Economics
8 April 2016

MonitorING Turkey

An easing cycle may weigh on currency

The CBT surprised the market and cut the upper band citing improvement in volatility indicators despite high inflation and a volatile capital flow environment. The move was presented as a measured step towards simplification. Continuation of simplification from the upper band may weaken the currency without a strong and permanent improvement in inflation outlook should the risk-on mood wane, while inflation expectations may remain de-anchored given volatility in food and energy prices.

Key points

- As long as the global backdrop allows and with regained composure in the financial markets and consequent TRY strength, we might see further reductions in the overnight lending rate. The CBT defines policy simplification as a narrower and more symmetrical rate corridor with an eventual single policy rate, however, given its bias to ease the upper band in times of favourable global backdrop we expect further cuts from the upper band, while keeping the 1-week repo rate on hold this year.

Appointment of the CBT Governor this month and new MPC members should provide more clarity on the monetary policy, while release of the second inflation report of the year towards the month-end will give more clues about how the CBT sees inflation outlook.

Strategy

FX: Good news, such as improving capital flow outlook with the supportive stance of global central banks, and better than expected inflation figures, has supported TRY and it has seen a significant appreciation in recent weeks. However, we still think ongoing TRY strength will not last long, given geopolitical risks and sensitivity to local politics.

Local debt: The Fed's positive effect on the risk environment and the subsequent decline in volatility indicators along with a CBT rate cut has resulted in a rally in the bond market since mid-Jan. We think still-high inflation, though lower recently, continuing policy uncertainty and ongoing geopolitical risks, should limit further drop in yields.

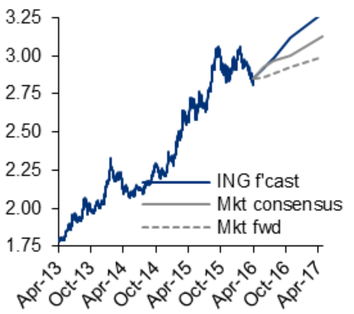
External debt: USD-denominated Turkey has returned an impressive 5.3% YTD. Returns in the early part of the year were driven primarily by the rally in core rates. This has been bolstered of late by credit compression in the past month and a half. A phase of risk-off is quite probable in the coming months, especially if long risk players begin to lock in returns, given the positive core central bank news (ECB QE and softer Fed) increasingly in the price. While the likes of Brazil, Mexico, the Philippines and Indonesia have performed even better and are open to a bigger correction risk, Turkey too is among the outperformers that would prove vulnerable should risk be taken off the table.

Quarterly forecasts

	4Q15	1Q16	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F
Real GDP (%YoY)	5.7	2.9	3.7	3.5	3.9	3.8	4.1	3.8
CPI (%YoY) eop	8.8	7.5	7.7	7.6	7.9	7.7	7.4	7.3
Policy interest rate (%) eop	7.50	7.50	7.50	7.50	7.50	7.50	8.00	8.00
3-month interest rate (%) eop	11.47	11.07	10.47	10.37	10.35	10.45	10.43	10.42
10-year yield (%) eop	10.74	9.95	9.80	10.26	10.15	10.27	10.94	10.91
Exchange rate (USDTRY) eop	2.92	2.82	2.94	3.08	3.20	3.26	3.33	3.39
Exchange rate (EURTRY) eop	3.17	3.21	3.24	3.38	3.52	3.75	3.89	4.00

