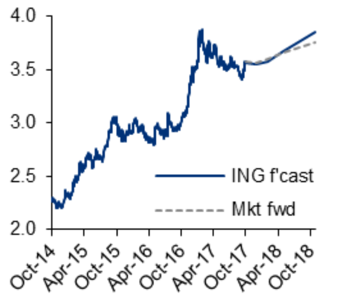
Emerging Markets
4 October 2017

USD/TRY

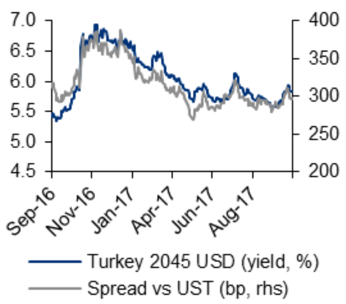


Source: Reuters, ING estimates

Local 10Y yields

Source: Reuters, ING estimates

US$ Eurobond 30Y



Source: Reuters, ING estimates

Latest indicator surprises

Output	Positive
Consumption	Positive
Inflation	Higher
External	Positive
Budget	Neutral

Source: Bloomberg

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Further fiscal support in the Medium Term Plan

In 2017, accelerated spending and significant drops in non-tax income have weighed on performance, though providing a lift to growth. In its Medium Term Plan (MTP) for 2018-20 the government anticipates a less ambitious fiscal performance than previously, showing the determination of the authorities to support economic activity by maintaining relaxed macroeconomic policies and stimulating domestic consumption.

- The favorable impact of the credit guarantee fund (CGF) and temporary tax cuts supported the economy in 2Q17. 3Q17 performance will likely be robust again with improving tourism, accelerating exports and supportive base effects. Despite expected momentum loss in 4Q17 with withdrawal of some expansionary fiscal measures and the ongoing tight monetary stance, early indicators suggest risks to the upside for this year. We expect 5.0% growth for 2017 and 3.8% for 2018.
- The CBT has consistently signaled that it would refrain from early easing and keep its current tight liquidity stance. It seems current price dynamics worry the CBT, it consistently mentioning the possibility of further tightening if needed. The bank also closely watches currency stability, a key driver of inflation stability and consumer confidence. So, the CBT will likely not make any change in its policy stance in the near term, though with CPI inflation peaking and forecast to see a marked drop by 1Q18 as the negative FX base effect wears off, market focus will turn to the likely easing cycle.

FX and Money Markets: A carry-friendly external environment and general USD weakness has contributed to recent TRY performance, also supported by growth resilience and monetary policy tightness, though ongoing escalation in geopolitical concerns has weakened the currency in recent weeks, along with the September FOMC announcement. External imbalances, a reviving inflation uptrend and expected momentum loss in activity argue in favor of a cautious approach, though the global backdrop and geopolitical risks are key in TRY's performance.

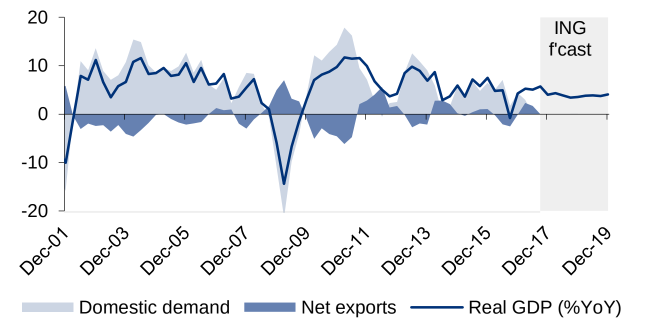
Domestic Debt and Rates: Supply pressure is an issue as the domestic debt roll-over ratio has already risen to close to 130% in the first nine months of 2017, with a possibility of further increases in the remainder of the year as the Treasury's domestic borrowing strategy for Oct-Dec shows a c.145% rollover ratio. With annual inflation to drop meaningfully in early 2018 on large base effects, the CBT is likely to embark on a cautious normalization, gradually cutting average funding costs. This should be a key theme of 4Q17/1Q18 as forward-looking investors pre-position for the event.

Quarterly forecasts

	2Q17	3Q17	4Q17F	1Q18F	2Q18F	3Q18F	4Q18F	1Q19F
Real GDP (%YoY)	5.1	5.7	4.0	4.3	3.9	3.4	3.5	3.8
CPI (eop, %YoY)	10.9	11.14	9.7	7.8	7.9	7.7	8.0	7.8
Central bank key rate (eop, %)	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
3m interest rate (eop, %)	12.71	12.74	11.74	10.67	10.86	11.00	10.97	10.71
10yr yield (eop, %)	10.53	10.83	10.71	9.75	9.93	10.05	10.33	10.26
USD/TRY exchange rate (eop)	3.52	3.55	3.55	3.64	3.73	3.82	3.90	3.98
EUR/TRY exchange rate (eop)	3.94	4.26	4.26	4.37	4.66	4.85	5.07	5.21

