Turkish turmoil: When liquidity tightens, idiosyncratic problems can trigger systemic moves.

Turkey is in a genuine currency crisis. The lira fell 30% over 3 days. Fundamentally speaking, the reason for the Turkish meltdown is primarily a large current account deficit (6% of GDP) and reliance on outside capital. Markets don't care as long as liquidity stays abundant, but are turning toxic when global liquidity dries up due to higher interest rates, the Fed's balance sheet shrinks and the US Dollar strengthens. Making things worse, there are serious doubts about policymakers' ability to correctly assess what kind of storm is currently brewing and how to deal with it. Adding to the pain, a dispute between Washington and Ankara around the arrest of a US pastor in Turkey has prompted Trump to impose additional tariffs on Turkey this week – altogether, we have a perfect storm.

The key question from an investor perspective: Is there a systemic element to the Turkish turmoil? According to Mr. Market this is indeed the case, as it helped push US 10-year government bond yields below 2.90%, spilled over to other Emerging Market (EM) countries and triggered a weekly loss in the S&P 500 for the first time in six weeks. As the global liquidity tide is turning and markets are toppish, investors all of the sudden stop ignoring Turkish problems that have been known for quite some time. Moreover, the drying up of global US Dollar liquidity is not only a problem for Turkey, but also for EMs as a whole. EM countries are by-and-large dependent on outside "capital sponsors" given the shortfalls in EMs own financial systems. Moreover, in the case of Turkey, some of these sponsors are not that far away: The ECB is reportedly becoming worried about EU bank exposure to Turkey. **So as the root *cause* behind Turkey's problems is global liquidity drying up, the country's predicament also is a *symptom* of the structural headwinds to risk appetite. These liquidity headwinds are unlikely to abate in the near future, confirming our cautious view on risk assets for H2 2018.** Equity investors should stay defensive. For fixed income investors, the attractiveness of core fixed income (especially US Treasuries) is constantly improving.