

**GLOBAL X ETFs RESEARCH**

# Views From the Ground: Turkey

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Looking at a year where Turkey faces a market-moving presidential election, we recently spent time in Istanbul for management meetings, channel checks, and to prepare our strategies for outcomes in either direction. We garnered insights from economists, political experts, sector experts, and even protestors. Though negative election outcomes could destroy value, it appears that a market friendly option is well positioned to lead Turkey out of 2023 and beyond.

When investing in emerging markets (EMs), our team consistently looks for company-specific stories supported by structural tailwinds. However, in EMs, we also play close attention to the macroeconomic picture to mitigate potential headwinds in the form of rising current account deficits and fiscal deficits; decreasing central bank autonomy; rising inflation; and opaque political pictures. In recent years, Turkey has checked every box. Consequently, we maintained an underweight positioning in the country for the last five years, as its equity market, as measured by the MSCI Turkey Index, has fallen 20.58% over that time period.<sup>1</sup> That said, this is an election year and Turkey may vote for change. Continuation of the status quo could lead to significant asset price depreciation, but new leadership could signal one of the best turnaround stories in the world.

**Key Takeaways**

- Unorthodox economic policies championed by President Erdogan have kept investors on edge, but that era may be nearing an end.
- Turkey has a presidential election scheduled for May 14th. This could result in a victory for the opposition, which would likely usher in more orthodox economic policies.
- Economic missteps, natural disasters, and the COVID-19 pandemic have taken a heavy toll on Turkey, but we see numerous reasons for hope, from the strength of the opposition party to the country’s favorable demographics.

**MSCI TURKEY INDEX (USD)**

Sources: Global X ETFs with information derived from: Bloomberg LP. GP [MXTR MSCI Turkey Index Last Price]. Data as of March 29, 2023.



## One of the Strongest Structural Stories in Emerging Markets

Though challenged by recent leadership driving unorthodox economic policies, Turkey boasts one of the higher potential growth rates in emerging markets. From a demographic perspective, Turkey has over 80 million citizens, more than 90% of which are under 64 years old.<sup>2</sup> Importantly, Turkey’s young population ranks top five in the world in terms of access to higher education.<sup>3</sup> With proximity to the Middle East, one foot in Europe and the other in Asia, Turkey also benefits from a geographical perspective. Geopolitically, Turkey maintains a vital alliance with the US and carries a working relationship with Russia, as well as a growing relationship with Saudi Arabia. On top of the above, Turkey offers a deep and liquid equity market. This recent trip reminded us of the top-notch management teams across Turkish corporations, who have managed to maintain profitability through the most difficult of economic conditions (almost 100% inflation!). Broadly speaking, our experience has been that these managers have a strong alignment with minority shareholders and pay close attention to balance sheet management, cost-controls, and responsible capital allocation decisions.

### TURKISH EQUITY VALUATIONS APPEAR ATTRACTIVE

Source: Global X ETFs with information derived from: Bloomberg LP. Data as of March 19, 2023.

	P/E Ratio	P/B Ratio	Return on Equity	Dividend Yield
MSCI Turkey Index	3.3x	1.1x	32.0%	8.8%
MSCI Emerging Markets Index	11.6x	1.4x	11.6%	3.3%
S&P 500 Index	16.2x	3.2x	18.4%	1.9%

## Unorthodox Policies Have Held Prices Down

The MSCI Turkey Index has dropped 21.7% and 43% over the past five and 10 years in USD terms.<sup>4</sup> Turkey exports tourism, and roughly 13% of GDP comes from the industry.<sup>5</sup> At the same time, the country imports oil. That means that the recent dynamics around COVID-19 and global supply disruptions have put pressure on the country’s trade dynamics. The country’s current account balance has deteriorated from a surplus of 1.4% of GDP in 2019 to a deficit of 5.8% of GDP in 2022.<sup>6</sup> In a more orthodox economic system, this dynamic would likely put pressure on a currency, which would lead to marginally higher inflation, causing a central bank to raise interest rates so that the country could maintain positive real rates and attract back foreign direct investment (FDI). In Turkey, this is a different story, as President Erdogan has consistently intervened in both monetary and fiscal policy. In earlier parts of his administration, the country’s central bank officials would push back on his views. However, in recent years, Erdogan has named his inner circle to important economic positions. In addition, the market has also remained skeptical following the failed coup in 2016, which allowed Erdogan to consolidate power within government ministries.

