

Turkey flash crash: Chaotic contagion

A sharp drop in the Turkish lira could have implications for Europe's banks and the Federal Reserve's interest rate path. We expect the yen to remain a preferred safe-haven vehicle



Source: iStock

USD: Hard to talk economics amid geopolitical turmoil

While we think the short-term cyclical US dollar dynamics may have peaked – with today's US CPI data likely to corroborate this view – it is difficult to credibly pitch any short-term economic view when global FX markets are grappling with a significant degree of geopolitical angst and unprecedented wild swings. In this environment, the mindset will remain 'default to dollars' – not least when the Fed is seemingly the only central bank tightening in any sustained manner. Were these emerging market gyrations to continue, however, one could imagine that the Fed may have to consider a pause in its tightening cycle – a stance we saw adopted in 2016 (Chinese yuan weakness and Brexit). From a data standpoint, the focus will be on July US CPI today; it's interesting to see US Treasury yields holding up fairly well despite the market turmoil that we are seeing in the emerging markets world. This may not last if things were to get worse – and if there is no major upside surprise in US CPI inflation, investors could start to rethink a more hawkish Fed. Still, look for the dollar index to move higher towards 96 as risk-off prevails.

EUR: ECB bank warning & Turkish lira flash crash sees rising contagion risks

EUR/USD decisively broke through the 1.1500 support level amid reports that the European Banking supervisor is looking at the exposure of European banks to the Turkish banking sector – where a weaker lira is posing a risk. With the TRY collapsing in the early European trading hours, and USD/TRY breaking above the 6.00 level, we see limited scope for a EUR/USD rebound in the short-term. That said, during the sharp TRY sell-off this morning, the spillover into the EUR was limited (non-existent) – implying that the euro contagion effects may be more muted than initially feared. This may hold for the time being unless the implications for the European banking sector deteriorate materially.

JPY: A preferred safe-haven vehicle amid a fragile global market environment

Along with the US dollar, we expect the yen to remain a preferred safe-haven vehicle. Stronger-than-expected 2Q Japanese GDP data overnight will likely go under the radar today; however, we feel the rebound in the economy – coupled with a slightly less dovish Bank of Japan – will enable the yen to revert back to exhibiting its usual safe-haven characteristics in a fragile global market environment. Long JPY against EMEA FX is a good tactical play as the balance of risks is for further weakness in EMEA markets, which may negatively impact on global risk.

EMEA FX: Russia, Turkey on ropes as US sanctions deliver sucker punch

It's been a torrid time for the TRY and the rouble – both on the receiving end of US sanctions. In the near-term, there seems little Russian authorities can do – or in fact would want to do – to take the pressure off the RUB since it is US Congress driving the story here. We think an additional risk premium priced into the RUB and a positioning adjustment from asset managers [could send USD/RUB to 70](#). Conversely, the near-term path for the TRY is more in the hands of Ankara. The Finance Ministry may provide some insights into its 'New Economic Model' later today – perhaps with reference to budget deficits to address fiscal imbalances. But we doubt Turkey is ready to limit its fiscal flexibility right now. And without measures to address its inflation problem, TRY will likely remain under pressure.