emerging market sell-off relatively well, but at some point, President Trump's bellicose economic policies may come home to roost. While China has so far played the role of the good citizen, there remains a risk that it reviews its \$1.2 trillion holdings of US Treasuries. Russia is not hiding the fact that it slashed its holdings of Treasuries to \$15 billion in May from \$96 billion in March. Any threats to do likewise from Chinese would probably see the Japanese yen top the US dollar as the preferred safe haven play right now. Certainly, the FX option market appears to be taking that view, with JPY implied volatility spiking higher and the risk reversal markedly in favour of JPY calls. Please [see our G10 FX Week Ahead](#) for more detailed views. In all, we see no improvement in the risk environment and the proposed de-leveraging by Swiss fund GAM only adds to the uncertainty

right now. The dollar index looks biased to 97.80, led by USD/Europe.

EUR: Weighed down by Turkey

EUR/USD broke decisively below 1.1500 on Friday driven by European banking exposure to Turkey. The break-out from a relatively narrow trading range suggests we could trade to 1.1300/1320 this week, while 1.1500/1530 should limit any rebound. German 2Q18 GDP released early tomorrow should be one of the macro highlights of the week (which should improve on the poor 1Q18 reading) but looks unlikely to turn the trend.

CHF: GAM de-leveraging play a role here?

News that one of GAM's absolute return bond funds will return money to investors (reports suggest CHF8-10 billion) is adding to the de-leveraging theme. The Swiss National Bank is still intervening in FX markets and could be buying EUR/CHF under 1.13.

TRY: Marginal measures, more required

Measures announced over the weekend by Turkish authorities seem to primarily: (i) support the local banking system with lower reserve requirements and (ii) tighten access to Turkish lira funding via reducing the amount of TRY that local banks would make available through swaps. More macro announcements are expected this morning, but investors really want to see i) improvements in politics - the US has given Turkey a deadline of Wednesday evening to release Pastor Brunson, (ii) ideally the adoption of a 'fiscal rule', although Ankara may not want to limit itself here and (iii) a significant central bank rate hike to break the vicious cycle of a weaker TRY and higher inflation. For the time being, it looks like TRY will stay under pressure and keep high yield emerging markets weak across the board.

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

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