## What Happened in 2022?

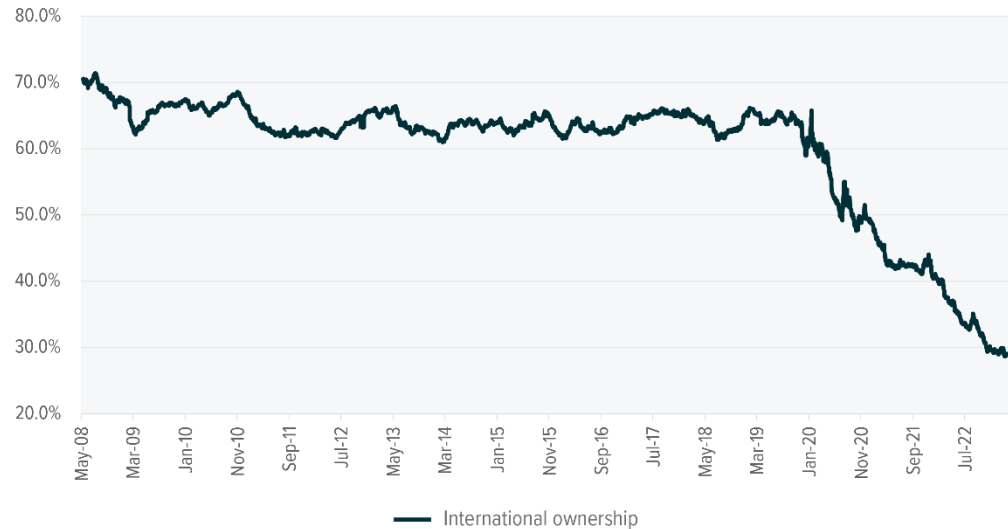
Counterintuitively, Turkish equities rallied more than any other market in the world in 2022, with the MSCI Turkey Index rising 90.55% in US dollar terms.<sup>7</sup> Local retail money drove the rally, as interest rates were cut to 9%, while inflation rose to 80%.<sup>8</sup> This resulted in a significant loss of purchasing power, and locals could not find a store of value for their money. One would first think to convert one’s lira to other currencies, but the government intervened with a foreign exchange protection deposit regime, which kept the lira steady, making a hard currency option less attractive. During the year, the lira actually strengthened from 18 per USD to 11, before starting to weaken again.<sup>9</sup> We spoke to one manager, who purchased four motorcycles, without having any intention to obtain a driver’s license. Ultimately, the equity market turned into Turkey’s most popular inflation hedge. In addition, Turkish politicians publicly promoted



the stock market as a safe place, because they were afraid for more currency outflows from the country driving more inflation. That said, Turkish assets remain significantly depressed and still leave potential for positive re-ratings. In fact, there has been an exodus of foreign investors (\$4.5bn in 2022 alone and \$13.5bn over the past five years).<sup>10</sup> Positioning is light and the market is dominated by local retail activity. Foreign ownership in free float is now down to historical lows at 28.8%.<sup>11</sup>

## INTERNATIONAL OWNERSHIP OF TURKISH EQUITIES HAS FALLEN SHARPLY IN RECENT YEARS

Sources: Global X ETFs with information derived from: Turkish Central Registry data of the Borsa Istanbul as of March 23, 2023.



## Natural Disasters

Adding to Turkey’s political and economic challenges, on February 6th, a 7.8 magnitude earthquake hit, soon followed by a 7.7. The disaster caused damage across 140,000 square miles (roughly the size of Germany) and killed at least 50,000 people with some estimates up to 150,000.<sup>12</sup> The United Nations estimates that roughly 1.5mm people lost their homes.<sup>13</sup> President Erdogan seems sure to leverage the occasion to vilify property developers and promise more infrastructure across the country. The opposition seems to be seizing the opportunity to point to Erdogan’s mismanagement of the crisis. From a market perspective, inflation may rise further with post-earthquake stimulus. The earthquake-affected region produces roughly 15% of Turkey’s agricultural output, and the negative supply shock could lead to faster food price growth near term.<sup>14</sup> Food retailers tend to have the best pricing power, and banks also benefit from their large consumer price index (CPI)-linked portfolios.