Source: Reuters, ING estimates

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

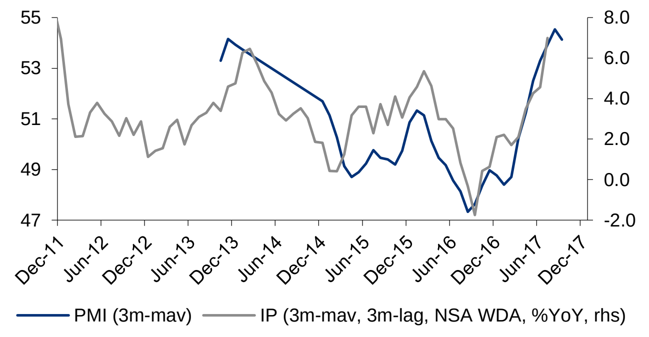


Source: TurkStat, ING estimates

Further strong growth in 2Q

- GDP expanded by 5.1% YoY in 2Q17. Private consumption again turns out to be a major driver thanks to continuing improvement in consumer confidence, with stabilization in the currency and the impact of stimulus measures as well as easing macro prudential measures supportive for households in accessing bank financing.
- Fixed investment gained further strength with the support of the credit guarantee fund (CGF). The composition shows the performance mainly stemmed from construction, while machinery has remained very weak – leading to increased concerns about long-term growth prospects. Net trade contributed significantly positively with improving export performance.

Fig 2 IP vs PMI

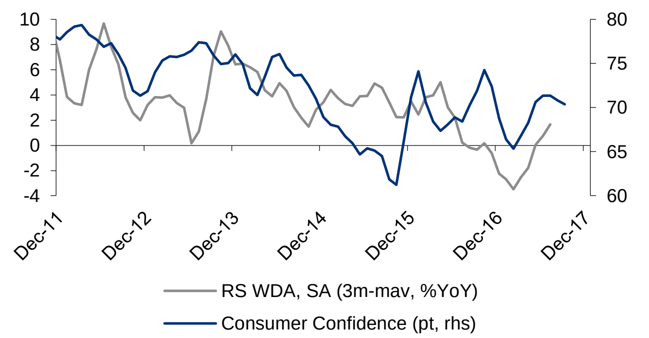


Source: Markit, TurkStat, ING estimates

Jump in July IP

- The seasonal and calendar adjusted (SA) IP index recorded a strong rebound at 2.29%, the highest sequential reading since Oct-16, continuing the strong performance of 1H.
- Production in all broad economic categories rose markedly. Intermediate and energy stood out with the highest sequential growth rates at 2.71% and 2.66% respectively. Capital goods production maintained a strong pace at 2.11% MoM, showing the impact of boosted credit expansion attributable to the support of the CGF. After a contraction in June, both durable and nondurable consumer goods saw healthy growth rates at 1.55% MoM and 0.96% MoM, hinting at continuing demand in 3Q.

Fig 3 Retail sales vs consumer confidence

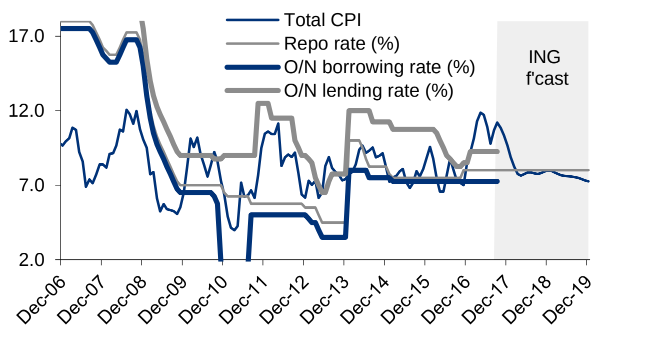


Source: TurkStat, ING estimates

Unemployment rate returning to recovery

- The seasonally adjusted unemployment rate recovered in 1H17 and stood at 11.1% in June, the lowest in a year. Following a temporary diversion from the downtrend in May, with measures taken by the government and strong recovery in the economy, unemployment resumed its improvement in June despite the increase in labour force participation to all-time highs, standing at 52.7%. The unadjusted unemployment rate in Jun-17 remained practically unchanged vs the same month of last year, at 10.2%.
- The improvement is set to continue, given that 3Q activity will likely be robust again with improving tourism, accelerating exports and supportive base effects.

