Emerging Markets
4 October 2016

MonitorING Turkey

Fiscal loosening?

The authorities seem determined to offset a slowdown in private investment on the back of elevated interest rates and a lower credit impulse by relaxing macroeconomic policies. Accordingly, fiscal policy is set to see some loosening. Given this backdrop, the government also raised taxes in September on fuel to ensure any loosening remains under control.

- Almost all high-frequency indicators released in August displayed a softening with the exception of consumer confidence, while CUR and business confidence in September recorded some recovery. Given the slowdown in 2Q growth and significant evidence for extension of weakness into 3Q, we further revise down our 2016 GDP forecast from 3.5% to 3.2%.
- We expect the CBT to complete the simplification in October, cutting both the upper lending and lower borrowing rate by 25bp to 8.0% and 7.0%, respectively (in turn making the corridor symmetric around the 7.5% repo rate). Changes in the September MPC statement hint at the increasing likelihood of more than expected policy easing, though this remains an open question after Moody's move, and will be dependent on TRY spot moves and the global environment.

FX and Money Markets: The initial currency reaction was relatively muted after Moody's downgrade decision on 23 September, though USD/TRY has increased above the 3.00 level since then. The direction of USD/TRY in coming weeks will depend on: (1) the extent of outflows from the local bond market (triggered by the sovereign rating downgrade) and (2) the way any TRY decline will be faded by domestic residents.

Domestic Debt and Rates: Given (a) the relatively limited TRY reaction since the downgrade and (b) experience from the post July coup world where the CBT continued its easing cycle (it even cut the upper band less than one week after the coup attempt), it suggests that the outlook for TURGBs may not be bleak as evidenced by the recent strong demand of the Treasury's auctions and consequent strength in yields.

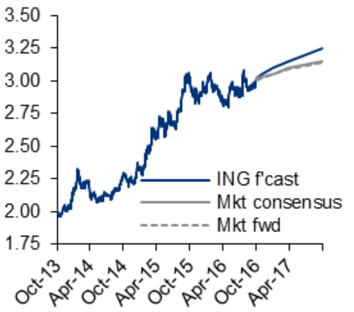
External Debt: TURKEY US$ at the front end (up to 2025 maturity) is still very concessional to BB+ peers (RUSSIA, AZERB), and even vs BB such as BRAZIL. With no Fitch review planned before year-end (the last downgrade to junk risk), external accounts rebalancing is likely to find further solace in consolidating oil prices (ING's call for Brent at US$40/bbl on avg in 1Q17), and a rather modest YTD total returns performance vs peers (6% vs RUSSIA's 13%), we continue to favour TURKEY '22s vs RUSSIA '22s.

Quarterly forecasts

	2Q16	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F	1Q18F
Real GDP (%YoY)	3.1	1.7	3.7	3.5	3.8	3.9	3.9	3.3
CPI (%YoY) eop	7.6	8.1	8.2	8.7	8.5	7.9	7.5	7.4
Central bank key rate (%) eop	7.50	7.50	7.50	7.50	8.00	8.00	8.50	8.50
3m interest rate (%) eop	9.50	9.13	9.12	9.26	9.40	9.54	9.67	9.82
10yr yield (%) eop	9.22	10.38	10.03	10.85	10.59	10.59	11.18	11.12
Exchange rate (USD/TRY) eop	2.88	2.99	3.10	3.15	3.20	3.25	3.30	3.38
Exchange rate (EUR/TRY) eop	3.16	3.23	3.41	3.53	3.68	3.84	3.96	4.22

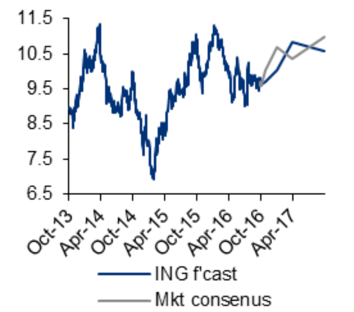
Source: Macrobond, ING estimates

USD/TRY



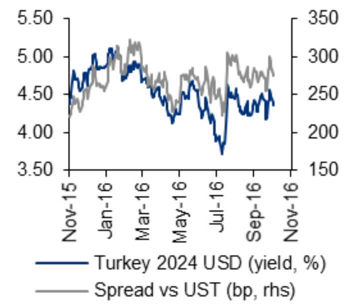
Source: Macrobond, ING estimates

Local 10Y yields



Source: Macrobond, ING estimates

US$ Eurobond 10Y



Source: Bloomberg, Reuters

Latest indicator surprises

Output	Negative
Consumption	Negative
Inflation	Lower
External	Positive
Budget	Neutral

