WHITEHELM ADVISERS

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FEATURE ARTICLE:

COULD TURKEY'S ECONOMIC WOES CAUSE CONTAGION?

TURKEY'S ECONOMIC GROWTH STREAK

For years, Turkey was considered the 'China of Europe' for having a sound financial sector that encouraged a great deal of capital from global markets. So far in 2018 however, the Turkish lira has depreciated by over 40% versus the US dollar and it slid by 27% in August alone.

The depreciation of the Turkish lira so far this year has proven that all that glitters is not gold. Turkey's impressive run of economic growth has largely been stimulated by cheap credit, notably from foreign lenders. As credit conditions tighten around the world, in large part because the US Federal Reserve has been raising its federal funds rate, investors have come to realise that Turkey's economic position is much more fractured than headline figures suggest.

In this month's feature article, we discuss the economic landscape in Turkey, and why it has suddenly become so concerning. We explain the political backdrop, specifically the escalating tension between the Trump administration and the Erdogan Government, and its effect on the economy's 2018 woes. We discuss whether we consider there to be a risk of contagion as a result of the issues that have been plaguing Turkey as of late. We also discuss the outlook for the emerging market equity asset class, as well as the implications that it could have for Europe and currency markets – notably the Australian dollar given its close alignment to the performance of emerging market currencies.

TURKEY'S IMPRESSIVE ECONOMIC GROWTH STREAK

Pre-Erdogan Era

The 1990s in Turkey were marked with a series of consecutive economic crises, with a severe earthquake in 1999 proving to be the icing on the cake. Many underlying economic weaknesses were exposed, notably a lack of fiscal discipline, which led to sustained fiscal deficits and an overreliance on monetary financing. This led to persistently high inflation (which averaged an eye-watering 78% per annum during the 1990s), increased the risk premium, pushed real interest rates higher, made debt servicing more expensive and hindered economic growth.[1]

In 2001, Turkey experienced an economic crisis, which exposed the full extent of the country's fragile economic situation, particularly its dependence on foreign investment. The stock market crashed, and the interest rate reached 3,000%. The financial crisis of 2001 led to a deep resentment for the revolving door of coalition governments that had ruled the country for the previous few decades. The newly formed Justice and Development Party, led by Recep Tayyip Erdogan, capitalised on that sentiment and won the 2002 election overwhelmingly, securing almost two thirds of the seats.

[1] Refer to *Growth and economic crises in Turkey: leaving behind a turbulent past?* European Commission, October 2009

The Early Days of Erdogan's Leadership

In the early days of his leadership, Erdogan received a great deal of praise given the economic strides that Turkey made in the decade following his election win. Between 2002 and 2007, the Turkish economy expanded by an average of 7% per year, and inflation averaged *just* 17% during this time, compared to 71% from 1996 to 2001.

The economic turnaround was in part thanks to strong and astute economic visionaries supporting Erdogan, who implemented solid financial system reform following the country's economic crisis in 2001. It was perceived by international investors that Turkey had transformed its financial sector into one backed by safe and sound standards, which drew a great deal of international investment into the country. For years, it was deemed a poster child for international investment, even being given the title of the 'China of Europe'.

During this time, Turkey's economic growth became increasingly dependent on both imports and foreign cash. The country's current account deficit was increasing because the country was importing far more than it exported. It paid for the difference between imports and exports by borrowing abroad. Global monetary conditions allowed this to occur without much notice from international investors.

As compared to many of its European neighbours, Turkey managed to navigate the GFC, making it out relatively unscathed. Its economy recovered relatively quickly and because of the country's relatively low level of corporate and household debt at the time, it continued to be a relatively attractive economy for foreign capital. This enabled a large degree of spending, and encouraged minimal saving on behalf of both the government and the Turkish people.

Trouble Brewing in More Recent Years

Since the global financial crisis, the Turkish economy has continued to outperform many of its peers. GDP growth averaged 7% per annum from 2010 to 2017. The domestic economic boom has also caused a significant boost to imports, weighing heavily on the country's current account balance, which ballooned to US$57 billion as at 30 June 2018. Turkey does not have natural resources that it can rely on to support its current account balance, unlike many commodity-exporting emerging market countries. Instead, Turkey's primary exports are manufactured goods.

Investors have kept a close eye on the size of the current account deficit, because it has shown to be a reliable proxy for the extent to which Turkey's economic growth is financed by foreign investment. Chart 1 below shows that compared to its emerging market peers, Turkey's current account deficit is the largest as a proportion of its GDP.

