TURMOIL IN TURKEY AND WHAT **IT MEANS FOR SOUTH AFRICA**

RHANDZO **MUKANSI** | PORTFOLIO MANAGER

ABOUT **THE AUTHOR**

Rhandzo manages Futuregrowth's Yield Enhanced STeFI+ product suite, segregated core bond portfolios and interest rate asset allocation funds. In addition, he is responsible for fixed income research and analysis.

2018 is proving to be a tough and an unpredictable year for emerging market assets, with Turkey bearing the full brunt of the latest investor fallout. As has been well documented in the media, the catalyst of the crisis was the US imposing trade sanctions and tariffs on Turkey, further souring bilateral relations between the nations. However, the beginnings of the Turkish crisis actually lie in the weakness of domestic fundamentals – particularly the country's wide external trade deficit that is largely financed by short-term borrowing, compromised macroeconomic policy credibility, and questionable central bank independence.

Despite emerging market debt not being the homogeneous asset class of old, seemingly isolated emerging market risk events often result in broad peer group contagion. "Contagion risk" is often used as a blanket term, but it's important to understand the transmission mechanisms that result in the spread of a crisis from one country to another. With this in mind, we distinguish between thematic, economic and portfolio contagion risk.

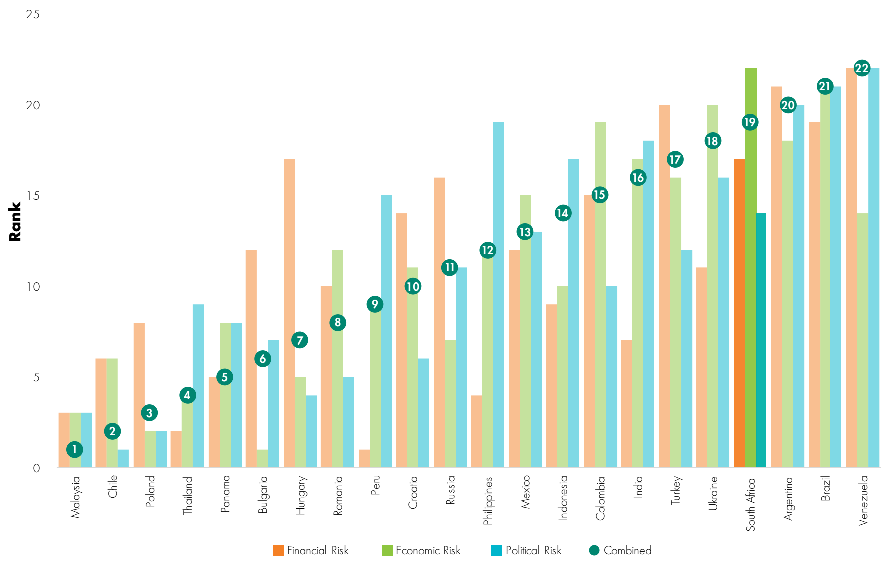
Susceptibility to thematic contagion is heightened when the macroeconomic vulnerabilities that push one country into crisis are evident in peer countries. On the other hand, economic contagion arises when a crisis in a particular country causes economic strife among its trading partners. Lastly, portfolio contagion risk matters most to those sovereigns with developed, liquid financial markets – where a sell-off in a particular country's portfolio allocation results in the reduction of risk appetite across an entire portfolio of assets.

This begs the question: does the Turkey crisis represent an idiosyncratic sovereign risk event or are the emerging market dominoes poised to fall? If there's a domino effect, who's next in line, what's the likely transmission mechanism and how far might the mayhem stretch? In our analysis of the macroeconomic health of a basket of emerging market sovereigns and our assessment of their susceptibility to the various contagion mechanisms, we make use of our internal Emerging Market Risk Monitor.

KEY TAKEOUTS

- EMERGING MARKETS FIND NO DELIGHT IN TURKISH CRISIS
- "CONTAGION RISK" MASKS THE TRUE TRANSMISSION MECHANISMS
- SA RANKS POORLY FROM AN ECONOMIC RISK PERSPECTIVE
- POLICYMAKERS NEED TO ACT BEFORE THE FINANCIAL MARKETS DICTATE TERMS

FUTUREGROWTH EMERGING MARKET RISK MONITOR: WHO IS MOST AT RISK?



Sources: Futuregrowth, Bloomberg

Our analysis highlights the economic and financial vulnerability of likely bedfellows Turkey, Brazil and South Africa; and somewhat less likely peer comparators in Argentina, Ukraine and Venezuela. Of this group, Brazil and South Africa stand out as being the most susceptible to all three contagion mechanisms.

Economic contagion risk is evidenced by both Brazil and South Africa's dependence on faltering Chinese growth for their commodity exports. Thematic contagion risk, on the other hand, is evidenced by both countries' high fiscal debt burdens in an increasingly left-leaning policy environment and their sizeable external accounts, which are largely funded by volatile portfolio flows. These economic vulnerabilities are compounded by the gradual tightening of global monetary conditions and the dangerous escalation of tit-for-tat trade tariffs between the US and China, which both provide the backdrop for broad portfolio contagion risk.

The erosion of policy credibility has previously been a harbinger of episodes of emerging market financial turmoil – and this is particularly relevant for both Brazil and South Africa at the moment, given the amplification of pre-election leftist rhetoric. When confronted by an increasingly populist median voter, it will become difficult to implement the public expenditure containment that is crucial for debt sustainability across both sovereigns.

Although the pressures of the Turkey-induced emerging market weakness will soon enough fade, the common symptoms endure strongest in Brazil and South Africa. The opportunity for painful, but necessary, macroeconomic reform remains open to policymakers in both countries – before a financial market rebellion starts to dictate terms. ■