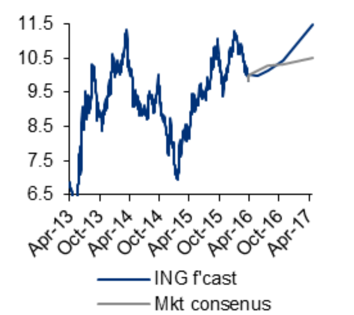
Source: Macrobond, ING estimates

USD/TRY



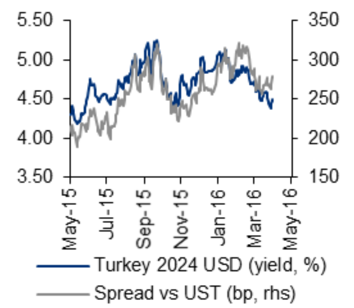
Source: Macrobond, ING estimates

Local 10Y yields



Source: Macrobond, ING estimates

US$ Eurobond 10Y



Source: Bloomberg, Reuters

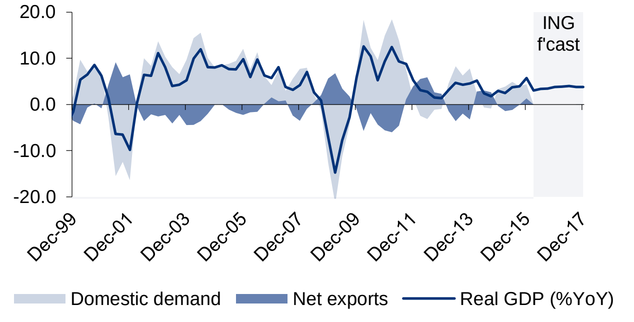
Latest indicator surprises

Output	Neutral
Consumption	Positive
Inflation	Lower
External	Positive
Budget	Neutral

Source: Bloomberg

Muhammet Mercan
Chief Economist
Istanbul +90 212 329 0751
muhammet.mercan@ingbank.com.tr

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

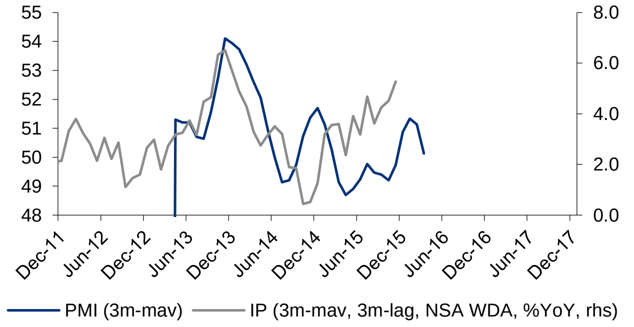


Source: Macrobond, ING estimates

Upside surprise in 4Q15 growth

- Economic activity came in better than expected in 4Q with a 5.7% YoY growth. Accordingly, annual GDP growth stood at 4.0%, in line with the government's projection for 2015.
- Private consumption stood out as the main driver of growth in 2015 pulling the headline growth up by 3.0ppt vs a limited 0.9ppt in 2014. Public demand turned out to be stronger from a mere 0.1ppt contribution to 1.1ppt last year, while, in the breakdown, investment expenditures were lower in comparison to consumption. Private investment, on the other hand, remained moderate, given volatile financial conditions and domestic uncertainties, while net exports and inventories were drags.

Fig 2 IP vs PMI

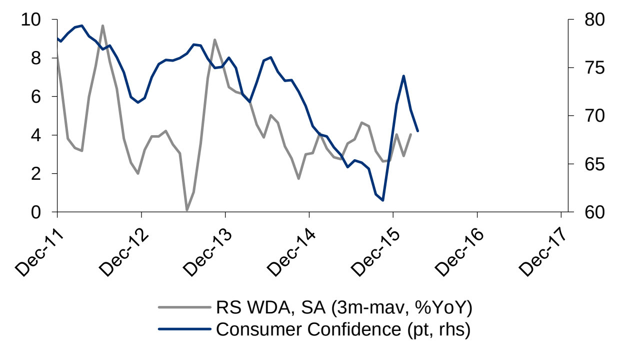


Source: Macrobond, ING estimates

Further expansion in IP in February

- The Industrial production index (calendar adjusted) has continued to expand since the beginning of 2015, recording a 5.8% YoY increase in February, higher than consensus at 4.6% (and our call at 4.2%), while the seasonal and calendar adjusted (SA) IP index rose by 0.4% on a sequential basis, the third positive reading in a row, a satisfactory performance given the volatility in IP indices.
- Growth was robust in all industrial sub-sectors, while chemicals, pharmaceuticals, textiles, apparel and fabricated metal products were the major contributors. On the flip side, the automotive sector that had been the leading driver of IP performance since July reduced the headline again in February after a negative reading in January.

