Emerging Markets
7 November 2016

MonitorING Turkey

Under stress

A recent slowdown in activity has set the groundwork for loosening in the macro policy mix. A further drop in inflation is likely to ease pressure on the CBT's credibility. However, upside risks have remained given volatile food prices, TRY weakness and a likely increase in the oil price. Turkish assets have remained under stress not only due to the country losing its investment grade rating, but also because of a less supportive global environment and ongoing idiosyncratic risks.

- Fiscal policy is likely to see loosening to offset a slowdown in activity as the government seems to be prioritising growth over disinflation and external rebalancing, as evidenced by the 2017-2019 MTP released at the beginning of October. However, we do not expect any marked deterioration in fiscal balances, and the primary balance is likely to remain in positive territory, keeping debt dynamics on track. We estimate the budget deficit-to-GDP ratio at 1.5% this year and 1.9% in 2017.

- The improving trend in external balances has seen a reversal lately given sluggish tourism revenue and less supportive energy prices. We expect the c/a deficit-to-GDP ratio to be above 4.5% this year, while further expansion is likely in 2017, towards 5%, following some domestic demand pickup, despite a recovery in tourism.

- Deceleration in lending came to a halt in 3Q due to CBT easing, macro prudential measures supporting the financial system and government incentives. Additional quantitative and macro-prudential measures cannot be ruled out, although the completion of policy simplification has been postponed until the market stabilises.

FX and money markets: Ongoing political risks (including discussions on the executive presidency, with a possible referendum in early-2017, and recent developments in local politics), geopolitical problems, and a reversal in the external balances are factors that are likely to keep the TRY weak, if we do not see signals from the CBT about higher policy rates. More supportive global conditions should also help stabilize the TRY.

Domestic debt and rates: October saw continued international outflows from the local bond market, which was also impacted by the Moody's downgrade. Given this backdrop, likely pressure on inflation over the remainder of the year, with TRY weakness as well as domestic politics and geopolitical tension, will weigh on domestic bond yields.

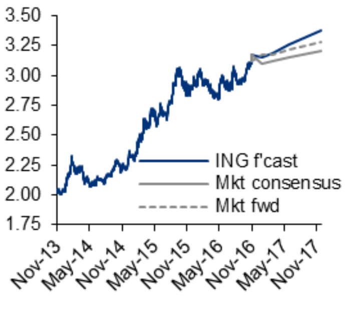
External debt: TURKEY US$ underperformed over the past month, hit by a core yields increase and domestic politics. The paper now looks very concessional among BB peers in the EMBI – we continue to see value in TURKEY 20's vs RUSSIA 20's at those levels. S&P switching Turkey from a negative to neutral outlook on 4 November should help.

Quarterly forecasts

	2Q16	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F	1Q18F
Real GDP (%YoY)	3.1	1.4	3.8	3.1	3.3	4.2	4.4	3.1
CPI (%YoY) eop	7.6	7.3	7.6	8.0	7.8	8.1	7.5	7.4
Central bank key rate (%) eop	7.50	7.50	7.50	7.50	7.50	8.00	8.50	8.50
3m interest rate (%) eop	9.50	8.91	9.03	9.02	9.02	9.07	9.09	9.04
10yr yield (%) eop	9.22	9.72	10.17	9.74	9.43	10.32	10.75	10.32
Exchange rate (USD/TRY) eop	2.88	3.00	3.15	3.21	3.28	3.34	3.40	3.46
Exchange rate (EUR/TRY) eop	3.19	3.37	3.47	3.60	3.77	3.94	4.08	4.33

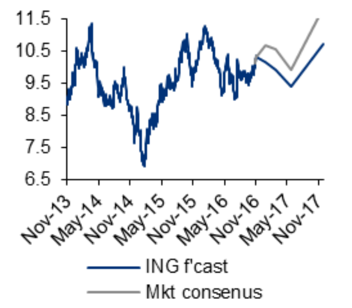
Source: Macrobond, ING estimates

USD/TRY



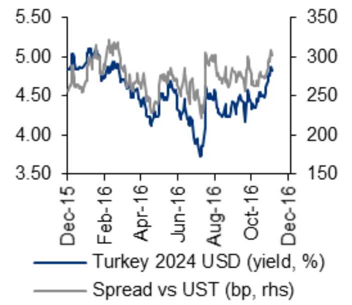
Source: Macrobond, ING estimates

Local 10Y yields



Source: Macrobond, ING estimates

US$ Eurobond 10Y



Source: Bloomberg, Reuters

Latest indicator surprises

Output	Neutral
Consumption	Neutral
Inflation	Lower
External	Neutral
Budget	Neutral

