Emerging Markets
9 March 2017

MonitorING Turkey

Gradual recovery

The negative confidence shock appears to have taken its toll in 3Q16, with a contraction in economic activity. A gradual recovery is already underway, as evidenced by the latest indicators, though it seems to be quite fragile. Risks are tilted to downside this year, given ongoing drags on the investment and consumption environments, while recent policy measures are supportive.

- The inflation outlook has seen deterioration beyond expectations in the last three months, while we are likely to see further increases in a few months on the back of the low March base and further reflections of FX pass-through. We keep our 2017 CPI forecast unchanged at 9.2% and note that risks are balanced.
- The CBT uses new unorthodox tools, which have moved the effective cost of funding markedly, to 10.5% recently. However, given that inflation has already passed the 10% threshold and looks likely to increase further towards 11% in the next few months, the CBT is likely under pressure to tighten further.
- This year, the weakness in domestic demand and price competitiveness from TRY weakness should be supportive, while this should be offset by less supportive energy prices and a mean-reversion to a structural deficit in the gold balance. Tourism revenue is likely to remain sluggish. We expect the current account deficit-to-GDP ratio to be 4.2% this year, from c.3.8% in 2016, reflecting the contractionary impact of significant TRY depreciation on the GDP, in USD terms.

FX and money markets: Significant undervaluation, the CBT's unorthodox tightening by introducing new tools and the recent improvement in flow dynamics have supported TRY, which recovered from all-time lows against USD. The evolution of TRY will be determined by ongoing domestic issues such as the April referendum, global risk appetite and the CBT response to the deteriorating inflation outlook. A CBT tightening should be bullish for TRY.

Domestic debt and rates: Following a weak start to the year, Turkish assets rallied, with the long end of the curve coming to 10.7% towards end-February, from close to 12% in mid-January, though it rose again recently to above 11%. We expect 10Y yields to remain sensitive to global volatility, while short-end yields are likely to be elevated with the CBT's ongoing tightening stance.

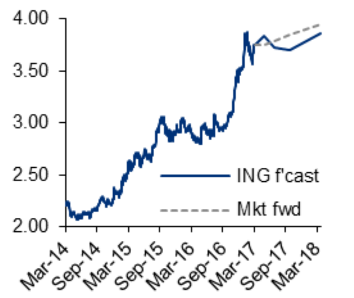
External debt: The 275bp 10yr spread versus US Treasuries is the place to be, and we would also look at fading USD RUSSIA longs into USD TURKEY in this area for a 155bp pickup. To switch from 10yr to the long end, we need 100bp (with the Treasury 10/30yr at 60bp) and that is attainable currently on extension to the 20yr.

Quarterly forecasts

	4Q16	1Q17F	2Q17F	3Q17F	4Q17F	1Q18F	2Q18F	3Q18F
Real GDP (%YoY)	2.8	1.1	2.3	3.0	3.3	2.9	3.0	3.7
CPI (%YoY) eop	8.5	10.7	10.4	10.5	9.2	7.9	7.9	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	10.13	11.50	10.85	11.06	10.20	10.63	10.55	10.50
10yr yield (%) eop	11.39	11.45	10.98	11.24	10.59	10.98	10.93	10.93
Exchange rate (USD/TRY) eop	3.53	3.82	3.73	3.70	3.80	3.86	3.93	3.99
Exchange rate (EUR/TRY) eop	3.70	3.89	3.91	4.07	4.26	4.37	4.48	4.59

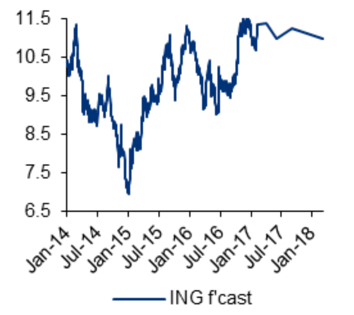
Source: ING estimates

USD/TRY



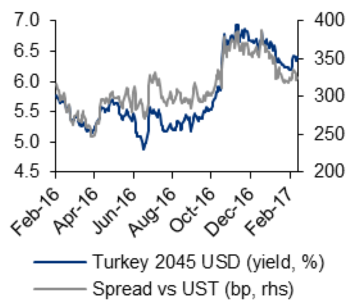
Source: Reuters, ING estimates

Local 10Y yields



Source: Reuters, ING estimates

US$ Eurobond 30Y



Source: Reuters

Latest indicator surprises

Output	Positive
Consumption	Negative
Inflation	Higher
External	Neutral
Budget	Neutral

Source: Bloomberg

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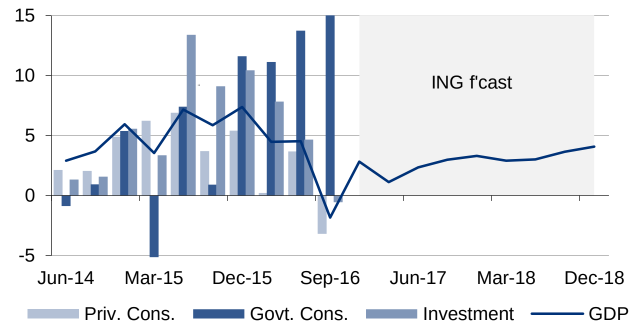
Fig 1 GDP breakdown (%YoY Growth)

