Tigress Financial Partners

Macro Snapshot – Chief Economist Jean Ergas

July 18, 2016

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Key point - The attempted military take-over in Turkey shall act as a reminder to not confuse GDP growth with political stability. Westernized elites are not in touch with the popular mood. We saw this in Iran in 1979 and we shall see it again!

Stock markets breathing a sigh of relief – coup plotters in Turkey not waiting for the Federal Reserve – This is not "Topkapi" and wild adventures in Istanbul, but re-emerging historical tensions - UK situation remains complex – further pressure on the pound likely

Stock markets breathing a sigh of relief! We do not buy the political risk – bad news is good news story!

Stock markets are breathing a sigh of relief at failure of military takeover in Turkey and cheering a monster tech deal between the Japan and the UK. Some are starting to view political turmoil as a new variant on the "bad news is good news" story. Central banks shall be further encouraged to keep the brakes on interest rate increases so as to avoid further de-stabilization.

The coup plotters in Turkey were not waiting for the Federal Reserve meeting!

What do we make of this new paradigm? Not much! Politics and coups are not marching in lockstep with monetary policy. Should the next attempt – and there shall be one – succeed no monetary tinkering shall mute the impact. The re-drawing of political and military alliances in one of the two riskiest areas in the world – along with Pakistan – is not at the whim of the ECB or the Federal Reserve.

Struggle in Turkey is about a vision of history and of society not about the discount rate!

The struggle that we are seeing in Turkey is a political undercurrent stretching back to the collapse of the Ottoman Empire. With the founding of a secular state Turkish history appeared uni-directional. This has not been the case as political Islam has steadily gained new adepts and legitimacy.
We see this struggle as far from over.

On the European front, we reiterate our view that the events in Turkey and the terrorist attack in Nice shall lend further legitimacy to security over economics.

Turkey is the new Stalingrad – We must hold it!

The US has cautioned Erdogan as to avoiding excesses in the repression of the coup organizers and participants. We see this intervention as stopping there. Turkey is the new Stalingrad which must be held at all costs – we are looking for the least bad fit and shall go with the flow.

Fortress USA shall continue to attract foreign investment

In the US investors shall be focusing on earnings. Bank of America has beaten estimates reinforcing the "Fortress USA" theme which we see as picking up steam. This does not presage a US boom but plays to the safe haven versus growth theme. US assets remain attractive both on a cash yield basis across a broad range of risks and due to lower interconnection with ROW.

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This is not 1962! EU outpunches Commonwealth!

As to the "Adventures of Brexit" the UK has boldly announced its intention to conclude trade agreements with Australia and Canada once free of the EU's yoke. Whether this shall be sufficient to offset – in a bizarre throwback to the pre-EEC era – commerce with the EU is highly doubtful. Canada has made clear that its key objective is to conclude a free trade agreement with the EU. They know what side their bread is buttered on.

In a nutshell!

We are going to continue to see safe haven buying

Despite a slight increase in yields from systemic risk levels, we still see a shift towards safe haven fixed income – with equity allocations falling and investors opting for security over return – We continue to see the UK pound as overvalued and expect a further fall in the "cable" – The bounce last week was ephemeral and not based on economic fundamentals

UK situation far from resolved – still substantial risk in UK property sector

Investors are relieved that the UK has a government but realize that the uncertainty as to timing of the exit and post-exit framework shall drag on for some time – The UK property sector remains a source of considerable potential systemic risk, with a further property collapse knocking the UK economy flat.

Investors continuing to look to central banks

Looking beyond the UK – we see investors as relying on continued and if necessary increased central bank intervention as the principal support for equity markets. The driver shall be collapsing fixed income returns pushing investors towards stocks and the prospect of dividend yields. Allocation is now a choice between the bad and the worse.

ECB shall they wait?

This week we shall also be hearing from the ECB in its first meeting since the UK vote. We expect that moderation shall prevail but that the ECB shall await further data on the single currency area economy prior to taking further measures.

ECB impact on real economy shall be slight

The assessment of the Euro Zone economy following June 23rd shall be key to defining expectations as to both the financial and the "real" economy. We see the ECB as easing further – triggering further buying of US assets. The impact on the Euro Zone economy shall be slight – with a likely further reduction of growth estimates.

1- The coming week!

Are we shifting from one locus of turmoil to another?

Last week some thought it was safe to start re-focusing on economic fundamentals and concentrate on earnings. The installation of a new UK government and the prospect of a "beginning of the end" scenario were seen as a positive first step. Optimism was further boosted by some better than expected US earnings and macro data.

EM elites represent nobody but themselves

Is all this going to be put in jeopardy by the prospect of political turmoil on the EU's borders? Have some mistaken GDP growth and other economic metrics for being synonymous with political stability? We see the "experts" as having fallen prey to a common mistake many EM analysts make – not realizing that the "westernized elites" represent nobody but themselves.