But the extent to which this growth has been fuelled by its expanding current account deficit and external borrowing is garnering an increasingly large amount of attention. As at the end of the second quarter of 2018, the country had amassed approximately US$466 billion in external debt, or approximately 53% of GDP, as shown in Chart 2 below.

Chart 1: Current Account Balances, as of 2017

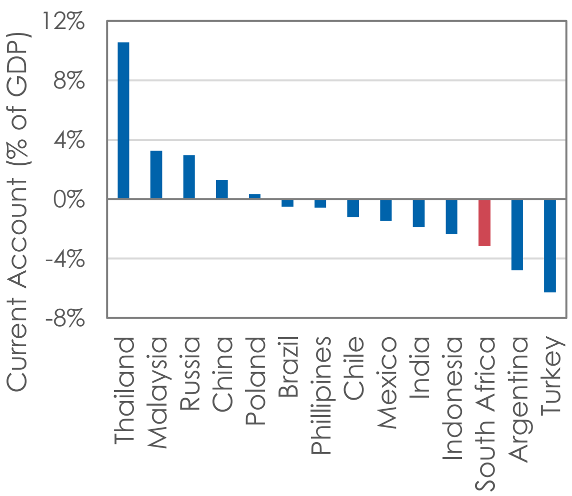
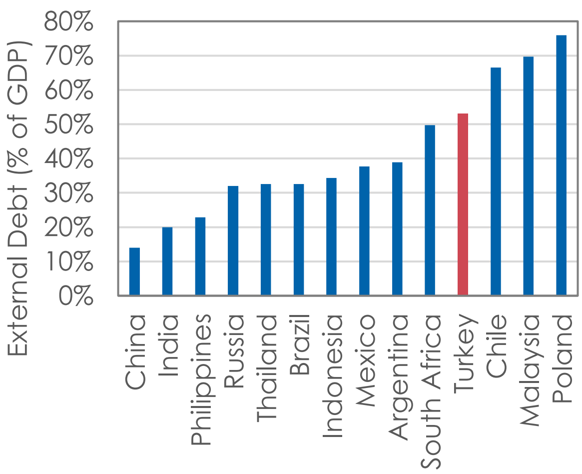


Chart 2: External Debts, as of 2018



Source: Bloomberg, Whitehelm Advisers

Of this external debt, approximately US$122 billion of it matures in the next year (circa 30% of the country's total debt), which is equivalent to approximately 15% of the country's annual economic output. Approximately 80% of this maturing debt is owed by the private sector. The rapid bank credit growth over the past couple of years has been helped by the expansion of state loan guarantees paired with the relaxation of macroprudential measures. The Government has consistently supported its Credit Guarantee Fund, which guarantees loans to small and medium-sized enterprises that could not otherwise get credit. Such initiatives helped boost bank profits for many years.

As defined by the OECD, the country's potential GDP growth rate is in the range of 3.5-4% per annum. Given that the actual growth rate (7%) is higher than the potential rate, unemployment has fallen, but inflationary pressures have re-emerged – inflation at the end of July 2018 recorded 16% per annum. Most central banks would increase interest rates to try to rein in inflation, however Erdogan has repeatedly illustrated his disdain for high interest rates, claiming that they cause inflation, rather than rein it in. This runs counter to widely accepted economic theory.

A Turbulent 2018

Escalating political tension between Turkey and the United States has brought a great deal of attention to Turkey's underlying economic woes. The tension is multi-faceted. One major point of contention has been over the imprisonment of American pastor, Andrew Brunson, on terrorism-related charges he was accused of during the 2016 Turkish coup d'état attempt against Erdogan. In late July 2018, US Vice President Mike Pence issued Turkey with an ultimatum – either release Brunson or face economic sanctions. Turkey did not release him, so on 1 August, Pence implemented sanctions on two Turkish government officials responsible for Brunson's imprisonment.

Global Backdrop is not Helping

The global backdrop of 2018 has contributed to Turkey's demise as the golden child of the emerging market family. Over the past two years, the US Federal Reserve has finally embarked on a monetary tightening path, by raising interest rates and starting the process of reducing the size of its balance sheet (which blew up as a result of the bank's post-GFC quantitative easing program). The Fed has already raised its federal funds rate twice in 2018 with a third hike fully priced in for its late September meeting, and a fourth hike possible at its December meeting. The ECB is also nearing the end of its asset purchase program, which is slated to end in December 2018. Several other global central banks have indicated that they are considering policy normalisation, although most are ensuring all their ducks are in a row before embarking on such a difficult journey.