Fig 3 Retail sales vs consumer confidence

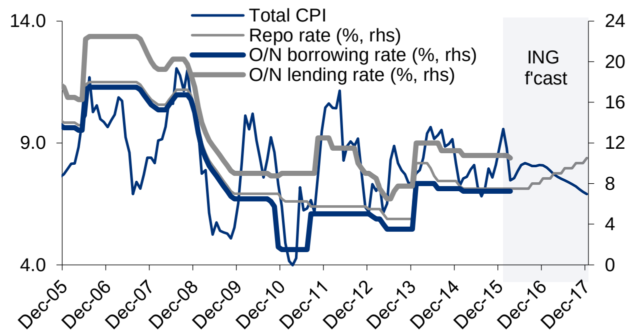


Source: Macrobond, ING estimates

Gradual rise in consumer lending NPL ratio

- NPL formation in the banking sector is mainly impacted by the level of economic activity, interest rate and currency movements as well as various other macro factors. Last year, net NPL formation was higher than in 2014, picking up towards the end of 2015 and in early 2016. Accordingly, the NPL ratio that remained flat at 2.9% until Sep-15, increased gradually to 3.3% in Feb-16
- In the breakdown, the NPL ratio for company lending that improved to 2.3% from 2.5% in the first nine months of 2015 turned north and stood at 2.6% in Feb. Consumer lending ratio on the other hand remained on an upward trend with a gradual increase to 3.4% from 2.5% at end-2014 mainly driven by GPLs.

Fig 4 CPI vs policy rate

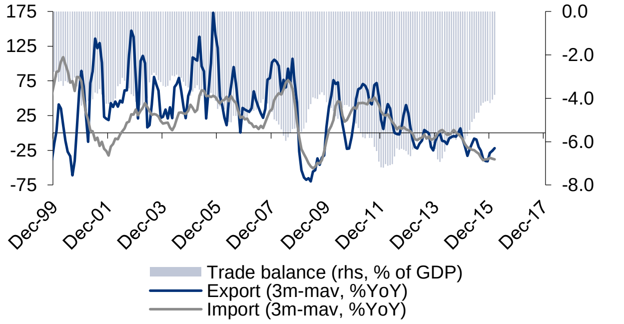


Source: Macrobond, ING estimates

Annual headline inflation decelerated further

- CPI changed by a slight -0.04% last month, well below consensus at 0.50%, driven mainly by a downtrend in food inflation. The March outcome was the lowest realised since the inception of the CPI series in 2003. Accordingly, annual CPI that peaked at 9.6% in January and went down to 8.8% in February, decelerated further to 7.5%, also with the support of strong base effects.
- Regarding core inflation, prices in H&I indicators recorded 0.45% and 0.41% changes, respectively. As a result, annual inflation in the H&I indicator dropped for the first time since July 2015 to 9.32% and 9.51%. So, core inflation remains elevated, close to double-digit levels and improvement is quite limited.

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

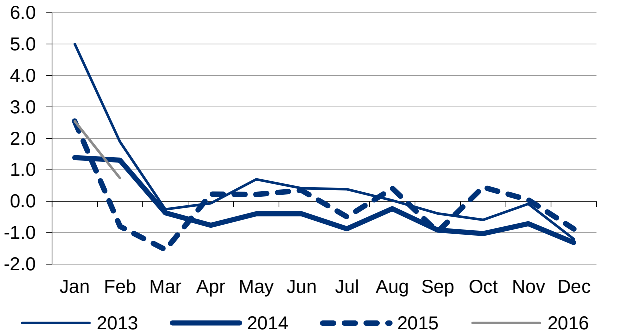


Source: Macrobond, ING estimates

Trade deficit maintains contracting trend

- The trade balance came at USD3.2bn in February and pulled the 12M rolling deficit down to USD61.4bn, the lowest since Sep-10. A continuous decline in imports on the back of lower oil prices, and strengthening exports paved the way for further contraction in the trade deficit. YoY import growth excluding oil turned to positive in February for the first time since end-2014, probably hinting at a further recovery in domestic demand.
- Overall, the narrowing trend in the trade deficit continued and should remain intact in the first half of this year, though lose momentum as evidenced by a significant drop in exports to Russia which is not among top 20 export markets in February any more.

