
What currency pressures in Turkey and other countries may mean for investors

Weekly Market Compass: The UK, China and Iran have also experienced currency pressure

Aug 13, 2018 | Kristina Hooper, Chief Global Market Strategist

Activity in currency markets has more than tripled in the last two decades. Between 2001 and 2016, global turnover in currency markets rose from \$1.2 trillion to \$5.1 trillion,¹ and the geopolitical disruption of the last two years has increased currency activity even further. Last week brought several significant examples of this trend in the UK, China, Iran and – most dramatically – Turkey. Is this a sign of more disruption to come?

UK: Brexit continues to pressure the pound

The British pound came under more pressure last week as the UK hurtled closer to its March 2019 Brexit date with the increasing possibility that it may not reach a deal with the European Union. According to the Commitments of Traders reports published by the US Commodity Futures Trading Commission, positioning adjustments in the past week showed a substantial increase in shorts against the pound. This suggests that foreign exchange traders expect further declines in the pound sterling, and I wouldn't be surprised to see that come to fruition given that uncertainty is growing. As I've said before, we are entering a critical period – I believe the next two months are “crunch time” as the UK really needs to have a deal in place by October in order to allow for enough time for ratification by all EU countries by March 2019.

China: Market forces lead to devaluation of the yuan

The Chinese yuan continued to weaken as the US-China trade tensions intensified last week. While some market participants believe that China has been purposefully devaluing the yuan, it appears that market forces are responsible for the devaluation. China has been easing monetary policy conditions in response to a slight weakening of economic conditions, which has pushed the yuan downward relative to the US dollar. In addition, it appears that investors are assuming that China would be hit harder than the US in an escalating trade war, which has also pushed the yuan lower relative to the US dollar.

Now, we are starting to get questions from clients about whether a tariff war between the US and China could turn into a currency war, especially given US President Donald Trump's criticism of Federal Reserve rate hikes last month. I believe a currency war is very unlikely, although the US Treasury does have a facility, the Exchange Stabilization Fund (ESF), that it could use to intervene in foreign exchange markets. However, the ESF is intended to be used in times of real crisis, and I don't believe this situation qualifies. In addition, China has an abundance of reserves that it could use to counter any currency moves by the ESF.

Iran: The rial sinks on news of US sanctions

The rial, Iran's currency, has been falling for several months following the US' announcement it was leaving the Iran nuclear accord. Last week, the rial sank further as the US announced the re-imposition of sanctions on Iran, and it could very well fall further given that pressure on Iran is building. Iran has already announced that it views US sanctions as an "economic war" being waged on Iran, as it faces the potential of a rapid and substantial recession. Economic policy issues can easily become entangled with foreign policy issues, and I worry about the potential geopolitical ramifications of increased pressure on Iran.

Turkey: The lira's free fall pressures other emerging markets

The megalodon of currency drops last week was experienced by the Turkish lira. The lira has long been falling on concerns about President Recep Tayyip Erdogan's shifting monetary policy and deteriorating relationship with the United States. However, the recent free fall was caused very directly by the US' dispute over an American pastor being held in Turkish custody. The situation was exacerbated at the end of last week as Trump announced via Twitter that the US would be doubling tariffs on Turkish steel and aluminum - to 50% and 20% respectively. Turkey responded over the weekend by announcing that it will seek new alliances, which could be problematic for the US in foreign policy terms, given the US' reliance on Turkish support in Middle East conflicts.

It is important to note that Turkey's foreign exchange reserves are minimal, which is why we are seeing Erdogan call upon the Turkish people to exchange their gold and US dollars for lira. This means that Turkey may need a bailout from the International Monetary Fund (IMF) - which of course would come with many strings attached, as is the usual case with the IMF. In the meantime, with Turkey showing no signs of either seriously intervening in the crisis (such as a significant hike in policy rates) or relenting in its standoff with the US, the selloff in the lira is now spreading to other emerging market currencies. The euro and the Australian dollar have also come under pressure as collateral damage.

I do think it is important to note that, to the extent that the situation in Turkey deteriorates from here, the scope for contagion to other emerging markets is limited, in my view. I believe contagion is likely to be confined to the markets of countries perceived as most vulnerable externally or at risk of US sanctions - rather than emerging markets at large.

Another wrinkle created by the lira's fall is the potential negative impact to eurozone banks, and so the Single Supervisory Mechanism - the arm of the European Central Bank (ECB) charged with monitoring the region's largest banks - has been more closely scrutinizing these banks for potential exposure to the lira. At this juncture, it appears that European bank exposure is relatively modest, despite the outsized reaction of a selloff in the euro as well. However, we will want to follow the Composite Indicator of Systemic Stress for the eurozone for signs of an erosion in market confidence. (The last time we saw a large increase in this indicator was during the Greek debt crisis; that spike in stress was quickly lowered when the ECB pledged to do whatever it takes to remedy the crisis. However, it is questionable whether the ECB has the ability to remedy a European explosion in the crisis.)

What's in store for the currency markets?

Looking ahead, I expect more disruption. After all, geopolitical uncertainty is likely to fuel continued weakness in the pound. And with regard to China, Iran and Turkey, the US is unlikely to alter its policies – suggesting continued weakness for these countries' currencies (and possibly their economies), which may then spread to other countries and other financial markets.

In my view, the real issue is the role of the US in the currency market disruption. Historically the US has served as a stabilizing force in currency markets. Now, it has acted as a destabilizing force; it's hard to imagine that it will now step in and attempt to stabilize currency markets. Therefore, I believe the situation could get worse before it gets better, as confidence is likely to weaken. And so, in my view, investors should not be scared away, but should be prepared for higher volatility in financial markets in general.

¹Source: Bank for International Settlements, 2016

Important information

The Commodity Futures Trading Commission (Commission or CFTC) publishes the Commitments of Traders (COT) reports to help the public understand market dynamics. Specifically, the COT reports provide a breakdown of each Tuesday's open interest for futures and options on futures markets in which 20 or more traders hold positions equal to or above the reporting levels established by the CFTC.

Published by the European Central Bank, the Composite Indicator of Systemic Stress (CISS) is designed to measure the stress level in the eurozone's financial system.

A short position is a directional strategy that is designed to profit when a security declines in price. Securities are borrowed and then sold on the open market. The expectation is that the price of the security will decrease over time, at which point new securities are purchased in the open market and the borrowed securities are returned.

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