So, what does this mean for Turkey? First, the monetary tightening path that the Federal Reserve has embarked on has tightened global liquidity conditions, making it more difficult and expensive for Turkey to retain the same volume of foreign direct investment. Higher interest rates from the Federal Reserve have also led to US dollar strength, and in general, emerging market currency weakness.

Approximately 58% of Turkey's external debt is denominated in US dollars. In order to pay its debt obligations when they fall due, Turkey needs to raise US dollars. Given that its foreign currency reserves are inadequate, it must sell the Turkish lira and buy US dollars, which has the effect of further exacerbating the Turkish lira weakness. The stronger US dollar so far in 2018 has made it even more expensive for the Turkish government to raise US dollars. Given that further rate hikes from the Federal Reserve are imminent, this problem is not about to go away anytime soon.

Of the US$122 billion worth of external debt that matures in the next year, 51% of it is denominated in US dollars. At the end of June 2018, the country had US$75 billion in foreign reserves (excluding gold), only a portion of which is denominated in US dollars. In other words, Turkey's reserves fall well short of being sufficient to cover its external financing needs over the coming year. This imbalance creates significant short-term risks which could conceivably come to a head sooner rather than later.

As a result, markets are understandably worried about Turkey. Over the month of August alone, the currency depreciated by 27% versus the US dollar, the Turkish share market fell by 23% and the 10-year government bond yield increased by just shy of 3% per annum over the month.

THE CONTAGION FACTOR

When the Turkish lira depreciated in August, it was not the only emerging market currency to fall. The Argentine peso (-30%), the Brazilian real (-10%) and the South African rand (-10%) also faced hefty depreciations. Select emerging market share markets also fell and have been weak since the start of the year. The fall in the Turkish lira had a contagion effect of sorts in emerging markets – Turkey's own troubles caused worry that the troubles might spread beyond the Turkish borders. The MSCI Emerging Markets Index fell by 4.2% in the first half of August before finishing the month down by 0.7% (in local currency terms). Since the start of the year, the emerging market index has fallen by 3.5%. We discuss broader emerging market weakness further in this section.

Contagion in financial markets usually involves the manifestation of negative externalities from one market to another. It could mean that a loss of confidence in one bank may cause a loss of confidence in many more banks. Or it could mean that a sell-off in a domestic market may cause widespread pain in markets in other countries. In this latter example, globalisation through cross-border trade and investment can cause a domino effect – when one domestic market fails, similar markets (whether geographically or in terms of development) could see similar downside effects.

Emerging markets are particularly exposed to contagion risk because investors often treat all emerging market countries the same when risk-off sentiment grips financial markets. Such investor sentiment can lead to a reversal of foreign portfolio flows from emerging market countries, which hurts emerging market countries given that their economic positions are often heavily dependent on robust foreign investment. Share market sell-offs, runs on emerging market banks, dramatic falls in currencies and spikes in bond yields are often also the result. Developed countries are often better able to weather contagions because their financial markets are more stable. Furthermore, developed market countries are nowhere near as reliant on cash flows from emerging market countries, unlike the dependence of emerging market countries on developed market capital.

So how real is the risk of a contagion effect in the ongoing case of Turkey? In the section that follows, we provide a high-level summary of the 1997 Asian Financial Crisis because it provides a reasonable precedent for how contagion can occur. Further in this section, we discuss the case for contagion in current conditions and also why contagion may be avoided in this case.

ASIAN FINANCIAL CRISIS OF 1997

Before the 1997 Asian financial crisis, Thailand had a sizeable current account deficit. In 1996, this amounted to approximately 8% of its GDP, compared to Turkey's deficit of 6.3% as of 2018. The country's central bank had the Thai baht pegged to the US dollar and attracted foreign investment by maintaining a high interest rate.

At the time, the US was in a recession, so US interest rates were very low. Both businesses and banks in Thailand capitalised on this environment to finance domestic infrastructure projects. However, in 1997, the financial markets realised the extent of Thailand's indebtedness and started losing faith in the nation's currency. The central bank continued to hold the peg through the use of its foreign currency reserves. But when the bank ran out of reserves, it was forced to float the baht, which caused an immediate and sharp depreciation in the currency.

