

## Matthews Asia Perspective

### Are Turkey's Troubles Contagious?



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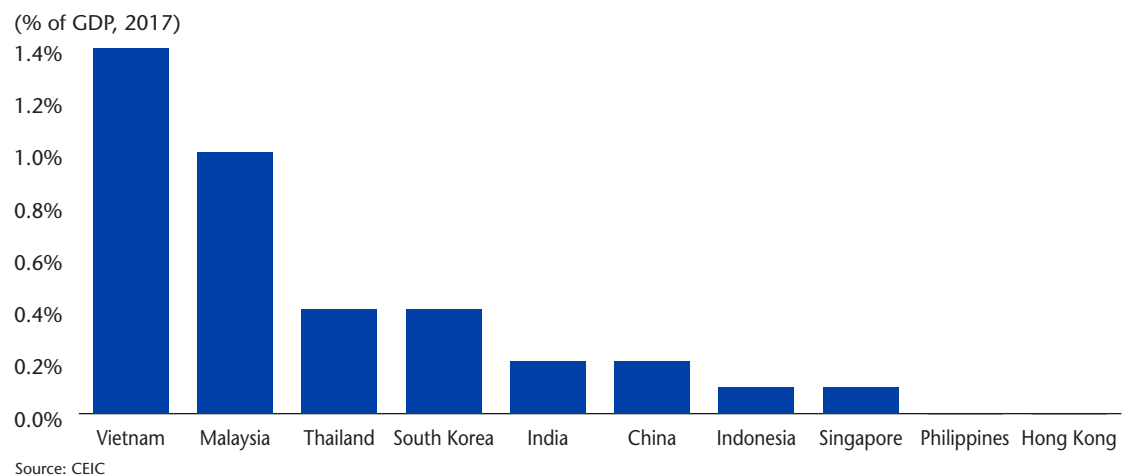
How concerned should investors be about the risk of market contagion from Turkey's slump?

Turkey's problems appear idiosyncratic and their spillover effects should be relatively contained unless there is a major investor retrenchment from emerging markets (EM) generally. This appears unlikely as EM holdings are already at low levels.

The situation may indicate potential future risks, however, as major central banks withdraw their extraordinary policy accommodation post-Global Financial Crisis. Financial crises tend to occur in a U.S. Federal Reserve tightening cycle, especially when major imbalances exist. The difference, with respect to Association of Southeast Asian Nations (ASEAN) countries and India, is that external imbalances have turned positive since the "taper tantrum" of 2013. So while Turkey's woes have sparked short-term volatility, the probability of a long-term impact is low.

There are three potential channels of contagion: trade, banking sector exposure and capital flows. Emerging ASEAN and India's exposure to Turkey is small via the first two channels of trade (Vietnam and Malaysia have the largest exposure at around 1.4% and 1% of GDP, owing to their highly open economies) and banking (negligible), while broader contagion is likely to manifest through the slowdown or reversal of capital flows, making it more difficult to finance external deficits.

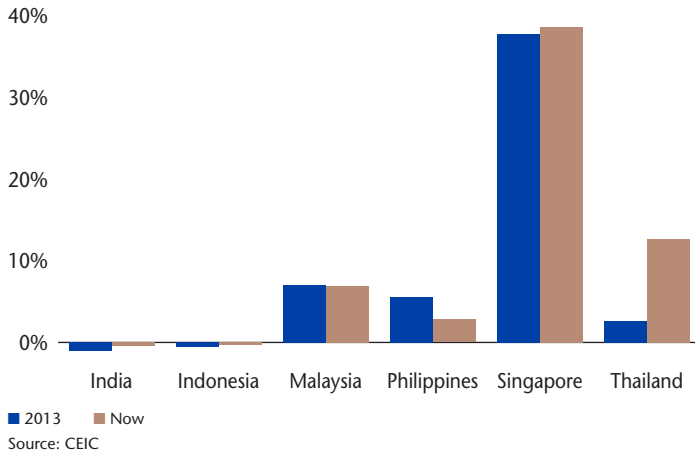
**FIGURE 1. EM ASIAN EXPORTS TO TURKEY**