## Reasons for Hope

President Erdogan triggered an early election process on March 10th by dissolving the parliament (which automatically triggers parliamentary and presidential elections to be held within a 60-day period) and declared Sunday, May 14th as election day. Our meetings with Turkish market leaders led us to believe that the opposition carries a strong chance of replacing the incumbent Erdogan and his AKP party. The leading opposition bloc (dubbed as the “Table of Six”) recently announced a joint presidential candidate in Mr. Kemal Kılıçdaroğlu (KK) from the CHP. In support to this nomination, two popular mayors, Mr. Ekrem Imamoglu (Istanbul) and Mr. Mansur Yavas (Ankara), have been designated as his vice presidents in the future potential presidential cabinet. With this move, the opposition block has brought forward and united



its three most popular presidential candidates (KK + the two mayors) under a “dream election team,” which recently led polls by close to 10 percentage points.<sup>15</sup>

Importantly, this alliance has agreed on restoring a parliamentary democracy based on the rule of law and proper governance. Leaders of all six political parties in the opposition alliance would assume key positions in the presidential cabinet. This could restore a system of checks and balances back to Turkey. From an economic perspective, the opposition has pledged a return to orthodoxy.<sup>16</sup> It has indicated that it would allow the currency to weaken and allow an independent central bank to raise interest rates to combat inflation.<sup>17</sup>

Beyond polls, we came across a positive anecdote in hearing about soccer fans being banned from a game due to chants for the resignation of Erdogan.<sup>18</sup>

## Painful Medicine

Currency devaluations and rate hikes don't sound like the most attractive investment environment for an outside allocator, but a potential return to a conventional economic policy framework is the painful medicine that could tame inflation, induce exports, balance the country's current account, reduce risk premiums, and ultimately increase Turkey's significant potential for growth.

## Conclusion

For the first time in over a decade, Turkey looks close to electing new leadership. The opposition block has pledged a return to orthodox economic policies. This could be a significant moment in Turkey's history. Though it could lead to a significantly weaker currency and a large spike in interest rates, we believe these moves would ultimately bring credibility back to the country and eventually unlock significant value across its equity market.

## Footnotes

1. Bloomberg LP. COMP [MXTR MSCI Turkey Index]. March 22, 2018 to March 21, 2023.
2. Statista. (2023, Jan 19). Turkey: Age Structure From 2011-2021.
3. Turkey Council of Higher Education. (2023). 10 Reasons to Study in Turkey.
4. Bloomberg. COMP [MXTR MSCI Turkey Index]. Data as of March 19, 2023.
5. Financial Times. (2021, June 11). Dollar Blow for Turkey as Tourism Season Runs into the Sand.
6. Bloomberg LP. ECFC [Turkey]. Data as of March 19, 2023.
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10. Turkish Central Registry data of the Borsa Istanbul as of 3/22/23.
11. Ibid.
12. Al Jazeera. (2023, Feb 25). Death Toll Climbs Above 50,000 after Turkey, Syria Earthquakes.
13. UN News. (2023, Feb 21). 1.5 Million Now Homeless in Turkey After Quake Disaster, Warn UN Development Experts.
14. Politics Today. (2023, March 7). How Turkey's Earthquake Affected the Agriculture and Food Security.
15. Reuters. (2023, March 13). Polls Show Erdogan Lags Opposition by More than 10 Points Ahead of May Vote.
16. Reuters. (2023, March 7). Factbox: Turkey's Anti-Erdogan Bloc Vows to Reverse his Legacy.
17. Ibid.
18. Middle East Eye. (2023, Feb 28). Turkey Bans Fenerbahce Fans From Attending Away Game Following Anti-Government Slogans.

## Glossary

**MSCI Turkey Index:** The MSCI Turkey Index is intended to gauge the performance of large- and mid-cap companies in the Turkish market. As of March 31, 2023, it held 17 constituents and covered about 85% of the equity universe in Turkey.



**Price to Earnings Ratio (PE Ratio):** The current PE Ratio looks at the price of an equity or an index relative to its historic earnings per share for the last twelve months. Similarly, the Forward PE Ratio looks at the price of an equity or an index relative to consensus earnings per share forecasts for the next 12 months.

**Price to Book Ratio (PB Ratio):** The PB ratio looks at the price of an equity or an index relative to the book value of its equity. Book value is often defined as shareholders' equity, which is total assets minus total liabilities.

**MSCI Emerging Markets Index:** The MSCI Emerging Markets Index is designed to capture large- and mid-cap representation from 24 emerging market economies. As of March 31, 2023, it held 1,379 constituents and covered roughly 85% of the free float-adjusted market capitalization in each country.

**S&P 500 Index:** The S&P 500 Index is a market-capitalization weighted index of 500 leading companies in the United States. It is generally considered the best single gauge of large-cap companies in the United States.

**Foreign Direct Investment (FDI):** Foreign direct investment is an ownership stake in a company or project made by an investor from another, outside country.

**Free Float:** Free float refers to shares of a company that are available to the public for trading. It excludes shares that are restricted in any manner, such as those held by insiders.

**Consumer Price Index (CPI):** A consumer price index is a measure of aggregate price levels in a given economy. It is designed to measure inflation by examining the price level of a basket of commonly purchased consumer goods and services.

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