The depreciation of the baht led to a widespread loss of confidence in East Asia, which led to wider spread currency depreciations, including a 77% depreciation of the Indonesian rupiah, a 37% depreciation of the Malaysian ringgit and a 35% fall in the South Korean won, all versus the US dollar. The MSCI Emerging Markets Index fell by 47% from August 1997 to August 1998 in local currency terms, while comparatively, the MSCI World Index fell by just 3%. The Thai share market fell by 75%, the Indonesian share market fell by 53% and the South Korean share market fell by 47% (all in local currency terms).

The mass amount of foreign debt that these Asian countries had led to a vicious cycle, first triggered by a loss of investor confidence, which causes a country's currency to depreciate, making it harder to repay foreign-denominated debt. This had knock-on implications for economic growth, further reducing confidence. The cycle then repeats itself with a further decline in the country's currency. As it relates to this example, this vicious cycle caused foreign debt to GDP ratios to move even higher. In the case of Indonesia, leading up to the financial crisis, its level of foreign debt to GDP was approximately 60% (just north of Turkey's current level), but the massive depreciation in the Indonesian rupiah caused the ratio to increase to almost 170% over the course of a year.

COULD THE ASIAN FINANCIAL CRISIS BE REPEATED TODAY?

Back to the current situation. There are certainly many parallels between Thailand in the mid-1990s and Turkey now, including:

- both countries were a haven for foreign investment, which they capitalised on to finance infrastructure investment;
- both countries had amassed significant current account deficits;
- both countries were particularly exposed to foreign currency movements because of their high levels of foreign debt, and lack of adequate foreign exchange reserves; and
- relatively low global interest rates led to the respective countries being an attractive investment opportunity.

While many emerging market countries have far more secure financial systems now than they did in the late 1990s, which we discuss in the next section, it is the last bullet above that is the most worrying in terms of the risk of contagion. The world has become so accustomed to the ultra-low interest rate environment that has persisted for close to a decade. The high levels of US-dollar denominated debt that many countries have make them particularly exposed to the rising interest rates being implemented by the Federal Reserve. Managing this changing environment while also dealing with a fall in confidence could spell trouble for many emerging market countries.

We consider those most at risk of contagion are ones that have high current account deficits, given that they are vulnerable to economic shocks and global liquidity conditions. Chart 1, found in the first section of this feature article, shows that Argentina, South Africa, India and Indonesia are the most exposed from this perspective.

Sustained deficits lead to high levels of external debt, which is an obvious issue for Turkey. As per Chart 2, it is also problematic for Chile, South Africa, Argentina, Mexico and Indonesia. Not surprisingly, this broadly lines up with the countries with high current account deficits.

Ultimately, there are many countries that are currently in vulnerable economic positions, notably South Africa, Argentina and Indonesia. Given that they have similar problems as Turkey, it is not inconceivable for such countries to come under pressure should the outlook for emerging market countries as a whole weaken.

Furthermore, there are several other geopolitical risks at the global level that are dominating market sentiment, most notably the early days of a trade war between the US and China, which has the potential to have many spill-over effects for many emerging market countries. We consider that the risk of the continuation of escalating tension between China and the US poses a bigger risk to China's economic stability than Turkey-led weakness.

If the worry about Turkey turns more widespread, including the outlook for both emerging markets and developed markets, this would be the most likely trigger for a full-blown contagion event. We consider China to be the linchpin for more widespread emerging market weakness, which we discuss further in the next section.

CAN CONTAGION BE AVOIDED?

On the other side of the coin, are emerging market countries better placed than they have been in the past to avoid full-blown contagion? Are they generally more resilient to deal with the challenges that Turkey's economic woes have brought to light? While many emerging market economies have experienced currency depreciations, rises in government bond yields and share market sell-offs since the start of the year, these effects have been most severe in countries that are vulnerable because of their political or economic situations. They have been less severe in countries more immune to external vulnerabilities.