Source: Bloomberg

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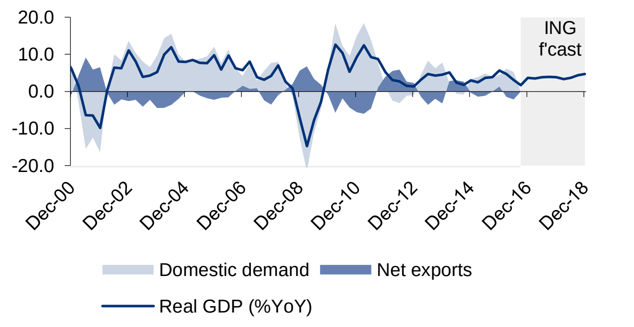
Fig 1 Real GDP (%YoY) and contributions (ppt)

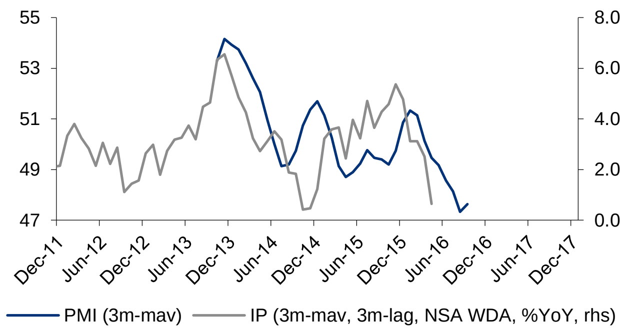


Source: Macrobond, ING estimates

Downside surprise in 2Q16 growth

- GDP grew by 3.1% YoY in 2Q16, lower than the market consensus at 3.4%, pulling annualised growth down to 4.3%. Private consumption remained the major contributor along with public spending, while net exports continued to drag.
- Private consumption added 3.4ppt to the headline, albeit dropping from 4.9ppt in 1Q. Public consumption continued growing fast, pulling the headline up by 1.7ppt, the highest since the global crisis. Strength in domestic demand is attributable to supportive labour market conditions given the government's fulfilment of election promises, the CBT's simplification process, which includes some policy easing, and resilient consumer confidence that slightly improved over 1Q.

Fig 2 IP vs PMI

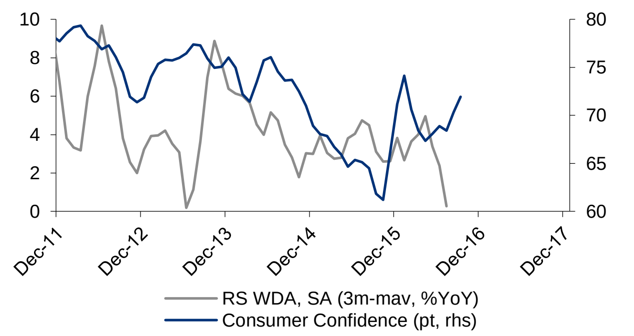


Source: Macrobond, ING estimates

IP plunged in July

- The IP index (calendar adjusted) was much lower than expectations with a -4.88% YoY change, a negative reading for the first time since Jan-15. Among broad economic categories, production in all groups contracted in July MoM, while consumption along with significant declines in nondurable and durable consumer goods production signals a slowdown following the relatively buoyant performance in early 2016. Capital goods production on the other hand plunged, indicating still weak investment appetite.
- Overall, the first hard data pertaining to the growth performance in 3Q which likely incorporate the partial impact of the 15 July events show further weakness following signals of the slowdown in 2Q.