Fig 4 CPI vs policy rate

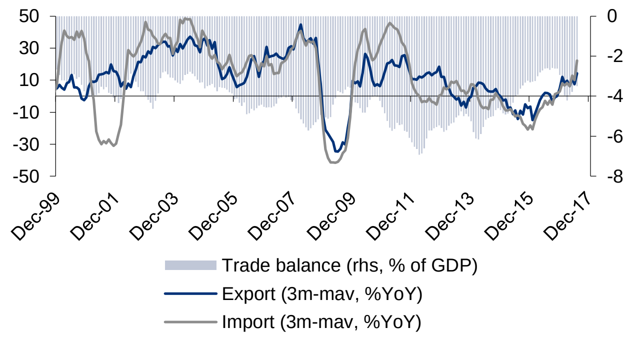


Source: CBT, ING estimates

Continued uptrend in core inflation

- CPI at 0.65% MoM in September was aligned with our call, but lower than consensus at 0.75%. Following the end in the headline disinflation trend last month, annual inflation increased further to 11.2%, from 10.7% a month ago. Price hikes were spread across all categories with the exception of declines in the food group.
- Core inflation, the "C" indicator, recorded a 0.88% change, pulling the annual figure up to 11.0%, its highest since early 2004. The data show continuation of the impact from the currency and strong economic activity, as core figures stay elevated with no clear sign of downtrend. Methodology change in the weighting system for clothing also contributed to the monthly increase.

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

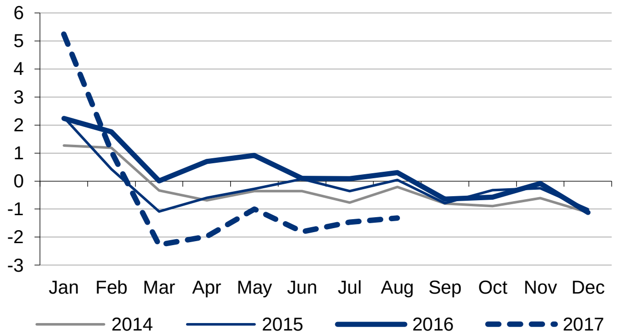


Source: TurkStat, ING estimates

12M rolling trade deficit maintained widening

- The foreign trade deficit came to USD5.9bn in August, while the 12M rolling deficit stood at USD64bn, the highest since Nov-15. Following a surge in imports, by 46.3% YoY in Jul due to calendar effects, we saw further double digit growth at 15.3% YoY (-7.5% on a sequential basis). Exports, maintaining the recovery in recent months, rose by 12.3% YoY (+2.6% MoM), translating into a 22.8% YoY expansion of the merchandise trade deficit.
- As a result, coverage of imports by exports on a 12M rolling basis dropped to 70.4%. The monthly data show the impact of less supportive net gold trade and a growing energy bill, despite a relatively flat core trade deficit (excluding gold and energy).

Fig 6 Budget performance YTD (% of GDP)

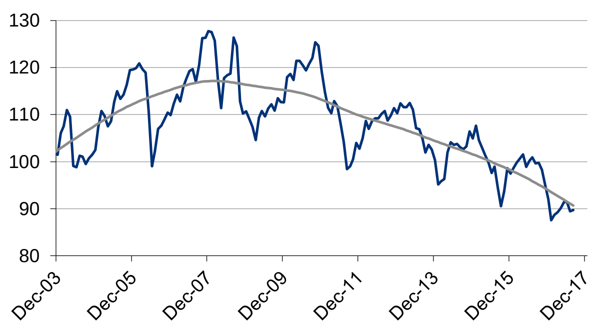


Source: Ministry of Finance, ING estimates

Another weak budget reading

- The monthly outcome shows double digit growth in revenue generation (by 12.5% YoY), thanks to a stronger than expected recovery in the Turkish economy. Momentum in primary expenditures was even stronger with a 23.6% YoY rise, showing a continuation of the deteriorating spending pattern this year.
- On a cumulative basis, the budget balance was in deficit by TRY25.2bn in the first eight months, vs a TRY4.9bn surplus in the same period of 2016, showing the extent of the deterioration, while the primary surplus fell by 68%. We see an ongoing expansion in the deficit to its highest since the global crisis in TRY terms, notwithstanding collections from tax amnesty and debt restructuring.

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



Source: CBT, ING estimates

CBT remains on hold

- At the September rate-setting meeting the CBT kept all rates unchanged, in line with the ING forecast and the unanimous consensus expectation. In other words, the CBT has not made any meaningful change and maintained its defensive stance.
- All in all, the CBT maintained its tight liquidity stance, given the expected increase in inflation until December reflecting continuing core pressure. It reiterated its commitment to tight monetary conditions until there is a marked improvement in the inflation outlook. Robust real growth dynamics as well as stickiness in inflation expectations should continue to make the CBT refrain from early easing, despite the ongoing recovery in TRY.