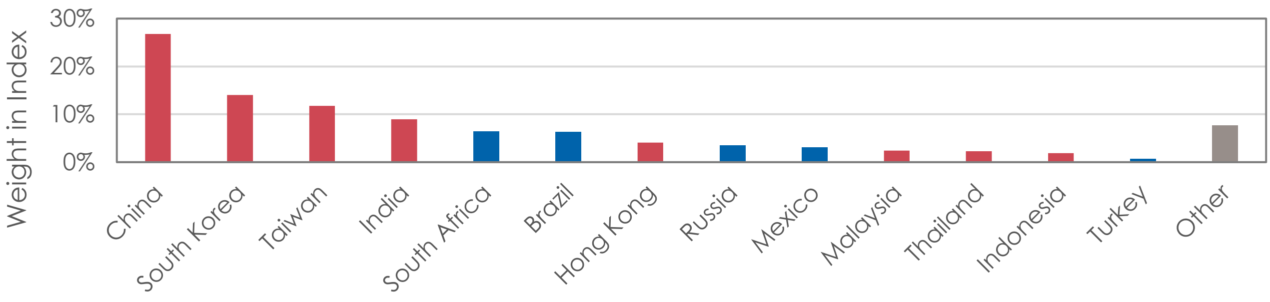
Many emerging market countries have made themselves more immune to contagion risks by reducing their current account deficits (in some cases, turning them into surpluses) and boosting their foreign currency reserves. This is particularly true for Southeast Asian countries that were left with such large war wounds following the Asian Financial Crisis. For example, Thailand's current account surplus is equivalent to more than 10% of its GDP, and its volume of foreign reserves is considered adequate.

Many Asian countries have fared relatively well so far in 2018. This is in part because economic growth across many Asian economies has been strong since the GFC, helped in part by the physical presence and interconnectedness of economic juggernaut China. Chinese economic growth has averaged 7% per annum since the end of the GFC and has supported relatively strong growth across the region as a whole.

Furthermore, inflation in most emerging Asian countries is low, which cannot be said about some of the countries that we have previously discussed (Turkey and Argentina specifically). Central banks have remained relatively accommodative. The lower levels of external debt and the high levels of foreign currency reserves make these countries well-placed to respond to economic shocks, including weakness in other emerging market countries.

The interconnectedness between Turkey and the developed world is also important for understanding the risks at play. Turkey accounts for just 1% of the global economy and the Turkish share market makes up less than 0.7% of the emerging market equity index, as shown below. This means that in the absence of any contagion, difficulties in Turkey could remain relatively insulated and will not have great implications for the developed world.

Chart 3: Composition of MSCI Emerging Markets Index, as at 31 August 2018



Source: World Bank, Bloomberg, Whitehelm Advisers

Note: Red bars represent Asian countries. 'Hong Kong' represents Chinese stocks traded in Hong Kong.

CHINA IS KEY

We consider that China is very much the trigger point for widespread weakness in emerging market countries. During the Asian Financial Crisis, China was a much smaller economy than it is today. China's economy was just 3% of the global economy in the late 1990s, but today accounts for 15% of it. It accounts for more than 30% of total global growth. It is the largest trading partner for many emerging market countries, and many developed market countries (Australia being the most relevant one!). It is also the largest commodity buyer in the world, and thus its economic growth is vitally important to the overall well-being of the global economy. Furthermore, in May 2018, MSCI included 226 large cap Chinese A-shares in the MSCI Emerging Markets Index for the first time. China now accounts for 27% of the index, almost double the next largest country in the index.

In the second half of 2015 and in early 2016, the Chinese equity market faced several major sell-offs, in part because of signs of softening economic conditions as well as the Government's effort to prop up the equity market through a series of regulations. The Chinese renminbi plunged and the country experienced a significant amount of capital flight. This unnerved global investors, which sent shockwaves through global share markets. This event contributes to our position that China will likely be the determining factor in the extent of the weakness in emerging markets, and global markets more generally.

So how likely is it that China will falter? The country is certainly navigating some pretty murky waters at the moment. The US implemented the first round of tariffs on US$34 billion of Chinese imports in early July. Both sides have threatened retaliatory tariffs on a wide range of goods. In mid-September, Trump announced his plans to implement a 10% tariff on an additional US$200 billion worth of Chinese imports. In early September, he claimed that he will impose tariffs on all Chinese imports.

On top of grappling with the implications of the tariffs, the Chinese Government is deleveraging its financial sector by reining in excessive debt growth. Meanwhile, improving quality of life and tightening pollution controls have become priorities for the Government. The combination of these tasks is likely to prove challenging given that the Chinese Government continues to target an annual GDP growth rate of 6.5%.

However, the Chinese Government has historically effectively intervened when necessary. During the Asian Financial Crisis, the central bank did not devalue the renminbi, which helped avoid even further downside implications. During the GFC, the Government implemented a massive stimulus program which propped up its economy (and helped Australia avoid a worse outcome given its commodity links with China).