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To the already existing political strains in Europe, shall now be added the- for some shocking reality - military take-overs are a distinct possibility on the EU's borders.

2- UK situation far from resolved – best is yet to come!

We expect a hard line in the UK exit negotiations

The UK situation is far from resolved, with the benefit of the installation of a new government being offset by two risks:
The calling of a general election in the short term
That the new powers that be shall – as we believe – pursue a harder line than expected in the disengagement talks.

Pressure building for invoking of article 50

We see the pressure building from the EU members for the UK to "pull the trigger" and invoke article 50. This shall not be the end of the uncertainty – trade agreements have never been easy to negotiate. Even after formal conclusion there shall be a considerable amount of "tweaking".

The UK is not Lichtenstein!

The free movement of labor being the sticking point – we do not see much chance of an EEA type agreement. This runs contrary to the idea that there might be an agreement as with Lichtenstein! This due to the size of the population and economy is a completely spurious comparison.

Recent terrorist attack in Nice shall push pendulum towards primacy of security

The recent terrorist attack in Nice shall push the pendulum towards ensuring domestic security as opposed to granting free movement of labor in return for trade access. In this context, we are seeing references to adopting an "omnibus" free trade agreement – falling short of the current market access.

Not surprised by pause in sterling's bounce

With regard to the UK economy, we are not surprised by the pause in sterling's bounce. Short term prospects for the economy in terms of traditional macro metrics are being steadily revised downwards. Capital investment is frozen and the property market is in shock – with a massive amount of transactions on hold in both the commercial and residential sectors.

See little improvement in visibility over next three months

Looking beyond the next 3 months, we see little improvement in visibility. The outlook shall continue to be clouded by the timing of the UK's invoking article 50 and some indication as to the trade regime feasible. We see this as placing the UK economy in a "holding" pattern – with business expenditure at minimum level and foreign direct investors hesitant to move.

This is not a managed sterling depreciation

While there has been much cheering last week, the fact remains that sterling is trading at Marianna's trench levels. Some see this as a necessary adjustment for sterling's overvaluation. We beg to differ! A managed depreciation with the prospect of improving the trade balance within a stable framework is not the same as a crash born of a political shock.

Outlook for pound weak

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We continue to view the outlook for the pound as weak both short and longer term. In the immediate uncertainty prevails and asset allocation metrics are being shifted from store of value to a return basis. Longer term, we do not share the optimism that sterling shall increase its role as a reserve currency.

Do not see central banks increasing their allocation to sterling

Central banks shall be wary of increasing their exposure to an economy which shall both likely contract and be more dependent on a devalued currency to accommodate a less welcoming trade regime. We see the shift as ideologically driven and doubt that the EM space can offset the loss of trade with the EU.

3- Italian banks source of systemic risk

Little concrete progress on the European banks

With regard to the European banking crisis there has been much talk but no concrete breakthroughs. Plans for a direct government recapitalization of the Italian banks are still deemed non-compliant with EU bank rescue rules.

Will the Italian government get the exemption?

The Italian government is seeking an exemption from using certain types of debt as first line loss buffer. Whether this shall be granted is far from certain. Whatever the outcome – we see the "banking question" as a constant.

The discussion as to a bad loans backlog is clouding the more important issue of a further addition to distressed assets as the economy continues to – at best – tread water.

As concerns the broader Euro Zone – Deutsche Bank is once again under pressure, with renewed concerns – as reflected in the sharp rise of CDS rates – as to its ultimate "stand – alone" solvency. We are now seeing the confluence of bank specific strategic missteps, regulatory pressures and linkages to the Italian banks.

4- US companies beneficiaries of US "stand alone" capacity

"Gathering storm" in Europe increases attraction of US

US markets have been the beneficiaries of increasing risk aversion with regard to the "stand alone" capacity of the other major developed economies. This has been paralleled by what some may see as "The Gathering Storm" about to break in Europe on multiple fronts.

Collapse in US consumption not yet on the cards

US economic data – while not stellar – indicates that the economy shall both continue its slow growth trajectory and that a collapse in consumption is not yet on the cards. With regard to the "financial economy" a favorable risk- return relationship across a broad spectrum of fixed income assets is also encouraging investment flows.

US attraction for investors hopefully not fatal!

We see the relative but hopefully not "fatal attraction" of the US economy continuing. Investors shall become increasingly impatient with regard to the EM argument – centered on FX spot rates –and to the European sales pitch, focused on the convergence of P/E ratios. We have yet to see why the P/E ratios should converge!

We reiterate our view that the Europe discount is amply justified by both economic prospects and the inability of the large European groups to leverage the dual benefits of currency depreciation and quasi- zero rate financing.

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5- China – still a wild card?

