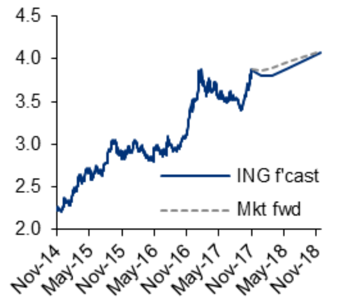
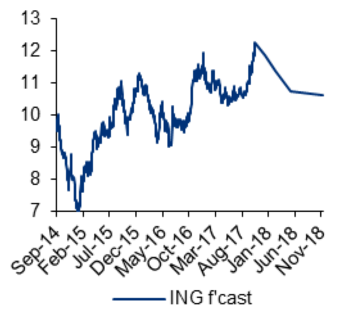
Emerging Markets
6 November 2017

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	Negative
Inflation	Higher
External	Positive
Budget	Positive

Source: Bloomberg

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MonitorING Turkey

More hawkish CBT

The CBT has struck a more hawkish tone recently and signalled that it would maintain hawkishness with a tightening bias, with continuing deterioration in headline inflation and core indicators, strong economic activity, and weakening pressure on the TRY in recent days. This implies that the bank will not ease for a long time since even in an optimistic scenario headline inflation should not show a sustained drop, while the CBT sounds more determined to implement further monetary tightening if any significant TRY underperformance.

- Given worsening inflation dynamics and ongoing currency weakness, with more than 10% TRY depreciation since mid-September and a higher than expected October reading, we have revised our 2017 inflation forecast up to 10.3%, while seeing end-2018 inflation at 8.4% (previously 8.0%).
- The CBT expects a continuation of robust performance in 3Q17 spreading to more industries, with continuing support from accommodative measures, while, after a long sluggish period, machinery & equipment investments signal some recovery. The latest indicators hint at strong 3Q growth also, with the contribution of a low base in the same period of 2016. Accordingly, we expect 5.3% this year, albeit with some softening in 2018 to 3.8%, given a fading credit impulse and reversal in some fiscal measures.
- The latest foreign data showing accelerating imports hint at some widening in the external deficit in the remainder of this year. So, we expect the current account deficit to GDP ratio to stand at 4.9% this year, with some improvement in 2018 on the back of moderating activity and an ING expectation of some softening in the oil price.

FX and Money Markets: TRY has depreciated markedly vs. USD and has been amongst the worst performing EM currencies on the back of bottoming US rates, ongoing geopolitical risks and a worsening inflation outlook. Despite the attractive valuation in REER terms being likely to return to long term lows again on recent price action, bouts of pressure will likely continue, given Turkey's idiosyncratic risks and vulnerability to shifts in risk appetite toward EM countries. The CBT's liquidity measures - adjusting the reserve option mechanism - provide some support for TRY to stabilize.

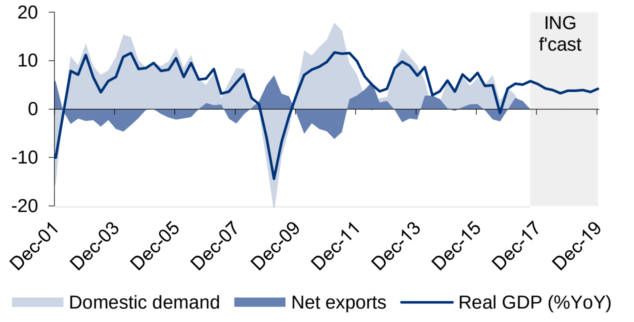
Domestic Debt and Rates: Turkish bonds will likely underperform in the near term, given the CBTs maintenance of a tight policy stance in response to a deteriorating inflation outlook, TRY weakness and ongoing supply pressure on high rollover rates. Vulnerability of TRY assets to volatility in international markets will not help yields either.

Quarterly forecasts

	2Q17	3Q17	4Q17F	1Q18F	2Q18F	3Q18F	4Q18F	1Q19F
Real GDP (%YoY)	5.1	5.8	5.2	4.3	3.9	3.3	3.8	3.8
CPI (eop, %YoY)	10.9	11.20	10.3	8.5	8.7	8.5	8.4	8.1
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	12.81	12.58	11.73	11.15	10.90	11.01	10.74
10yr yield (eop, %)	10.53	10.97	11.88	11.12	10.62	10.46	10.67	10.60
USD/TRY exchange rate (eop)	3.52	3.56	3.80	3.84	3.91	4.00	4.10	4.18
EUR/TRY exchange rate (eop)	3.94	4.28	4.48	4.61	4.89	5.09	5.33	5.47