Fig 6 Budget performance YTD (% GDP)

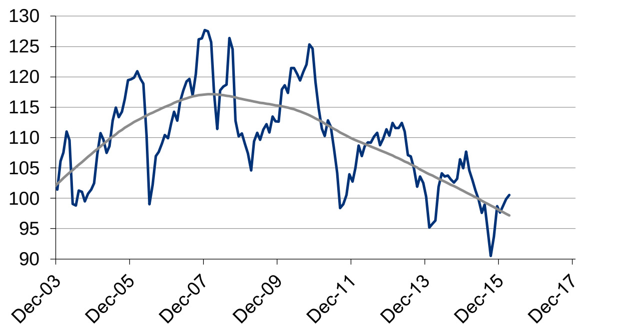


Source: Macrobond, ING estimates

Budget surplus surged in the first two months

- The budget balance posted a surplus in February with TRY2.4bn, markedly up from the TRY2.4bn deficit in the same month of the previous year. Primary surplus also expanded with double-digit growth in revenues and a decline in interest expenditures. On a monthly basis, revenues grew by 11.4% YoY attributable to healthy tax generation up by 10.8% YoY. On the spending side, primary expenditures moderated to 7.2%, driven by capital expenditures, capital transfers and lending.
- The budget performance remains on track despite concerns that government policies to stimulate growth, such as the 30% minimum wage hike, might weigh on the fiscal metrics.

Fig 7 FX: REER vs trend (index)



Source: Macrobond, ING estimates

CBT started simplification

- The CBT kept the policy rate at 7.50% and O/N borrowing rate at 7.25%, while it cut the upper band by 25bp to 10.50%, citing the improvement in volatility indicators. So, the bank started policy simplification but the process will be gradual, in our view, given the global and domestic uncertainties.
- Despite relative improvement in volatility indices, we were expecting the CBT to be reluctant to make any move at this point since it may be quite early to conclude that the decline is permanent. However, the bank is quite content with easing global volatility and sees less need for a wide rate corridor assessing recently introduced policy instruments have been successful.

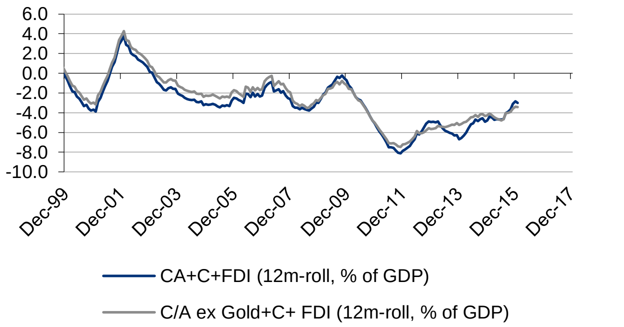
Fig 8 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Jan	74.9	Feb	73.5	Mar	74.3		-
Industrial Confidence	Jan	103.3	Feb	104.5	Mar	106.0		-
Industrial Production (SA WDA, MoM%)	Dec	0.9	Jan	1.0	Feb	0.5	-	0.9
Industrial Production (WDA, YoY%)	Dec	4.6	Jan	5.5	Feb	5.8	+	4.5
Consumer Confidence	Jan	71.62	Feb	66.64	Mar	67.0		-
Unemployment Rate (%)	Oct	10.5	Nov	10.5	Dec	10.8	-	11
GDP (SA WDA, QoQ%)	Q2	1.3	Q3	1.2	Q4	0.7		0.7
GDP (YoY%)	Q2	3.7	Q3	3.9	Q4	5.7	+	5.0
GDP (WDA, YoY%)	Q2	3.8	Q3	5.3	Q4	4.1		4.1
Core CPI (YoY%)	Jan	9.6	Feb	9.7	Mar	9.5	+	9.5
CPI (YoY%)	Jan	9.6	Feb	8.8	Mar	7.5	-	8.2
PPI (YoY%)	Jan	5.9	Feb	4.5	Mar	3.8	-	4.1
1W Repo Rate announcement (%)	Jan	7.50	Feb	7.50	Mar	7.50		7.50
Overnight Borrowing Rate announcement (%)	Jan	7.25	Feb	7.25	Mar	7.25		7.25
Overnight Lending Rate announcement (%)	Jan	10.75	Feb	10.75	Mar	10.50	-	10.75
Trade Balance (US$bn)	Dec	-6.2	Jan	-3.9	Feb	-3.2	+	-3.2
Current Account (US$bn)	Nov	-2.2	Dec	-5.0	Jan	-2.2	+	-2.4