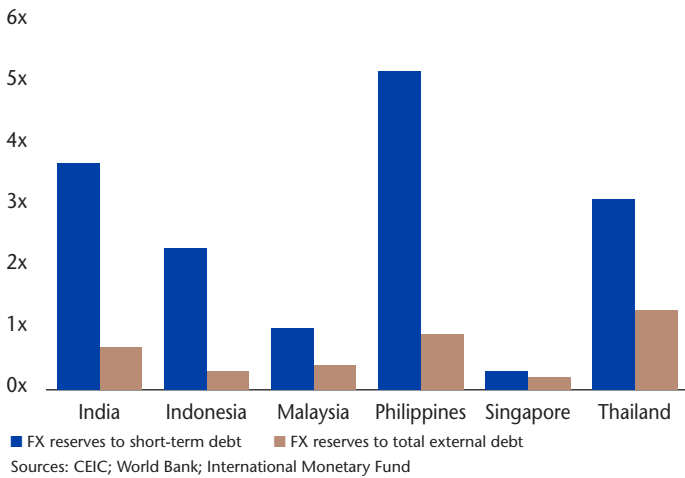
*Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.*

The basic balance (current account balance plus net foreign direct investment) indicates the ability to finance the current account deficit from long-term funding sources. On this metric, Indonesia and India have small basic balance deficits that must be funded by portfolio capital inflows, with the rest having moderate to significant surpluses. Short-term external debt is also well-covered by international reserves, guarding against the event that such liabilities may not be rolled over during a crisis.

**FIGURE 2. BASIC BALANCE (Current Account + Net FDI)**



**FIGURE 3. FX RESERVES TO EXTERNAL DEBT**



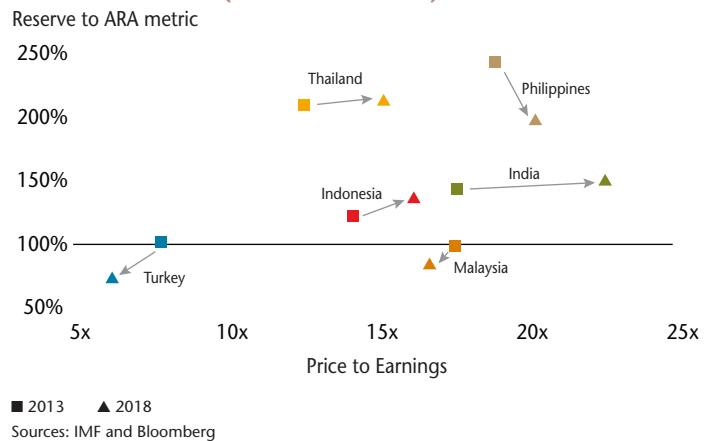
Although fundamental vulnerability is low, short-term volatility is possible as contagion from the slump in the Turkish lira puts pressure on countries reliant on external financing. These include current account deficit (CAD) countries such as Indonesia, India, and the Philippines, which are perceived as more exposed to a slowdown in capital inflows. In response, central banks have tightened monetary policy by raising interest rates to provide a more attractive real interest rate differential against foreign currencies, as has been done by Indonesia, India and the Philippines. Higher interest rates may involve forfeiting some growth for the sake of stability, but it is worth noting that India, the Philippines and Indonesia are among the fastest-growing countries in Asia with GDP growth rates in the range of 5.3% to 7.7%.

While EM contagion results from investors selling the asset class as a whole due to concerns over individual country issues, there can be offsetting benefits. Since Asia's external position is significantly better than during the 2013 taper tantrum-induced outflows, it is largely more insulated against crises in other parts of EM. The region could benefit from reallocation flows within EM as investors move away from more vulnerable economies such as Turkey, South Africa and Argentina.

How vulnerable are ASEAN and India equities to Turkey contagion? The International Monetary Fund (IMF)'s assessment of international reserve adequacy shows that while Turkey's reserve adequacy has slid sharply since the taper tantrum period of 2013, Indonesia has improved from 123% to 138%, India from 144% to 151%, while the Philippines remains a robust 199%, despite declining. ASEAN and India markets are trading at a higher valuation today compared to 2013, reflecting the improved fundamentals, although valuations today are significantly lower than at the beginning of 2018. On a more positive note, real bond yields and real effective exchange rates are already close to the troughs they reached in 2013.

We believe Asian market volatility offers investors the opportunity to build positions in ASEAN and India, in economies where fundamentals have improved over the past five years and a new domestic-driven growth cycle is commencing.

**FIGURE 4. IMF'S ASSESSMENT OF RESERVE ADEQUACY VS PE (2013 VS TODAY)**



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