Source: Bloomberg

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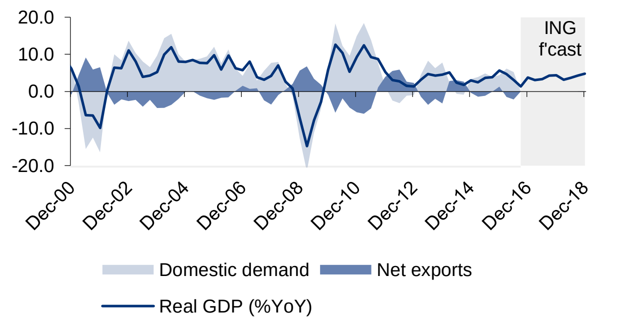
Fig 1 Real GDP (%YoY) and contributions (ppt)

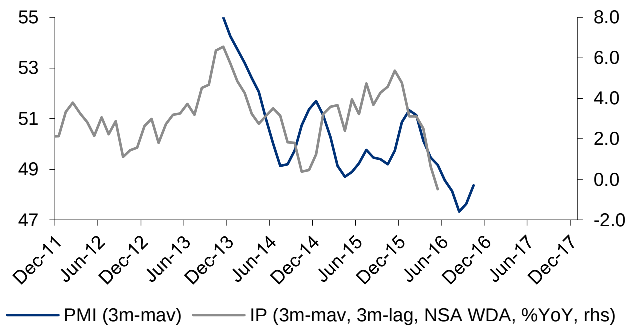


Source: Macrobond, ING estimates

Likely slowdown in 2H

- The second set of hard data (August IP) pertaining to growth in 3Q shows some recovery in the wake of the 15 July events, although the overall quarterly performance is likely to display a marked slowdown given still-sluggish investment on the back of a precautionary postponement until the appearance of concrete signals on improving political certainty, as well as weakness in consumption.
- The Jul-Aug average IP index is still some 3.1% vs 2Q, indicating a sequential contraction in 3Q GDP. Accordingly, we expect full-year 2016 growth at around 3.2%YoY, while for 2017 we see 3.8% on supportive base effects and a looser macro policy mix.

Fig 2 IP vs PMI

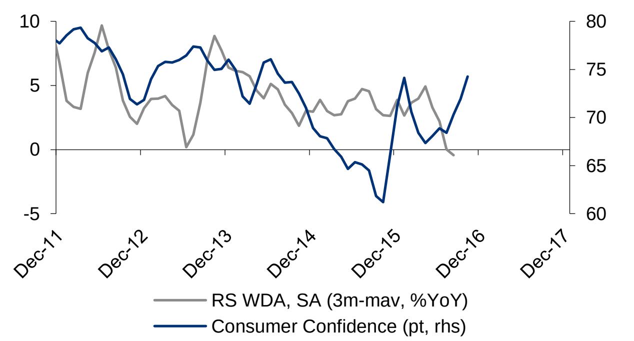


Source: Macrobond, ING estimates

Recovery in August IP

- The industrial production index (calendar-adjusted) beat expectations with a 2.2% YoY change, following a plunge a month ago on the back of a momentum loss that immediately followed a failed coup attempt and relatively soft activity during long national holidays. The seasonal and calendar-adjusted (SA) IP index rose to its highest monthly reading since the start of the series in 2015, with a -9.42% increase on a sequential basis.
- Among broad economic categories, production in all the groups that contracted MoM in July rose markedly in August – also attributable to supportive base effects.