Fig 3 Retail sales vs consumer confidence

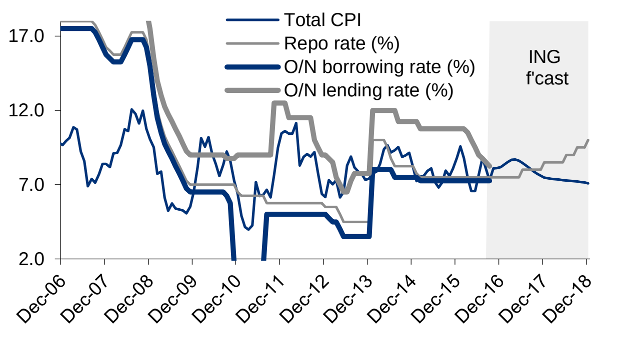


Source: Macrobond, ING estimates

Unemployment (SA) rose to the highest since 4Q10

- On a seasonally adjusted (SA) basis, the unemployment rate jumped to 10.9%, its highest since Sep-10, from 10.3% a month ago. Following a relatively benign outlook in 4Q15 and 1Q16, the deterioration in 2Q16 is due to a drop in the number of employed especially in June despite continuing expansion in the labour force.
- Overall, the unemployment rate adopted an uptrend in recent months in line with some momentum loss in the 2Q activity. Given relatively downbeat macro picture painted by most of the 3Q indicators, the labour market is likely to remain under pressure in the 2H, though further in easing economic policies should limit the expected deterioration to some extent.

Fig 4 CPI vs policy rate

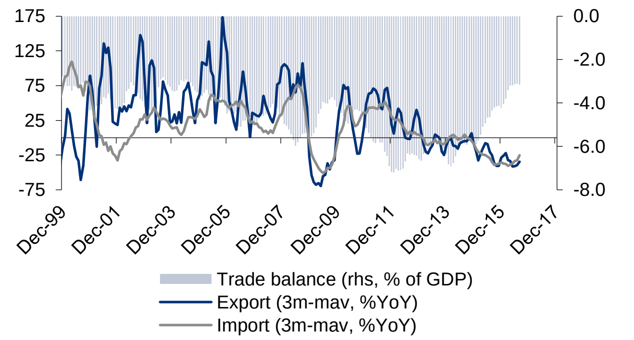


Source: Macrobond, ING estimates

Better than expected September inflation

- CPI increased by 0.18% in September, better than the market consensus, pulling annual inflation down sharply to 7.28% from 8.05% a month ago. This is attributable to a further downward correction in food prices after a marked drop in August as well as more-than-expected seasonal price declines in clothing, while recent tax adjustment in fuel prices limited disinflation.
- The Domestic Producer Price Index rose by 0.29%, while annual inflation dropped significantly to its lowest level since Apr-13 at 1.78%, from 3.03% in August, indicative of relatively subdued producer-driven cost pressures on consumer prices. In the breakdown, the basic metals contributed to the benign reading.

Fig 5 Trade balance (3m, % of GDP)

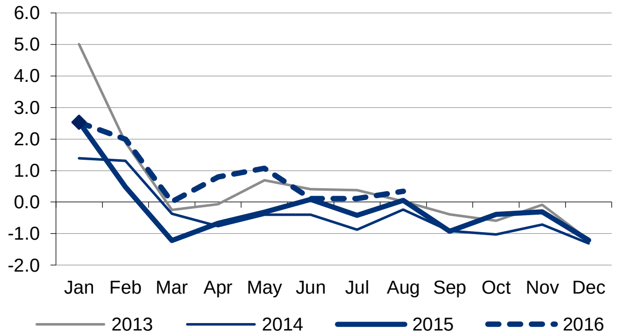


Source: Macrobond, ING estimates

Slight improvement in August trade balance

- The foreign trade deficit, at USD4.7bn in August, cut the 12M rolling deficit to USD55.6bn, the lowest in six years, and maintained the downtrend since end-2013. Following an extra sharp drop in July likely due to disruption from the 15 July events, both exports and imports recorded positive growth rates in August.
- Coverage of imports by exports further improved to 71.8%, showing the impact of contribution from soft energy prices – with net energy trade at its lowest on an annual basis since end-2006, better penetration in to the Eurozone and strong gold trade, despite the adverse impact of geopolitical risks. Finally, the 12M core trade deficit (excluding gold & energy) widened slightly in August.