Ultimately, we consider that China is relatively immune to Turkey's economic woes, and the real risk for China is the one in which its economic growth is hit because of the ongoing Trump-led trade tensions while it is deleveraging its financial sector. We consider that a change in these circumstances will make or break the argument for broad emerging market weakness. Economic conditions in Asia, notably China, are the harbinger for further emerging market currency weakness.

China's status as the second largest economy in the world, on its way to be the largest, means that reverberations would certainly be felt around the world if China has a hard landing. Whitehelm Advisers closely monitors China's economic landscape given its significant exposure in the emerging markets share index, but also given its capacity to affect global markets, including developed countries of which Australia is one.

Investment Considerations

Given the possibilities of how far Turkey's economic woes could spill over to other markets, it is important to address some of the likely share market implications. In the following sections, we discuss some financial market considerations, including asset classes that we consider have the most potential to be affected by recent events, specifically the European banking sector, emerging market equity and currency.

EUROPEAN BANKING SECTOR

It is important to understand the extent to which Turkey's impact is felt in the European banking sector. Given the extent to which Turkey has borrowed abroad, it makes sense that investors are concerned about the extent to which European banks are exposed to Turkish debt. The worry that Turkish borrowers may not be able to repay their debts sent the MSCI Europe Financials Index falling by 5% in August.

Per data from the Bank of International Settlements, exposure to Turkish debt within the European banking sector is relatively limited. Spain and Italy are the most exposed to Turkish debt, with Turkish debt making up about 4.5% and 2.0% of their banks' balance sheets respectively. All other European countries are significantly less exposed, with Turkish debt making up less than 1.2% of their banks' balance sheets.

While at the headline level, exposure to Turkish debt within the European banking sector is relatively small, there are a few large banks that are more at risk than others. BBVA, Spain's second largest bank, Unicredit, Italy's largest bank, and BNP Paribas, France's largest banks all have relatively significant exposures to Turkish debt. All three banks saw their share prices fall by at least 10% in August.

Currently, the proportion of Turkish loans that are considered non-performing is low, at just 3%, however, ratings agencies have warned that this figure would be expected to move higher in light of further economic pressure., including continued US dollar appreciation versus the Turkish lira. As discussed, Turkish debt defaults are likely to directly impact some European banks more than others. We consider that the 5% fall in the MSCI Europe Financials Index is not commensurate with the minimal exposure in the entire European banking sector. Rather it shows that there is a perceived risk on behalf of shareholders of greater impacts to a larger number of Europe's banks.

Of the MSCI Europe Index, the Financials sector accounts for approximately 19% of the index and is the largest sector weight in the index. At the MSCI World level, European banks account for approximately 5% of the index. Given the small number of banks that have Turkish exposure, we would not expect sustained material developed market equity weakness as a result of a rising level of defaults in Turkey, unless there is spill-over weakness or ongoing concern to other troubled economies.

EMERGING MARKET EQUITY

The recent sell-off in the Turkish equity market, and more broadly the emerging market equity market, so far this year makes them look attractive relative to investment opportunities in developed markets. In local currency terms, the MSCI Emerging Markets Index fell by 3.5% in the first eight months of the year, while the MSCI World Index rose by 4.4%.

The poor performance of the emerging market equity asset class recently, paired with the poor performance of the asset class from 2011 to 2016, is reflected in valuations, in particular, the cyclically adjusted Price/Earnings ratio (CAPE), also known as the Shiller ratio. The Shiller ratio is based on average earnings over 20 years, adjusted for inflation. In Chart 4, we present the current CAPE ratios (as of end August 2018) for several key equity markets, as compared to their historical average and distributions. The US market is very expensive compared to its long-term average, in the top quartile of the measurement. Emerging market equity on the other hand is still well below historical averages, only just above its all-time low.

