Let's Talk Turkey

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Turkey has received significant press coverage this year, but the attention has been anything but positive. Market sentiment took a turn for the worse due to growing concerns over widening fiscal and current account deficits driven by President Erdogan's stimulative fiscal and monetary policies. The level of consumption that ensued was largely funded by foreign borrowing, but is no longer sustainable as U.S. Dollar interest rates increase and U.S. Dollar funding availability decreases with more restrictive U.S. Federal Reserve monetary policy.

Consequently, the Turkish Lira has rapidly depreciated and the local stock market has taken a tumble, with the MSCI Turkey Index down approximately -30% in U.S. Dollar terms for the first half of the year. Election uncertainty coupled with rising oil prices for the oil importing country have only added to recent woes.

FIGURE 1: PERFORMANCE OF MSCI TURKEY INDEX

Source: MSCI

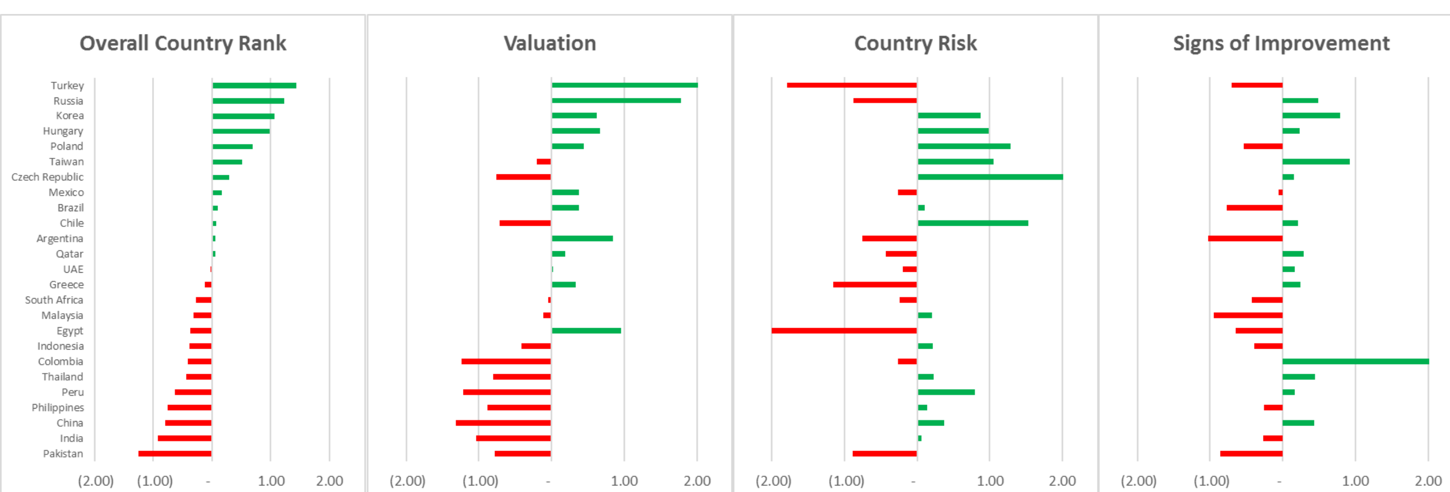
You Did What?

We recently increased our exposure to Turkey within our Emerging Markets Equity strategy. Why would we increase our exposure when the current economic climate is so unfavorable? Simply put, we believe the expectation of a significant financial crisis has already been priced into the Turkish currency and stock valuations. We are confident that anything short of a major financial crisis will produce a favorable financial market response.

In our experience, investors tend to over-react to episodes of economic stress, and liquidate positions without appropriate consideration of long-term economic and business fundamentals. Investors often fail to weigh offsetting factors that may alleviate the given stress, such as potential changes to government policy.

To take advantage of such country level mispricings, our team has constructed a country selection model that seeks to balance stock and currency valuations with country risk and indicators of improvement/deterioration. Our goal is to exploit market forecasting errors by utilizing an analytical process that removes emotional biases from decision making.

The graphic below shows DuPont Capital's current assessment of the Emerging Market Equity universe (as of July 12, 2018), including the overall country rankings, as well as the subcomponents used to calculate the aggregate score. Per our



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model, Turkish equity market valuations are near global financial crisis lows, and the currency is significantly undervalued on a real effective exchange rate basis. While we believe valuations are at an extreme, we need to balance the country's undervaluation with both economic and political risks, as well as the potential for any further deterioration. Even after combining these components, Turkey remains the most attractively valued country in our model.

On a cautionary note, selecting the appropriate companies can be as equally important as the country exposure itself. Turkish companies that are highly leveraged, reliant on U.S. Dollar borrowing, or are vendors of interest rate sensitive durable goods are significantly strained in this adverse environment. Conversely, financially strong companies with U.S. Dollar revenues are less impacted. This year's market sell-off has been broad-based, allowing us to establish or add to positions in financially sound companies. We expect such companies will be less impacted by today's harsh environment, with the potential to share in the upside as sentiment recovers. Our portfolio's Turkish exposure is currently positioned away from negatively exposed sectors, including financials and domestic real estate.

Outlook

While we do not anticipate a quick fix for Turkey's troubles, we expect that a few of the current negative drivers will dissipate during the second half of the year. A decrease in government spending following June's presidential elections and higher consumer borrowing costs will likely reduce the fiscal and current account deficits. These measures should begin to help dampen consumption, moderate inflation, and bring a level of support to the currency. In the interim, an undervalued currency should benefit select segments of the local market, including Turkish export oriented companies. On a positive note, the recent presidential elections brought some level of political stability to the country. Given the overwhelmingly negative sentiment expressed in Turkish financial instruments, even slight improvements such as this have the potential to swing the pendulum in a positive direction.

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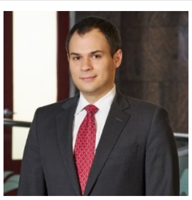

Daniel M. Petruzzi, CFA, is a Senior Equity Analyst in DuPont Capital's Emerging Markets Equity Team. In this capacity, Mr. Petruzzi focuses on the fundamental analysis of the Emerging Markets in Eastern Europe, the Middle East, and Africa. Prior to joining DuPont Capital in 2008, Mr. Petruzzi was an Associate Research Analyst at Delaware Investments and an Investment Strategy Analyst and Alternative Investment Analyst at Lincoln Financial Group. He joined the financial services industry in 2005. Mr. Petruzzi holds a B.S. in Business Administration from Villanova University and is a CFA charterholder.