Source: Bloomberg

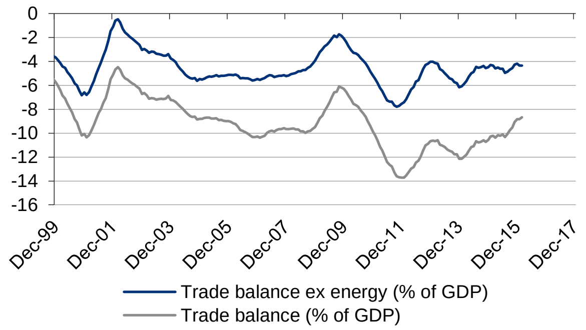
Additional charts

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



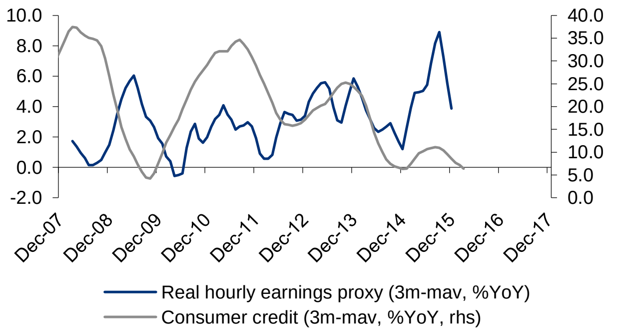
Source: Macrobond, ING estimates

Fig 10 Trade balance (annual; % of GDP)



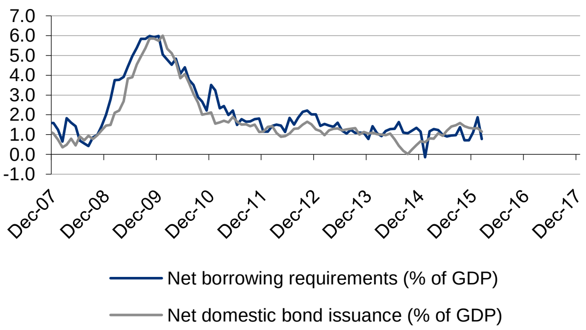
Source: Macrobond, ING estimates

Fig 11 Real wages growth (%)



Source: Macrobond, ING estimates

Fig 12 Govt central borrowing requirements (annual)



Source: Macrobond, ING estimates

ING Bank A.Ş. Economic Research Group

Muhammet Mercan Chief Economist + 90 212 329 0751 muhammet.mercan@ingbank.com.tr

DISCLAIMER:

Investment information, comments and recommendations stated here, are not within the scope of investment advisory activity. Investment advisory service is provided in accordance with a contract of engagement on investment advisory concluded between brokerage houses, portfolio management companies, non-deposit banks and clients. Comments and recommendations stated here rely on the individual opinions of the ones providing these comments and recommendations. These opinions may not fit to your financial status, risk and return preferences. For this reason, to make an investment decision by relying solely to this information stated here may not bring about outcomes that fit your expectations.

This report has been prepared by ING Bank A.Ş. Economic Research Group solely for the information purposes of its readers. While reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, ING Bank A.Ş. makes no representation that it is accurate or complete. The information contained herein is subject to change without notice. Neither ING Bank A.Ş. nor any of its officers or employees accepts any liability for any direct or consequential loss arising from any use of this report or its contents.

ING Bank A.Ş. is responsible for the distribution of this report in Turkey.