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Turkish lira collapses

Key Points

- **Currency crisis in turkey amid tensions with US**
- **Limited contagion so far, yet rates revisit recent lows**
- **BTP spreads about 280bp vs. Bund, rating downgrades likely**
- **Slight credit spread widening, high yield steady**
- **Japanese yields find equilibrium about 0.10%**

As often August will have been quite a choppy month in financial markets. Emerging markets have fallen, in particular currencies.

Trade sanctions on Turkey imposed by the US have sent the dollar-Lira exchange rate above 7 around the middle of the month. Brazil's elections are also caused speculative attacks against the BRL which depreciated above 4 against the US dollar. Brazil's currency lost 8% month to date.

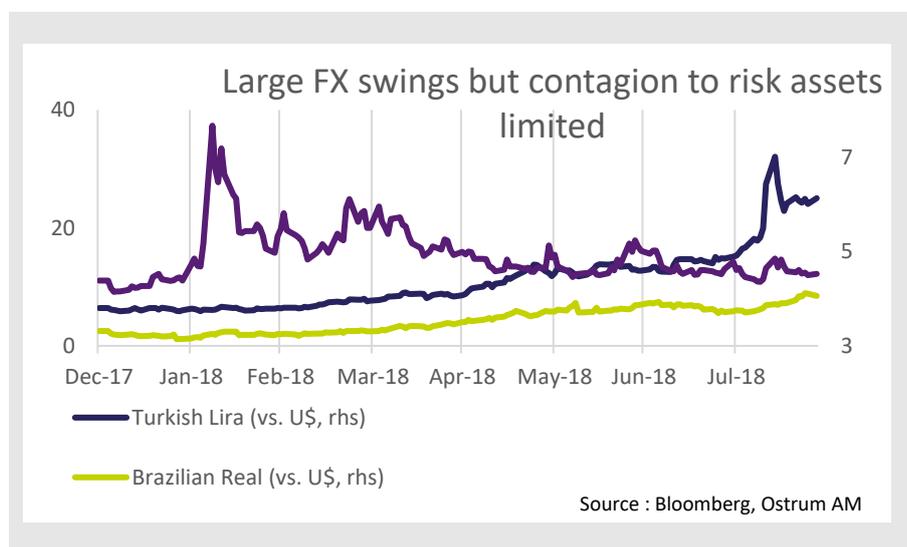
In Italy, the political situation remains uncertain. Likely rating downgrades in the coming months are already reflected in a 10-year spread close to 280bp currently (+52bp in August). These risks have

naturally buoyed risk-free bonds as US Treasuries (-14bp in August) hit 2.80% and their German equivalents touched prior low at 0.30%. Inflation breakevens tightened slightly. The yield on 10-year JGBs has seemingly found equilibrium about 0,10%.

Credit spreads widened moderately by 2 to 7bp in August across the euro investment grade universe. High yield fared better.

Equities are up some 2% in the United States. European indices have nevertheless fallen by 1-2% despite support from a weaker euro. Sterling lost 2% in August trading down to \$1.285.

Chart of the week



The collapse of the Turkish currency and the fall in the Brazilian real did not trigger widespread weakness across markets.

Despite mechanical support to risk-free rates (T-note, Bunds), equity volatility has remained very low throughout the month.

The VIX index is indeed trading about 12% at present.

Turkey: Lira collapses

The Turkish Lira depreciated by as much as 30% in August. This represents a sharp acceleration in the depreciation trend observed over the past few years. Indeed, the US dollar was worth 2 liras in 2013 and is now trading above 6.20. Istanbul's stock market has fallen back and Turkey's sovereign spreads are now above 515bp compared with around 400bp early on this summer. The collapse in the exchange rate is the consequence of several factors: a strengthening dollar on the back of Donald Trump's protectionism; Turkey's own macroeconomic imbalances and a clear deterioration in the US-Turkey diplomatic relations.

The dollar's rise is often associated with asset price declines in emerging markets. That said, Fed policy has been in line with guidance and dollar appreciation is traceable to trade policy designed by the Trump administration. Furthermore, Turkey's sovereign has no refinancing risk this year as the next bond to mature is a March 2019 issue (worth \$1.5b). However, Turkish corporate liabilities denominated in foreign currencies are sizeable at 25% of GDP. Turkey's current vulnerability is a consequence of years of expansionary policy mix. The current account deficit is significant and public deficits are set to double this year. Inflation is running close to 16% and price acceleration reinforced by rising oil prices in the past two years now requires a painful monetary adjustment.

Tensions with the US have been attributed to the detainment of a US pastor in Turkey. Donald Trump indeed may be sending signals to his base ahead of November mid-term elections but this may reflect the heart of the matter. Turkey seeks to purchase military hardware from Russia and it may be Turkey's position on Syria that motivated US trade sanctions. In any case, consequences both politically and militarily of improved relations with Moscow and possibly Beijing in exchange from foreign financing appear uncertain at this juncture although this would likely make NATO even more fragile. As concerns financial markets, the Central Bank of Turkey raised one-week repo rates repeatedly to 17.75%. Growth in Turkey may halve to 4% this year and slow further next year.