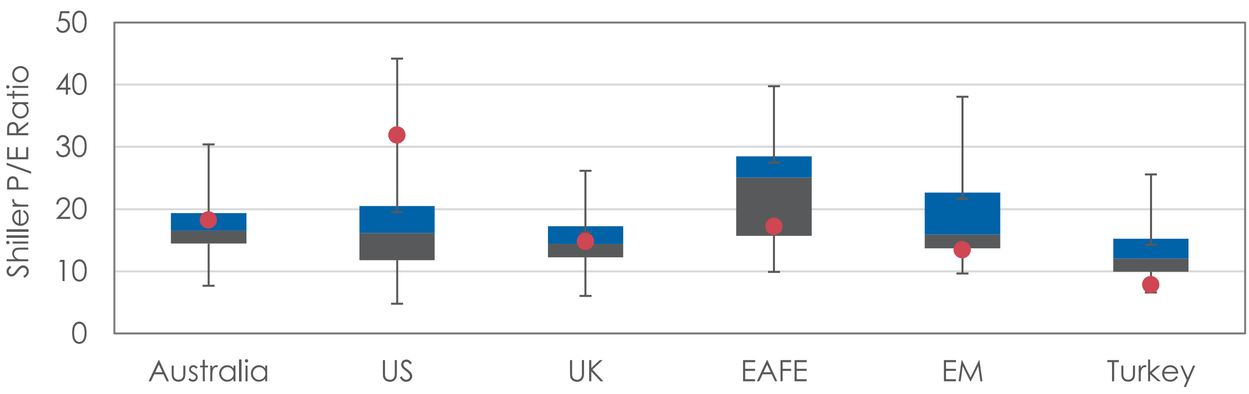
This is important because the CAPE ratio has historically been a strong predictor of subsequent performance over the next decade. When markets look cheap on this measure (as is the case for emerging markets currently), they have tended to outperform, while when markets have looked expensive, they have tended to underperform. It should be noted that this valuation is only useful for predicting subsequent performance over the relatively long time period of 10 years.

It is less useful in predicting turning points and for market timing decisions. Markets can go on to become more expensive for some time (good news for emerging market equity investors), or to continue to underperform and become even cheaper. A broad-based emerging market sell off, such as what could stem from a Turkish contagion, could be an example of a driver of short-term continued underperformance.

While Turkey accounts for a small part of the MSCI Emerging Markets Index, the worry is of broader near-term weakness across emerging market countries in general. As we discussed in the previous section, we consider that there are several countries that continue to exhibit strong growth and resilience to external shocks such as Turkish contagion. As of the end of August, Turkish-domiciled shares account for just 1% of the MSCI Emerging Markets Index, while China (27%), South Korea (14%) and Taiwan (12%) are the heaviest hitters in the index. These are among the countries that we discussed that have had strong economic growth and relatively improved external debt and current account positions.

We are cognisant that macroeconomic fundamentals could deteriorate further and that geopolitical issues will continue to dominate market sentiment, reflecting the skew to downside risk that is present globally. Countries with strong fundamentals, particularly those that are not dependent on foreign capital flows, are likely to outperform in this environment.

Chart 4: Shiller P/E Ratios, Current and Historical Distributions



Source: Bloomberg, Whitehelm Advisers

CURRENCY MARKETS

The Australian dollar and emerging market currencies have historically had a complicated relationship in that despite the Australian dollar being a developed market currency, it often performs like an emerging market currency during risk-off periods. This is in part because the Australian dollar is a 'commodity currency', or is heavily reliant on commodity prices, which is also true for many emerging market currencies. Additionally, the Australian dollar is exposed to many Asian economies, so when Asian currencies slide, so too can the Australian dollar.

In August, the Australian dollar proved to be relatively resilient, not enduring the same significant depreciation as other emerging market currencies, as shown in Chart 5 below. This is largely because the Australian economy exhibits many important differences with emerging market economies. Australia's current account deficit is approximately 3% of its GDP, which means that it is a net borrower with the rest of the world. However, Australia's foreign debts are largely denominated in Australian dollars, while its foreign assets are largely denominated in foreign currency (see Chart 6 below). Therefore, Australia has a net positive foreign currency asset position, meaning that the country is not as vulnerable to currency depreciations as many emerging market countries.

Investors need to be conscious of the currency exposure that arises when investing in emerging market assets. From the perspective of an Australian investor, in most market conditions, maintaining an exposure to emerging market currencies offers a potential source of return, given that as emerging market countries develop, their exchange rates are expected to depreciate. Over the medium to longer term, this makes emerging market currency exposure an important source of returns to investors. However, as shown through recent market movements, emerging market currency exposure can bring about volatility in an investor's portfolio.