Source: Reuters, ING estimates

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

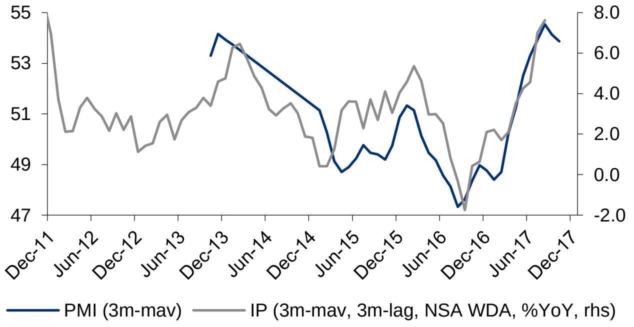


Source: TurkStat, ING estimates

Growth to be strong in 2017

- Growth this year is to be above 5%, with further acceleration in 3Q as evidenced by the latest indicators, though to lose some momentum in the last quarter with fading impact of fiscal stimulus and slowdown in credit expansion. The government sees continuation of this performance at 5.5% each year until 2020 driven by robust private consumption and relatively strong investment demand, while net exports remain supportive.
- Corporate lending has decelerated in 3Q17 with the Credit Guarantee Fund facility nearing the ceiling, though consumer loans have remained on an upward path given strength in domestic demand & continuing effects of macro prudential easing.

Fig 2 IP vs PMI

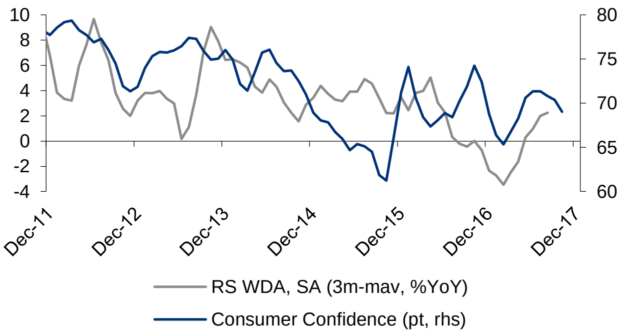


Source: Markit, TurkStat, ING estimates

IP close to the consensus in August

- The industrial production index (calendar-adjusted) was broadly in line with market consensus at 5.1%, with a 5.2% YoY increase in August on solid expansion in manufacturing. On the other hand, following a strong 2.30% reading in July, the seasonal and calendar adjusted (SA) IP index was practically unchanged while the performance in the first two months of 3Q17 shows some deceleration over the strong 1.9% QoQ reading recorded in 2Q17.
- Overall, the IP in 3Q17 hints that the recovery that started in the last quarter of 2016 is continuing, driven by policy measures such as macro-prudential easing, the credit guarantee fund facility and supportive fiscal stance, along with buoyant external demand.

Fig 3 Retail sales vs consumer confidence

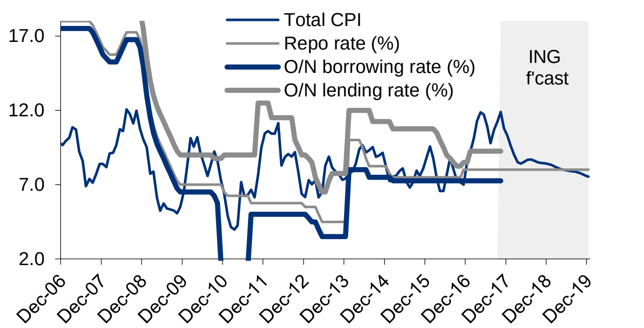


Source: TurkStat, ING estimates

Increase in July unemployment rate

- The seasonally adjusted unemployment rate recovered in the first half of 2017 with measures taken by the government to support the labour market and strong recovery in the Turkish economy. It stood at 11.2% in July, a slight increase on a sequential basis vs 11.1% a month ago.
- Despite continuing employment gains in July, the further rise in labour force participation to an all-time high at 52.9% was the main reason for an unfavourable unemployment rate. On the flipside, the unadjusted unemployment rate remained practically unchanged vs the same month of last year at 10.7%, reflecting the weak outlook in the labour market.