Italy still under pressure

The political backdrop is not improving in Italy. Internal difficulties risk spreading cross Europe if the Italian government – currently pressured by the consequences of the migrant crisis and the Genoa tragedy - goes ahead with its threat to veto the EU budget. Such environment does contribute to market nervousness. Fiscal uncertainties are significant and the risk of open disagreements with Brussels appear elevated at this juncture. The 10-year spread is now

280bp. Fitch and Moody's will likely cut their ratings in the coming months. However, it is worth mentioning that Moody's postponed its decision to October-end.

Neutral stance on rates

Such uncertainty favoured Bunds throughout the month of August. The yield on German debt is however bouncing off lows to 0.38%, close to the mid-point of the recent trading range. In turn, T-note yields have hit 2.80% before rebounding slightly. The yield stays some 20bp below fair value, which it hit early on in this month. Curve flattening continues as 2s10s spreads dip below the 20bp mark. The Jackson Hole meeting unveiled little information that would jeopardize the expected rate path. Two more 25bp increases are still in the cards in September and December. At current levels, neutrality in duration terms looks warranted in the near term. In Japan, the BoJ's rhetoric change was interpreted by market participants as increased tolerance for higher bond yields, de facto raising the target to 0.10%. The Japanese market is now trading about that level. The yen is the only major currency to have gained ground against the dollar in August. A short bias remains appropriate as markets test the BoJ's commitment to a yield target.

Credit markets have suffered from wider swap spreads (+3bp in August) and tensions in Italy. The average spreads investment grade space is up 6bp month-to-date to 116bp. Bank and insurance subordinated debt has outperformed. European high yield, however exposed to Italian risk, is 2bp tighter than at the end of July. The premium on high yield is now 355bp against Bunds.

In emerging credit markets (in dollars), specific risks in Turkey and Brazil have sparked some widening but contagion is limited. The average spread in the asset class is now close to 360bp (EMBI).

Amongst risky asset classes, the S&P index is up 2% since the start of the month. Volatility linked to Turkey has had no effect on US equity prices. The US benchmark gauge even hit fresh historical highs. In fact, earnings growth in 2q18 (+25%) has turned to be much higher than consensus had predicted so that valuations are no hurdle to price gains. Upside surprises on EPS account for 85% of releases in the second quarter. Financing conditions remain favourable to equity buybacks and mergers and acquisition deals. In Europe, indices lost 1-2% this month. Slowdown signals evident since the start of the year have fed through weaker corporate profit growth. Earnings surprises break even and average growth is only 7% with very large disparities across sectors.

Main Market Indicators

G4 Government Bonds	28-Aug-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.58 %	+2	+2	+5
EUR Bunds 10y	0.38%	+5	-3	-5
EUR Bunds 2s10s	96 bp	+3	-4	-10
USD Treasuries 2y	2.65 %	+5	-2	+77
USD Treasuries 10y	2.85 %	+2	-10	+45
USD Treasuries 2s10s	20 bp	-3	-8	-32
GBP Gilt 10y	1.45 %	+19	+17	+26
JPY JGB 10y	0.1 %	+1	-1	+5
€ Sovereign Spreads (10y)	28-Aug-18	-1wk (bp)	-1m (bp)	Ytd (bp)
France	34 bp	-1	+4	-2
Italy	282 bp	+16	+48	+123
Spain	104 bp	+1	+7	-10
Inflation Break-evens (10y)	28-Aug-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	139 bp	-1	-3	-4
USD TIPS	211 bp	+3	-1	+13
GBP Gilt Index-Linked	307 bp	+1	+3	+1
EUR Credit Indices	28-Aug-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	116 bp	+1	+1	+30
EUR Agencies OAS	50 bp	-3	+2	+12
EUR Securitized - Covered OAS	53 bp	-3	+0	+13
EUR Pan-European High Yield OAS	355 bp	-6	-10	+61
EUR/USD CDS Indices 5y	28-Aug-18	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	65 bp	-3	+3	+20
iTraxx Crossover	285 bp	-11	-2	+52
CDX IG	59 bp	-2	+0	+10
CDX High Yield	324 bp	-7	-7	+17
Emerging Markets	28-Aug-18	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	360 bp	-8	+35	+75
Currencies	28-Aug-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.168	+1.07	-0.28	-2.68
GBP/USD	\$1.289	+0.1	-1.88	-4.6
USD/JPY	¥111.17	-0.65	-0.21	+1.37
Commodity Futures	28-Aug-18	-1wk (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$76.3	\$3.7	\$1.5	\$11.9
Gold	\$1 211.3	\$19.0	-\$12.3	-\$91.5
Equity Market Indices	28-Aug-18	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 897	1.39	2.76	8.35
EuroStoxx 50	3 456	1.31	-2.01	-1.36
CAC 40	5 487	1.44	-0.46	3.28
Nikkei 225	22 813	2.67	0.44	0.21
Shanghai Composite	2 778	1.62	-3.33	-16.00
VIX - Implied Volatility Index	12.02	-6.53	-7.75	8.88

Source: Bloomberg, Ostrum Asset Management

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