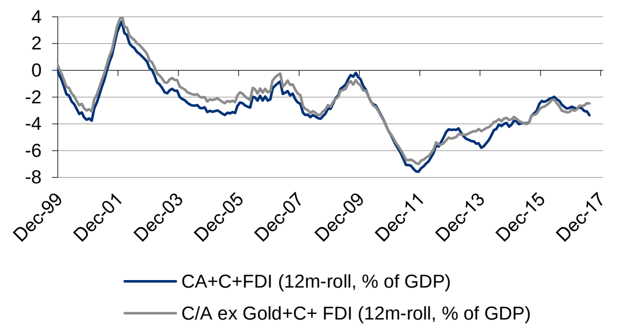
Fig 8 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilization (%)	Jul	78.7	Aug	78.8	Sep	79		-
Industrial Confidence	Jul	109.5	Aug	110.7	Sep	111.6		-
Industrial Production (SA WDA, MoM%)	May	-1.4	Jun	-0.3	Jul	2.3	+	0.8
Industrial Production (WDA, YoY%)	May	3.5	Jun	3.4	Jul	14.5	+	9.7
Consumer Confidence	Jul	71.3	Aug	71.1	Sep	68.7		-
Unemployment Rate (%)	Apr	10.5	May	10.2	Jun	10.2	-	10.4
GDP (YoY%)	Q4	3.5	Q1	5.0	Q2	5.1	+	3.7
GDP (WDA, YoY%)	Q4	3.5	Q1	5.2	Q2	5.0	+	3.9
Core CPI (YoY%)	Jul	9.6	Aug	10.2	Sep	11.0	+	10.5
CPI (YoY%)	Jul	9.8	Aug	10.7	Sep	11.2	+	11.1
PPI (YoY%)	Jul	15.5	Aug	16.3	Sep	16.3	-	16.6
1W Repo Rate (%)	Jun	8.00	Jul	8.00	Sep	8.00		8.00
Overnight Borrowing Rate (%)	Jun	7.25	Jul	7.25	Sep	7.25		7.25
Overnight Lending Rate (%)	Jun	9.25	Jul	9.25	Sep	9.25		9.25
Trade Balance (USDbn)	Jun	-6.0	Jul	-8.9	Aug	-5.9	+	-5.9
Current Account Balance (USDbn)	May	-5.3	Jun	-3.8	Jul	-5.1	+	-5.5

Source: Bloomberg

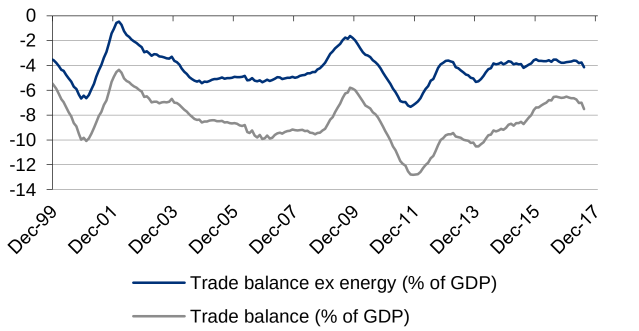
Additional charts

Fig 9 C/A (annual; % of GDP)



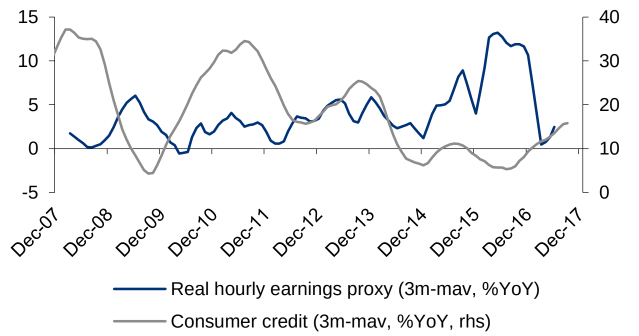
Source: CBT, ING estimates

Fig 10 Trade balance (annual; % of GDP)



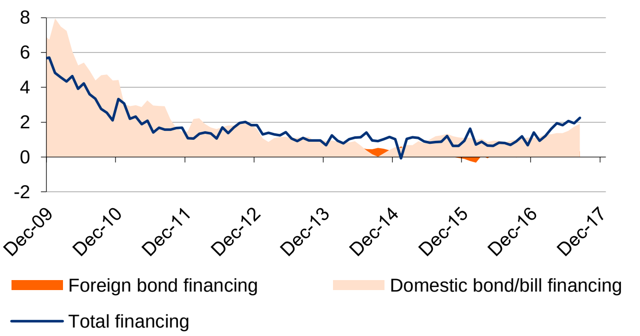
Source: TurkStat, ING estimates

Fig 11 Real wages growth (%)



Source: TurkStat, BRSA, ING estimates

Fig 12 Central govt borrowing (annual; % of GDP)



Source: Treasury, ING estimates

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