Fig 4 CPI vs policy rate

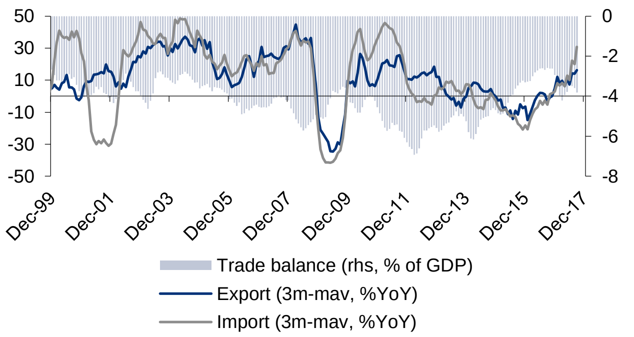


Source: CBT, ING estimates

Inflation surprises to the upside in October

- October inflation came at 2.08% in October driven by reversal of tax cuts introduced to support growth this year, further negative impact of methodology change in clothing, higher energy prices, ongoing TRY weakness and consequent pass through as well as robust domestic demand. Accordingly, annual inflation hit 11.9%, while upside surprise in core continued and reached its highest since early 2004, at 11.8%.
- Annual inflation is to follow a downward trajectory from December until April, reflecting the strong base, while the CBT expects monetary policy to become more effective, with the contribution of decelerating demand due to expiring stimulus measures.

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

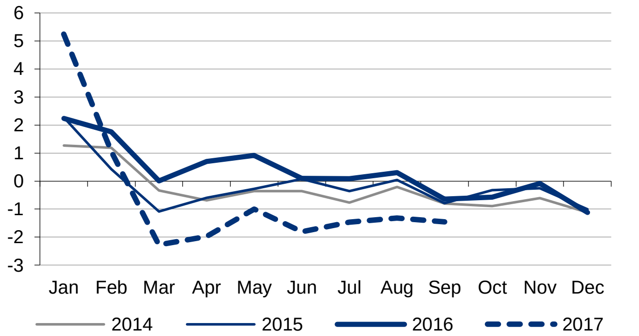


Source: TurkStat, ING estimates

12M rolling trade deficit maintained widening

- The foreign trade deficit came to USD8.1bn in September, while the 12M rolling deficit that has been going up in the last six months stood at USD67.8bn, the highest since Oct-15. Imports maintained double digit growth at 30.6% YoY, while exports, strong in recent months, moderated somewhat to 8.7% YoY, translating into a sharp 85.0% widening of the merchandise trade deficit vs the same month of the previous year.
- Coverage of imports by exports on a 12M rolling basis recorded a drop to 69.4%. Monthly data show the impact of less supportive net gold trade and a growing energy bill, while the core trade deficit that was relatively flat this year recorded a strong increase.

Fig 6 Budget performance YTD (% of GDP)

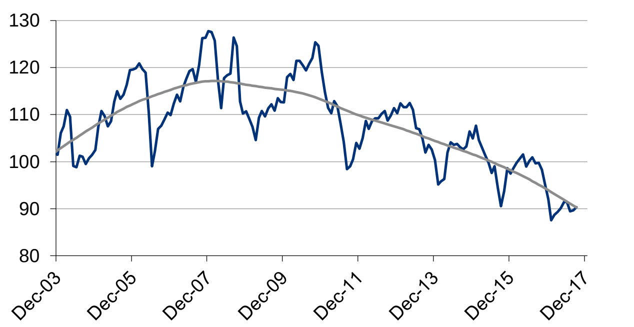


Source: Ministry of Finance, ING estimates

Lower budget deficit in September

- The monthly central administration budget in September saw some improvement on the back of robust tax collection and contraction in primary spending, despite significant expansion in interest expenditures.
- The MTP sees the budget balance/GDP ratio at -1.9% for 2018 and to this end the government has been working on a revenue boosting package. To keep fiscal metrics in line with the MTP, the government decided to hike corporate tax (from 20% to 22%) for three years. The steps announced by the Minister of Finance to compensate for the expected increase in defence expenditures hint at an inclination to keep the budget deficit under control.

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



Source: CBT, ING estimates

The CBT to decisively maintain tight stance

- At the October MPC the CBT kept rates on hold and maintained policy direction, as expected, given elevated inflation and significant divergence of inflation expectations from the target as well as ongoing stress on the currency.
- It seems not only the pace of decline, but also the quality of improvement will be important for the CBT. Accordingly, it has become more hawkish and signalled that it would keep the current tight liquidity stance "decisively" until an inflation outlook consistent with the targets. So, robust real growth dynamics as well as stickiness in inflation expectations and ongoing currency pressures should continue to make the CBT refrain from early easing.