Fig 3 Retail sales vs consumer confidence

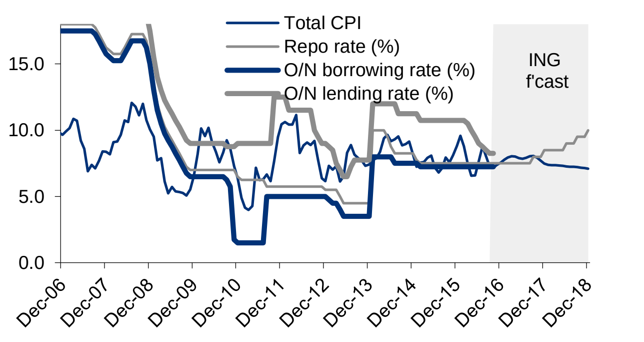


Source: Macrobond, ING estimates

Slowdown in consumer demand in 3Q

- Retail sales volume (SA) jumped 3.1% MoM, a correction following the plunge a month ago on a confidence loss after the 15 July events. However, the quarterly average of retail turnover (SA) recorded a significant weakening after turning to negative in June for the first time since Apr-15. Production of consumer goods dropped on average in July-August versus 2Q, while sales of white goods, which recorded a relatively modest performance in 2Q, remained flat in 3Q vs the same period in 2015. Sales of automobile and light commercial vehicles plunged in 3Q by 14.2%.
- Overall, data on the spending side paints a sluggish picture, with signals of a slowdown in consumer demand in 3Q.

Fig 4 CPI vs policy rate

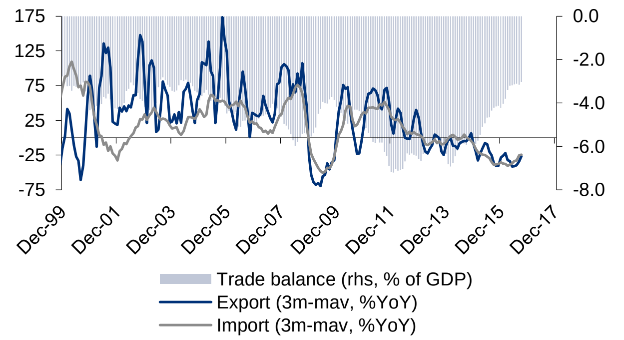


Source: Macrobond, ING estimates

Slight decline in October annual inflation

- CPI increased by 1.44% in October, slightly better than market consensus at +1.62%, pulling annual inflation down to 7.16% from 7.28% a month ago. This is attributable to still-mild food prices as well as a decline in utility prices. Also worth noting was the weakening in core inflation.
- The Domestic Producer Price Index (D-PPI) rose by 0.84%, while annual inflation rose from its lowest level since Apr-13 at 1.78% to 2.84% in October, indicative of still subdued producer-driven cost pressures on consumer prices. A recent recovery in commodity prices pulled coke and refined petroleum products and basic metals higher, while the food group limited the monthly increase.

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

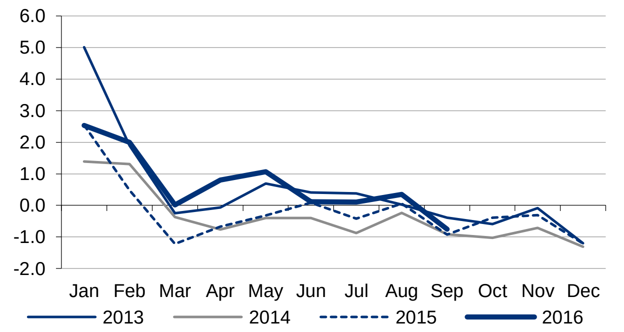


Source: Macrobond, ING estimates

Trade deficit widens in September

- The foreign trade deficit raised the 12M rolling deficit to USD56.2bn from its lowest-in-six-years point a month ago. This is likely a reversal in the long-term trend given the gradual decline in the supportive effects of commodity prices and ongoing risks stemming from geopolitical tensions. Following strong YoY growth in August, exports and imports contracted by 5.6% and 0.7%, respectively, translating into a 14% widening of the trade deficit.
- Going forward, warming relations with Russia and a consequent removal of sanctions are also likely to contribute to the external balances, although commodity prices are expected to become less accommodative, implying gradual expansion in the deficit.

