Investment Strategy Update

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Beware of the Turkish lira's potential impact on gold prices

♦ **Turkish lira dropped 5% against the US dollar and 5.3% against the euro in the past two days.**

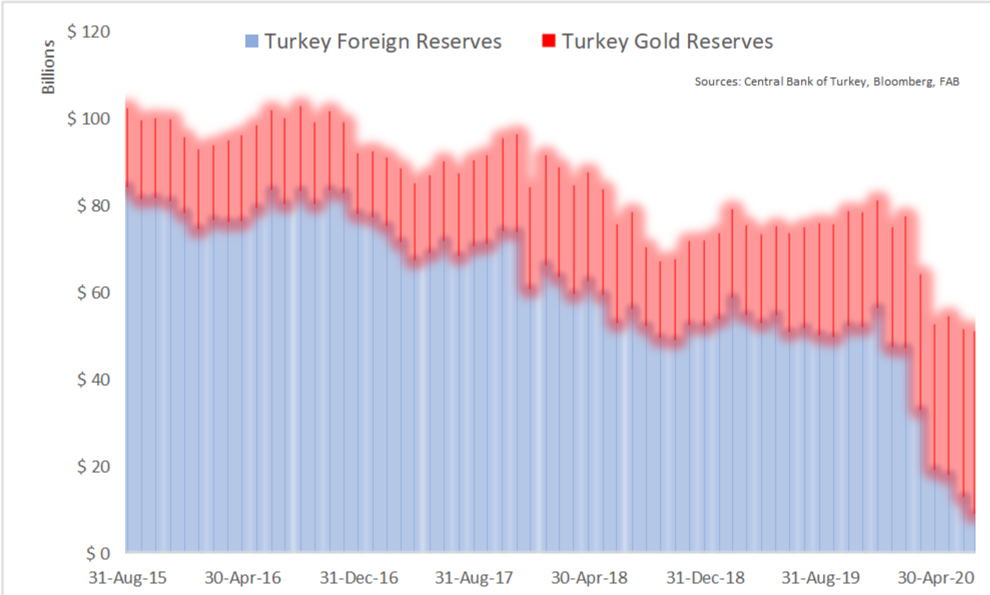
♦ **Turkey has 83% of its foreign currency reserves in gold, one of the highest percentages of the yellow metal in the world.**

♦ **The country has burned through more than a third of its FX reserves this year as it defended the lira.**

♦ **Turkey has sold mostly foreign currency reserves while it continued to build its gold stash.**

♦ **Further selling of the lira could create a ripple effect on other currencies and hit gold prices too.**

♦ **The FAB AAC has recently reduced its overweight position in gold, though it remains bullish about the metal.**



One of the challenges for investors in modern times is that markets are so connected that seemingly unrelated events can have wide-ranging impacts. A sudden sell-off in the Turkish lira is a candidate for that kind of situation.

The Turkish currency has gone on a free-fall in the past two days, having dropped 5% against the US dollar and 5.3% against the euro, reaching all-time lows against both currencies today. The move was sparked by an unintended effect of a recent liquidity squeeze imposed by the central in a bid to control the devaluation of the lira, which began in 2018.

The sharp move has already started to impact other emerging market currencies but could soon spread wider.

The South African rand, which suffers from some of the same ailments as Turkey (current account deficits and high debt) and is also a carry-trade favourite, has started to sink, down 2.3% in the past two days. Based on previous moves of this kind, the next candidates would be the Brazilian real and the Indonesian rupiah, though those are yet to feel the impact.

Perhaps the asset at the biggest risk of being dragged into the lira cyclone is gold. Turkish banks are allowed to hold gold as liquid reserves — one of the few countries that allows that — and could sell gold to meet foreign currency payments if the lira continues to drop. More importantly, the Turkish central bank's foreign exchange reserves are heavily concentrated in gold.

As of 24 July, the latest data available, almost 83% of Turkish foreign reserves were held in gold, the highest such percentage in recent history. This means that if the central bank has to burn reserves to protect the lira it will sell gold.

Turkey has burned through 37% of its reserves this year, but has not touched its gold

Such a large seller of gold could push the price down, particularly as the yellow metal's price has just breached through several resistances which, on its own, could already have prompted some profit-taking. This happened in 2018, when the central bank sold roughly 5 million ounces of gold between June and October as it tried to slow down the lira's depreciation.

This year, the Turkish central bank has already burned through about 37% of its FX reserves, but it has chosen to keep its gold. In fact, in ounces, the amount of gold Turkey holds is higher than at the end of 2019. The seeming bet on the yellow metal has worked out well as it rose 35% year-to-date. With the lira under pressure, however, Turkey's central bank may have to sell, and that could hit gold prices.

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