Not convinced by Chinese data

Turning to the emerging markets we have seen better than forecast data from China. We see this data as of scant relevance. Growth continues to be driven by government spending and currency depreciation. The Chinese government has opted for stabilization via overcapacity and exports.

The incremental impact of the devaluation is steadily decreasing. We see a Chinese government that is running out of time and measures – is a repeat of 2015's "Guns of August" scenario likely?

6 – Commodities – are we at a turning point?

Do not see another commodity super-cycle on the horizon

As concerns commodities, we continue to see little chance – despite talk of a "bull market" – that this segment shall attract the same funds flow as during the "super cycle". In the light of both slowing global growth and a hiatus in capital expenditure – we are hard put to see where the demand boost shall come from.

Unwinding of long positions in the oil market

We are seeing an "unwinding" of long positions in the oil market. Easing of disruptions and robust US supplies have stemmed fears of an incipient balancing of the oil market.
The much touted demise of the US shale industry has yet to materialize!

7 - Focus on Turkey

Turkish delight? – Not quite!

The political challenge

We have not seen the end of the turbulence in Turkey. This is the beginning of a rocky ride which shall force "The West" to choose between increasing democratic freedoms and secure borders. We see secure borders as trumping free speech.

More political tremors – Primacy of politics reasserts itself brutally!

We ended last week on another political tremor, with an attempt at a military take-over in Turkey. While this is nothing new – there have been repeated interventions by the army since 1945:
It highlights the risks attaching to the EM space overall, there are reasons for the risk premiums.
Once again the "primacy of politics" is pushed to the forefront

Turkey bulwark of the west in a "tough neighborhood"

The risks attaching to the Turkish situation are political, economic and closely intertwined. Turkey is once again the bulwark for the "free world" as it was during the Cold War.
Strategically situated astride East and West it is seen as a reliable outpost in a "tough neighborhood".

For US and EU – bottom line is security

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While after 1945 this was aimed at the Communist bloc, the focus is now on ISIS and Islamic fundamentalism. "Holding" Turkey continues to be part of the dominant strategy of the US and its allies. With the EU risking coming apart at the seams – UK secession and migrant crisis – the "bottom line" remains security.

Greek collapse bad enough but economic – Turkey potential re-drawing of post 1945 security framework

"Losing" Turkey would be a Greek catastrophe writ large.
We correctly argued last summer that the US would pull out all the stops to halt a debacle in Greece – in the case of Turkey they shall stop at nothing.

Key transit point for global oil supplies

From the economic angle – three per cent of the world's oil supplies transit through Turkey as well as significant shipments of grain. Interruption of the oil flow – largely from Iraq – could contribute to a significant disruption in supplies.

Do not confuse swimming pool at the Hilton with "brute force" realities of power!

What lessons can we draw from these dramatic events? The key point is not that the takeover was successful or not but that it was attempted. We see too many continuing to confuse GDP and assorted economic metrics with political stability. The development of political institutions often lags growth.

Remember hanging of Menderes in 1961!

While considered a key Eurasian economy Turkey is not a country steeped in political niceties! Following a military coup in 1960 – the former prime minister, Menderes, was hung! We see a close parallel to analysis of the Middle East where foreign observers – familiar with the "westernized" elites - do not grasp the more "basic" forms of political dialogue.

Attempted takeover heaven sent opportunity for Erdogan to crack down on dissent

The tensions which have underpinned recent events on the Bosphorus have not disappeared. The takeover attempt is a heaven sent opportunity for the Erdogan government to both crack down further on dissent and wring further concessions out of the US and EU.

We have not seen the end of the turbulence in Turkey. This is the beginning of a rocky ride which shall force "The West" to choose between increasing democratic freedoms and secure borders. We see secure borders as trumping free speech.

Economic volatility up ahead - Are we heading towards a balance of payments shock?

Turkish current account deficit key weakness

With regard to economics and global markets – the Turkish central bank shall provide the banking system with unlimited liquidity. While this shall help to avoid an internal liquidity squeeze it shall do little to resolve the key weakness of the Turkish economy - a massive current account deficit.

Will investors continue to finance short term financing gaps?

The attempted and almost successful coup has put "red alert" political risk on investor radar screens. Will Turkey be able to continue to attract sufficient short term inflows? Is the much talked of risk of a balance of payments crisis looming nearer?

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Shall foreign direct investors stay the course?

We are also concerned as to the impact on longer term foreign direct investment which has been a key factor in:
providing capital investment
Lessening the link between foreign borrowing and economic growth
The Turkish crisis may put to the test those investors who confused the wealthy neighborhoods in Istanbul with a polarized country.

Are we heading towards an IMF facility?

In Turkey political chaos and sudden economic collapse have been closely correlated. Should investors hesitate to cover financing gaps there are two scenarios:
The central bank raises interest rates pressuring the economy
The IMF extends an emergency facility
We reiterate our view that the Turkish situation may cast a pall on the EM space.

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