Fig 6 Budget performance YTD (% of GDP)

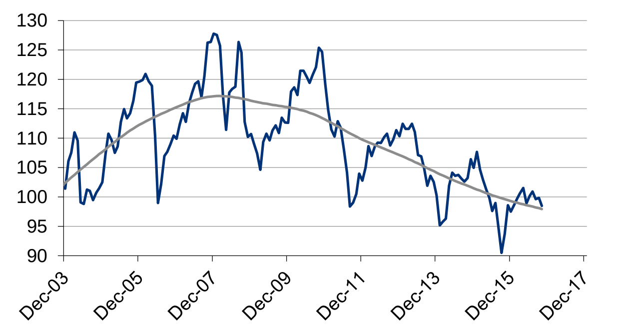


Source: Macrobond, ING estimates

Treasury plans to roll over 98.1% domestic debt in 2017

- The Treasury plans to increase its domestic debt roll-over from 91.2% to 98.1% in 2017 given the rise in domestic financing with a lower contribution from the budget (sources other than borrowing in financing to decline), despite a 1.1% drop in domestic debt service.
- In 2017, TRY78.4bn domestic debt redemptions will be made to the market (TRY19.7bn to public institutions with non-competitive sales). Assuming domestic borrowings from public institutions will be rolled over totally (the usual assumption when the Treasury has to meet demand from them), of TRY96.2bn domestic borrowings, TRY76.5bn might be made from the market (corresponding to a market roll-over ratio of 97.6% in 2017).

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

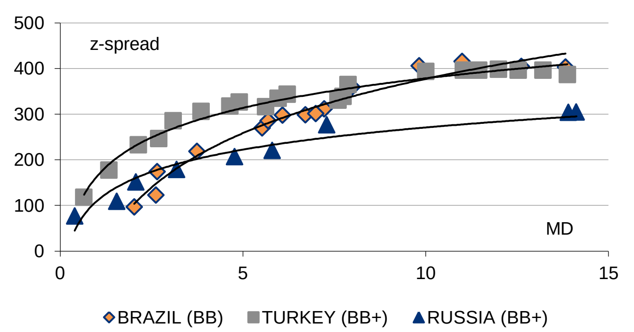


Source: Macrobond, ING estimates

The CBT paused in October

- At the October MPC, the CBT sounded far more cautious than before, signalling its acknowledgment that the easing cycle is constrained by external conditions and the TRY outlook. However, the CBT maintained macro prudential easing to provide further FX liquidity support to the banking sector.
- Accordingly, the CBT recently re-adjusted reserve option coefficients. If utilization rates remain unchanged, USD620m of liquidity will be released. The CBT also increased the upper limit of FX reserve requirements that can be maintained on average, with the objective of facilitating banks' FX liquidity management. The move will lead to a c.USD2.9bn rise in banks' free reserves.

Fig 8 TURKEY US$ curve vs peers



Source: Macrobond, ING estimates

Time to buy?

- TURKEY USD had a poor month, widening by 30bp on average in z-spread terms. EUR fared better (wider by 7bp) – but TURKEY generally was the underperformer in the EMEA region.
- In the whole BB peer group of the EMBI, and looking at the interpolated 10Y area of the curves, TURKEY is now the third-cheapest (after COSTAR and BTUN) – broadly on par with BRAZIL. The discount is even more striking on shorter maturities.
- We continue to like TURKEY vs RUSSIA in the 20's area. The spread is at the 100bp mark (ie, 64% of the historical high reached in 1Q14 with post-taper-tantrum CBT hikes). S&P's Turkey switch to neutral outlook on 4 November should help re-ignite interest.

