From the Desk of the Adaptive Multi-Asset Solutions Team

Turkey: Risk Budgeting is Critical

As problems have mounted in Turkey over the past three months, the liquidity of options on the Turkish equity ETF has picked up sharply, lending itself to rich and meaningful forecast information on risk to Turkish equities. Based on the level of potential upside and downside priced by the option market over the last three months, we can calculate a forward "Tail-Based" Sharpe Ratio equal to the ratio of upside over downside potential. The value of this Tail-Based Sharpe Ratio currently sits below its average level over the last three months indicating below average attractiveness, as noted in Exhibit 1.

While Tail-Based Sharpe Ratio provides a risk-adjusted measure of attractiveness, it is also important to know how large the downside risk is to gauge how bad it can get. In other words, a high Tail-Based Sharpe Ratio with high downside risk is a very different scenario than a high Tail-Based Sharpe Ratio with low downside risk. Today, we see the downside to Turkey to be quite large (see Exhibit 2).

While the Tail-Based Sharpe Ratio for Turkish equities doesn't look extremely low, the potential downside is very high, so risk budgeting is very important here. Turkish equities are showing a 10% probability of losing 50% over the next two months, compared to 30% and 17% for Brazilian and Mexican equities, respectively. Allocating 1% exposure to Turkey is nearly 3 times more risky than allocating 1% exposure to Mexico.

The risk reversals on the Turkish Lira are also showing heightened downside risk to the currency. In our opinion, unless the U.S. removes its economic sanctions on Turkey, which have essentially priced Turkish steel out of the U.S. market, for example, it will be difficult for the Lira to experience a sustained rally, even if its central bank hikes rates as an effort to support the currency. Thus the risk here is very much geopolitical. Argentina, for example, hiked its 7-day repo rate to 40% from 27% at the end of April. Yet, the Argentine Peso has continued to sell off sharply. Circumstances are surely different between Argentina and Turkey, but if growth isn't viable, it will be hard for a currency to rally.

Summary

Given our signals, Turkish equities and currency are still showing significant downside risk leading to below average expected risk adjusted returns. Unless the geopolitical tensions are resolved, we fear this downside risk will not abate, but if it does resolve the ensuing right tail may be quite large.

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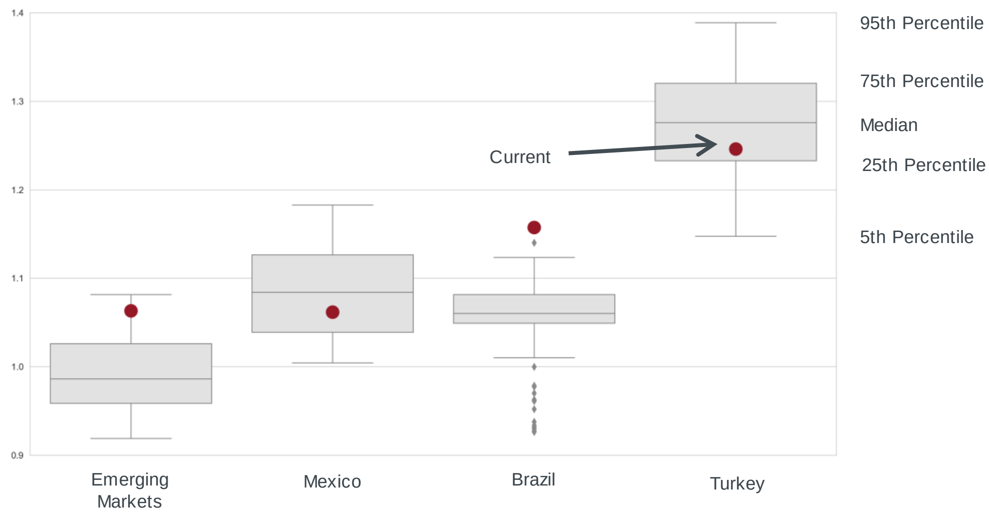
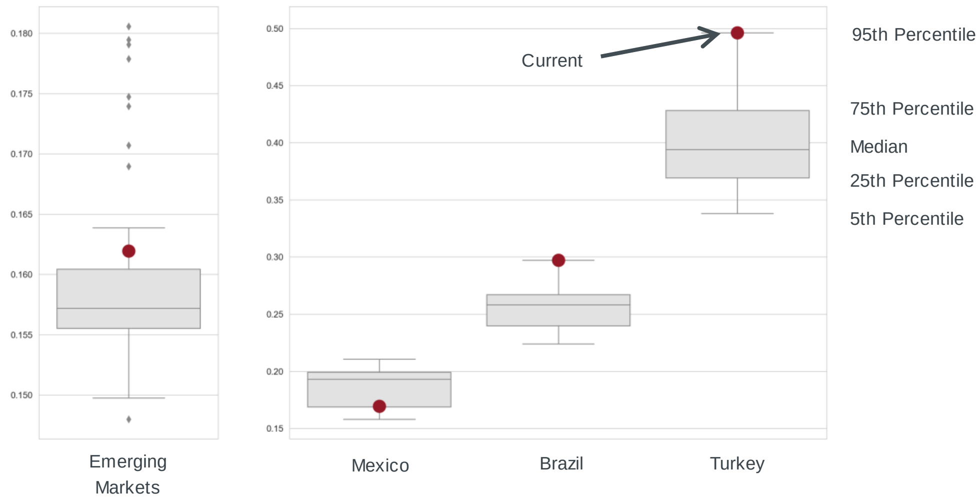
Exhibit 1: Tail-Based Sharp Ratios across EM Equities



As of August 14, 2018.

In Exhibit 1, the red dot represents today's "Tail-Based" Sharpe Ratio. The grey shaded regions represent the inter-quartile range for this ratio over the last three months, with the horizontal dividing line representing the median value. A red dot below this median value suggests a level of attractiveness below average.

Exhibit 2: Expected Tail Losses across the EM Region



As of August 14, 2018.

Turkish and Brazilian equities are showing very elevated downside risk that is very high relative to recent history. The downside risk for the emerging markets also has increased over the last three months, sitting at a decently high level today. In contrast, the downside risk to Mexican equities has fallen over the last three months.

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