Fig 6 Budget performance YTD (% of GDP)

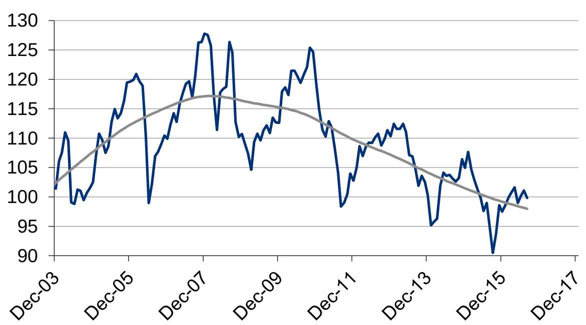


Source: Macrobond, ING estimates

August budget slightly deteriorates year-on-year

- The central administration budget balance recorded a strong TRY3.6bn surplus in August, though partially down vs the same month of last year, with a TRY+5.2bn reading. The monthly outcome shows hefty revenue generation (20.9% YoY), while primary spending maintained its uptrend with 25.0% YoY growth, and a jump in interest expenditures by 34.0% YoY on the back of the uneven payment structure of Treasury debt.
- Fiscal policy is set to see some loosening given a recently announced incentive package, while further incentives are also likely. Given this backdrop, the government also raised taxes in September on fuel to ensure any loosening remains under control.

Fig 7 FX: REER vs trend (index, ppt)

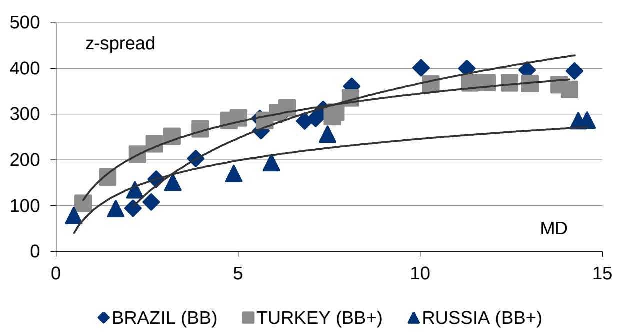


Source: Macrobond, ING estimates

The CBT maintained the easing mode

- In Sep MPC, the CBT carried on upper band cuts by another 25bp to 8.25%, while keeping the policy rate and lower band unchanged at 7.50% and 7.25%. The ongoing benign global environment and relative TRY stability supported such a move, along with the better-than-expected August inflation on the back of downward corrections in food prices and seasonal price declines in clothing.
- A significant change in the key statement that "cautious monetary policy stance will be maintained" while the CBT was defining its policy stance as "tight" a month ago, not surprising given the ongoing rate and macro prudential easing, with continuing focus on tight financial conditions.

Fig 8 External debt: TURKEY US$ curve



Source: Macrobond, ING estimates

Cheap front end

- TURKEY US$ z-spreads tightened on average over the past (volatile) month, in spite of Moody's downgrade to junk.
- Turkey is still very concessional to BB+ peers (RUSSIA, AZERB), and even vs BB such as BRAZIL up to the 2025 maturity. Further rating downgrade this year is unlikely (Fitch on BBB- negative outlook but no review scheduled before year-end), the external accounts should continue rebalancing (slower imports/ING's oil forecast of US$40/bbl by 1Q17) and YTD avg total return of 6% vs 13% for Russia could offer a "buffer" vs profit taking mood.
- We like the TURKEY 6.25% '22s vs RUSSIA 4.5% '22 trades. The spread on both credits is close to its historical high.