Contribution from Dorothée Gasser-Châteauvieux, Chief Economist EMEA,

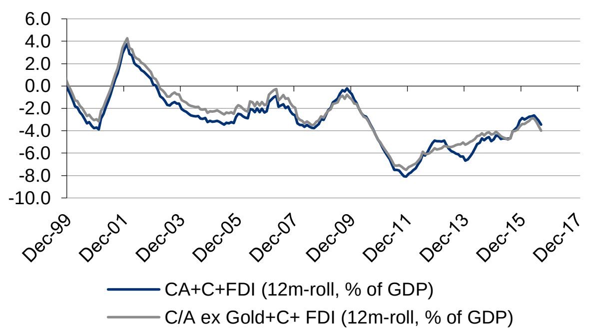
Fig 9 Main macroeconomic recent releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Aug	75.2	Sep	76.6	Oct	76.4	-	76.9
Industrial Confidence	Aug	103.6	Sep	106.5	Oct	101.7	-	104.9
Industrial Production (SA WDA, MoM%)	Jun	-1.3	Jul	-7.2	Aug	9.4	+	5.5
Industrial Production (WDA, YoY%)	Jun	1.3	Jul	-4.87	Aug	2.2	+	2.2
Consumer Confidence	Aug	74.44	Sep	74.29	Oct	74.0		-
Unemployment Rate (%)	May	9.4	Jun	10.2	Jul	10.7		10.7
GDP (SA WDA, QoQ%)	Q4	1.1	Q1	0.7	Q2	0.3	-	0.5
GDP (YoY%)	Q4	5.7	Q1	4.7	Q2	3.1	-	3.7
GDP (WDA, YoY%)	Q4	4.5	Q1	4.4	Q2	3.0	-	3.9
Core CPI (YoY%)	Aug	8.4	Sep	7.7	Oct	7.0	-	7.2
CPI (YoY%)	Aug	8.1	Sep	7.3	Oct	7.2	-	7.4
PPI (YoY%)	Aug	3.0	Sep	1.8	Oct	2.8	+	2.5
1W Repo Rate announcement (%)	Aug	7.50	Sep	7.50	Oct	7.50		7.50
Overnight Borrowing Rate announcement (%)	Aug	7.25	Sep	7.25	Oct	7.25		7.25
Overnight Lending Rate announcement (%)	Aug	8.50	Sep	8.25	Oct	8.25	+	8.00
Trade Balance (US$bn)	Jul	-4.8	Aug	-4.8	Sep	-4.4	+	-4.4
Current Account (US$bn)	Jun	-5.0	Jul	-2.6	Aug	-1.8	-	-1.4

Source: Bloomberg

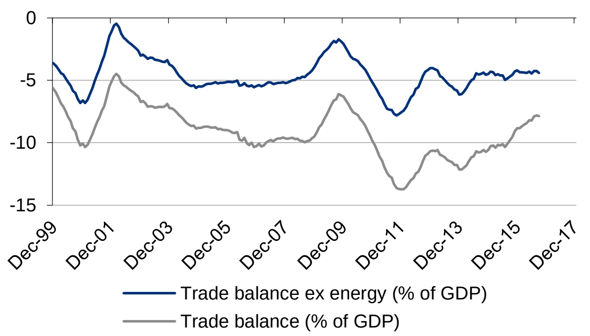
Additional charts

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



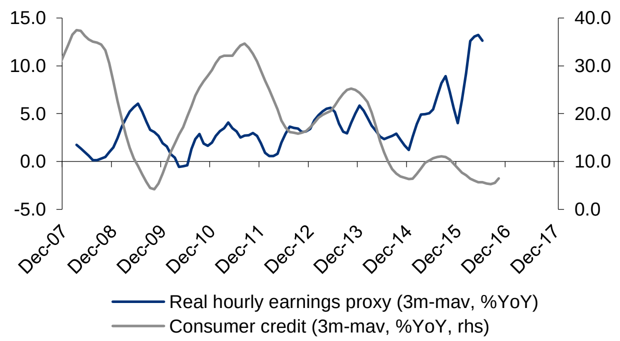
Source: Macrobond, ING estimates

Fig 11 Trade balance (annual; % of GDP)



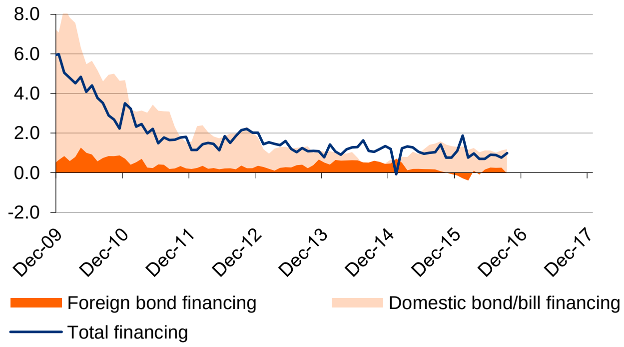
Source: Macrobond, ING estimates

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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