So far, the emerging market countries that have seen depreciations would typically make up a small portion of an Australian superannuation fund's residual foreign currency exposure, given the small proportion of diversified portfolios that are typically allocated to emerging market investments (in either equity or debt). Broader emerging market currency weakness may necessitate investors to address the emerging market contribution to their residual foreign currency exposures, but this would involve balancing the potential shorter-term risks and possible magnitude of moves against the longer-term benefits of emerging market currency exposure.

Chart 5: EM Currencies and AUD vs. USD - August

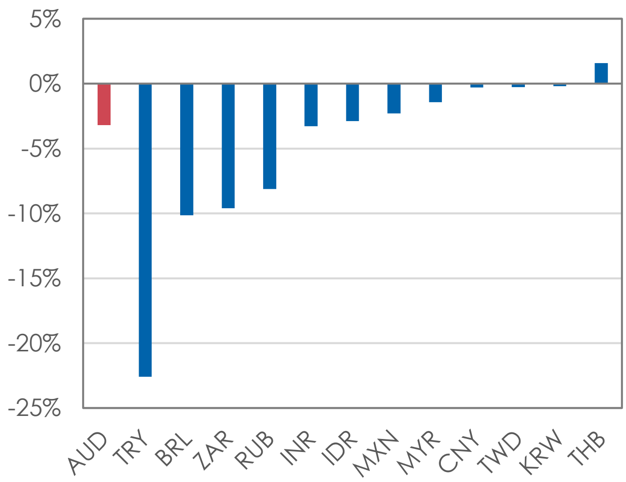
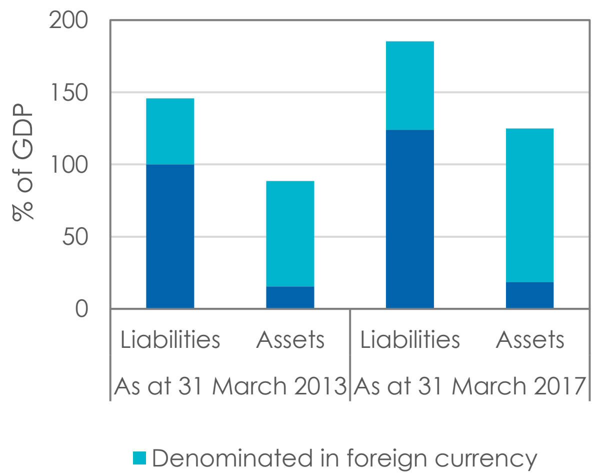


Chart 6: Australia's External Position



Source: RBA, ABS, Bloomberg, Whitehelm Advisers

Conclusion

Turkey is currently facing homegrown economic woes that have been in the making for the past two decades. Since Erdogan came into power in 2002, the country has been an economic growth engine, and a shining light amongst developing countries. The backdrop of global monetary conditions during this time period allowed Turkey's foreign debt-fuelled growth to not present any major issues for foreign investors. But the current global liquidity conditions have made it clear that Turkey's growth has not always been supported by wise decision-making, and that the country is incredibly exposed to many external shocks.

As we have discussed throughout this feature article, there is a very real likelihood that there could be a contagion effect in financial markets because of the ongoing uncertainty in Turkey. In August, we saw a glimmer of that, with broader emerging market currency market depreciations and share market sell-offs. This could be the tip of the iceberg if we continue to see unwise political manoeuvring and a lack of action from the Turkish government. However, we consider China's economic stability and growth the linchpin in the extent of downside emerging market share market pressure, given its material 30% weight in the emerging markets share index, and limited exposure to Turkish contagion.

As such, to the degree that any contagion is only felt by other emerging market economies that do not comprise significant proportions of the MSCI Emerging Markets Index, and that spill-over effects to larger economies or developed markets are contained, the end impact to Australian investors may be somewhat muted or temporary.

While the recent sell-off in emerging market equity has increased the attractiveness of the asset class from a valuation perspective, it is difficult to say if the worst is behind us. Furthermore, alongside the individual share market exposures, investors must be conscious of the emerging market currency exposure that comes with investing in emerging market assets. As seen in August, emerging market currencies can be volatile, and with further US dollar strength expected on the back of the Fed's monetary tightening path, weakness in emerging market currencies could continue for some time. Investing in emerging market assets involves having a risk tolerance that requires being able to stomach an inherent amount of volatility that comes with the asset class, and this factor must therefore be taken into account when setting investment exposure.

This feature article is a condensed version of a more in-depth article. If you are interested in accessing the longer-form version, contact Nicole McMillan at Nicole.McMillan@WhitehelmCapital.com

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