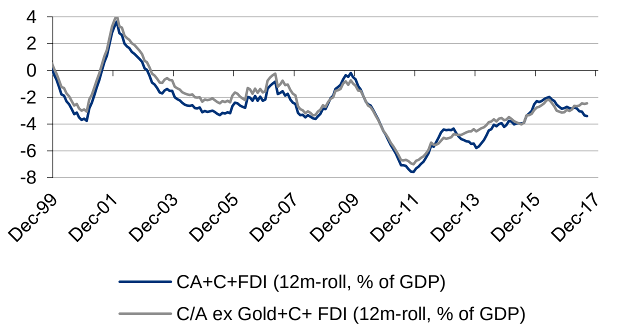
Fig 8 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Aug	78.8	Sep	79	Oct	79.7	+	79
Industrial Confidence	Aug	110.7	Sep	111.6	Oct	109.5	+	109
Industrial Production (SA WDA; MoM%)	Jun	-0.3	Jul	2.3	Aug	-0.1	-	0.5
Industrial Production (WDA; YoY%)	Jun	3.5	Jul	14.5	Aug	5.2	+	5.1
Consumer Confidence	Aug	71.1	Sep	68.7	Oct	67.3	-	67.7
Unemployment Rate (%)	May	10.2	Jun	10.2	Jul	10.7	+	10.4
GDP (YoY%)	Q4	3.5	Q1	5.0	Q2	5.1	-	5.3
GDP (WDA; YoY%)	Q4	3.5	Q1	5.2	Q2	5.0		
Core CPI (YoY%)	Aug	10.2	Sep	11.0	Oct	11.8	+	11.2
CPI (YoY%)	Aug	10.7	Sep	11.2	Oct	11.9	+	11.5
PPI (YoY%)	Aug	16.3	Sep	16.3	Oct	17.3	+	16.0
1W Repo Rate Announcement (%)	Jul	8.00	Sep	8.00	Oct	8.00		8.00
Overnight Borrowing Rate Announcement (%)	Jul	7.25	Sep	7.25	Oct	7.25		7.25
Overnight Lending Rate Announcement (%)	Jul	9.25	Sep	9.25	Oct	9.25		9.25
Trade Balance (US$bn)	Jul	-8.9	Aug	-5.9	Sep	-8.1		-8.1
Current Account (US$bn)	Jun	-3.8	Jul	-5.1	Aug	-1.2	+	-1.4

Source: Bloomberg

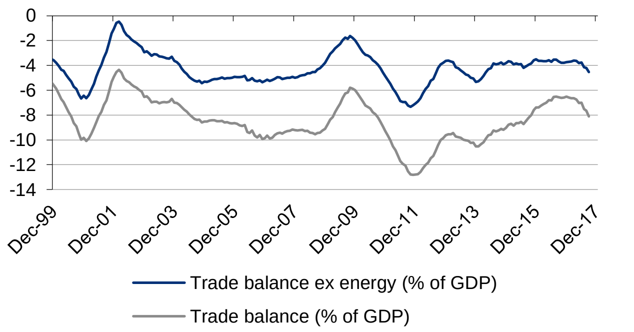
Additional charts

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



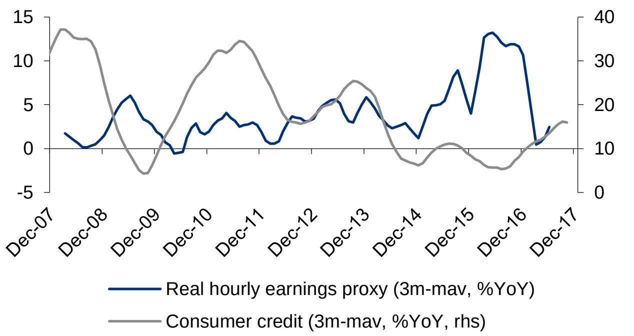
Source: CBT, ING estimates

Fig 10 Trade balance (annual; % of GDP)



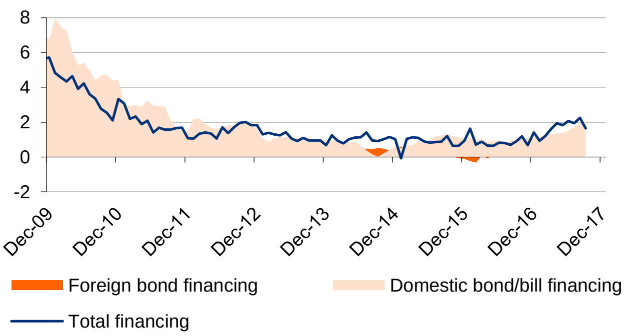
Source: TurkStat, ING estimates

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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