Contribution from Dorothée Gasser-Châteauvieux, Chief Economist EMEA,

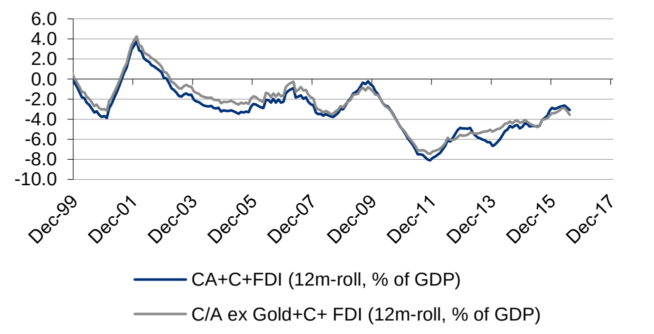
Fig 9 Main macroeconomic recent releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Jul	75.7	Aug	75.2	Sep	76.6		-
Industrial Confidence	Jul	108	Aug	103.6	Sep	106.5		-
Industrial Production (SA WDA, MoM%)	May	1.6	Jun	-1.3	Jul	-7.0	-	-1.0
Industrial Production (WDA, YoY%)	May	5.6	Jun	1.25	Jul	-4.9	-	1.3
Consumer Confidence	Jul	67.03	Aug	74.44	Sep	74.3		-
Unemployment Rate (%)	Apr	9.3	May	9.4	Jun	10.2	+	9.8
GDP (SA WDA, QoQ%)	4Q	1.1	1Q	0.7	2Q	0.3	-	0.5
GDP (YoY%)	4Q	5.7	1Q	4.7	2Q	3.1	-	3.7
GDP (WDA, YoY%)	4Q	4.5	1Q	4.4	2Q	3.0	-	3.9
Core CPI (YoY%)	Jul	8.7	Aug	8.4	Sep	7.7	-	8.0
CPI (YoY%)	Jul	8.8	Aug	8.1	Sep	7.3	-	7.9
PPI (YoY%)	Jul	4.0	Aug	3.0	Sep	1.8	-	2.7
1W Repo Rate announcement (%)	Jul	7.50	Aug	7.50	Sep	7.50		7.50
Overnight Borrowing Rate announcement (%)	Jul	7.25	Aug	7.25	Sep	7.25		7.25
Overnight Lending Rate announcement (%)	Jul	8.75	Aug	8.50	Sep	8.25		8.25
Trade Balance (US$bn)	Jun	-6.6	Jul	-4.8	Aug	-4.7	+	-4.7
Current Account (US$bn)	May	-3.2	Jun	-5.0	Jul	-2.6	+	-2.7

Source: Bloomberg

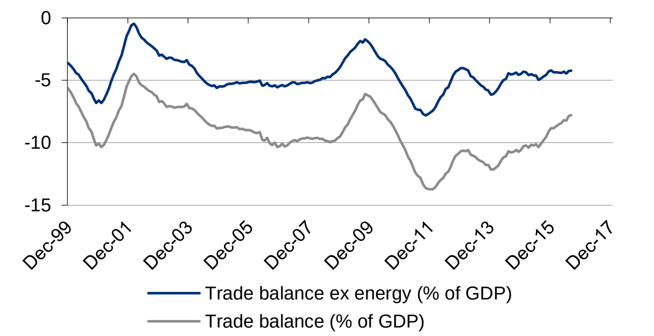
Additional charts

Fig 10 C/A (annual; % of GDP)



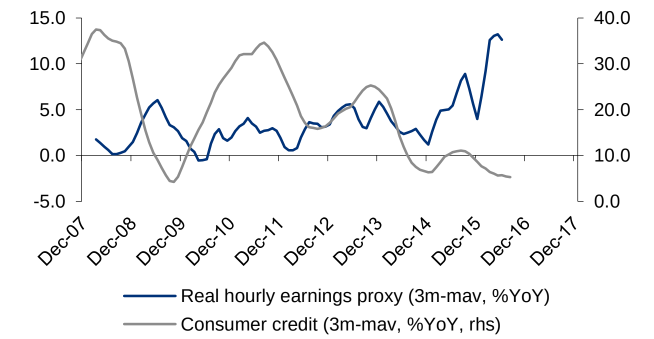
Source: Macrobond, ING estimates

Fig 11 Trade balance (annual; % of GDP)



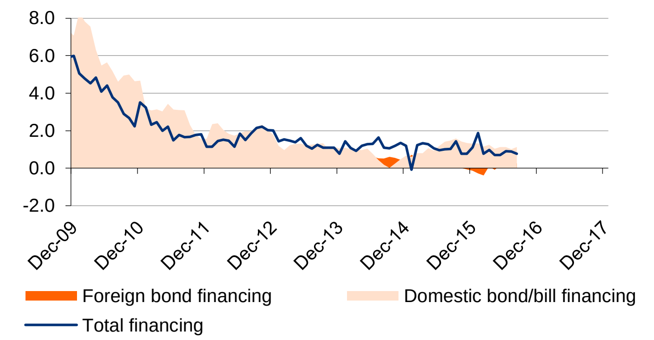
Source: Macrobond, ING estimates

Fig 12 Real wages growth (%)



Source: Macrobond, ING estimates

Fig 13 Central govt borrowing (annual; % of GDP)



Source: Macrobond, ING estimates

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