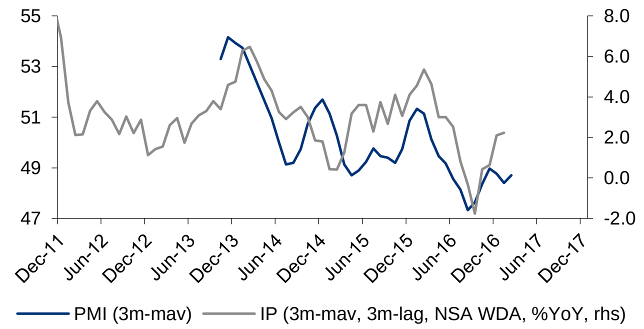


Source: TurkStat, ING estimates

Muted recovery after contraction in 3Q16

- The IP figures show an improvement in 4Q16 with a 3.9% expansion in sequential terms, following a marked 2.9% contraction in 3Q16 as a result of the confidence lost in the wake of the failed coup attempt. The data suggests a positive performance in real GDP, though it is likely to be modest, given a relatively high base effect from the previous year. We expect 2016 growth to be 2.3%.
- Economic indicators show the recovery remaining on track, as evidenced by some confidence indicators improving in February following volatility in the financial markets, while latest core foreign trade figures and the PMI and CUR recorded increases. However, economic activity is still subdued and quite fragile, in our view.

Fig 2 IP vs PMI

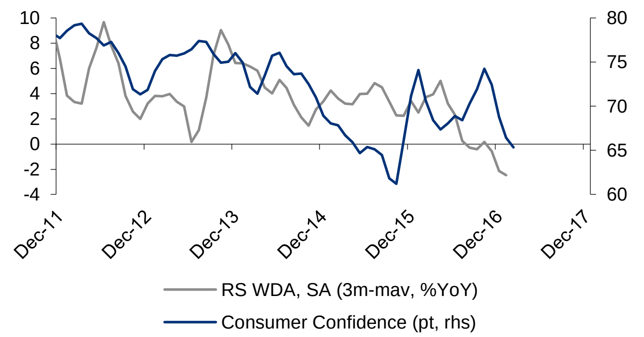


Source: Markit, TurkStat, ING estimates

IP maintains recovery

- The IP (calendar adjusted) was better than market consensus, with a 2.6% YoY increase in Jan-17. On the other hand, following a flat reading in Dec-16, the seasonal and calendar adjusted (SA) IP index recorded 1.3% growth in the first month of the year, despite harsh weather conditions, showing continuation of the recovery.
- Of the broad economic categories, the heavyweight non-durables turned out to be the only one with an MoM contraction (-0.1%), showing the fragility of consumption demand. The data supports our view that a tentative recovery that started in the last quarter of 2016 is continuing, mainly on the back of policy measures, such as macro-prudential easing and a supportive fiscal stance.

Fig 3 Retail sales vs consumer confidence

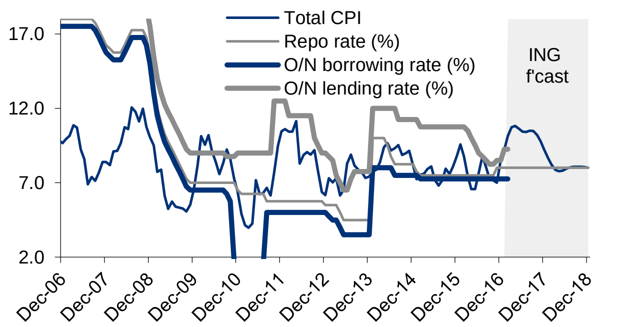


Source: TurkStat, ING estimates

Unemployment (SA) maintained its uptrend

- The unadjusted unemployment rate in Nov-16 increased to 12.1%, from 10.5% on a YoY basis, driven by continuing expansion in the labour force, while employment generation has remained sluggish. On a seasonally adjusted (SA) basis, the unemployment rate stood at 11.8%, the highest in nearly seven years, and maintained the uptrend continuing from the 9.9% recorded in 1Q16.
- Going forward, we expect the unemployment rate to maintain its uptrend, with likely sub-par economic growth performance, though government incentives and promises made by some private legal entities after President Erdogan's call to increase hiring should limit the deterioration in the near term.

Fig 4 CPI vs policy rate

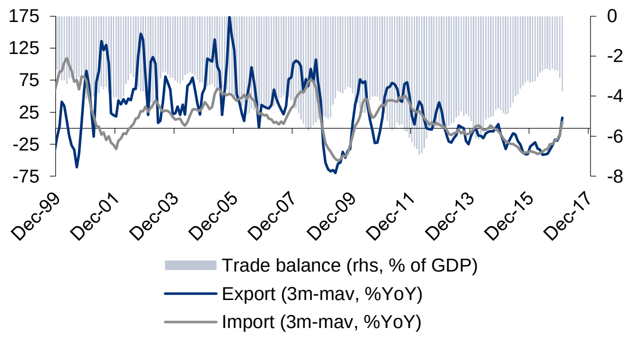


Source: CBT, ING estimates

Annual inflation into double digits

- The CPI at 0.81% MoM in Feb-17 was worse than market consensus at 0.47% (and our call at 0.50%). The figure pushed annual inflation to double digits at 10.1%, the highest in nearly five years, from 9.2% a month ago. This is attributable, once again, to volatile food prices and TRY weakness.
- Regarding core inflation, the CPI excluding all food & beverages, energy, alcoholic drinks & tobacco and gold recorded a 0.70% MoM change in Feb-17. Annual inflation as per this indicator jumped to 8.56% and maintained its upward movement since Nov-16. Despite TRY strength in Feb, the lagged structure in the FX pass-through from earlier TRY depreciation implies further pressure on the core outlook.

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

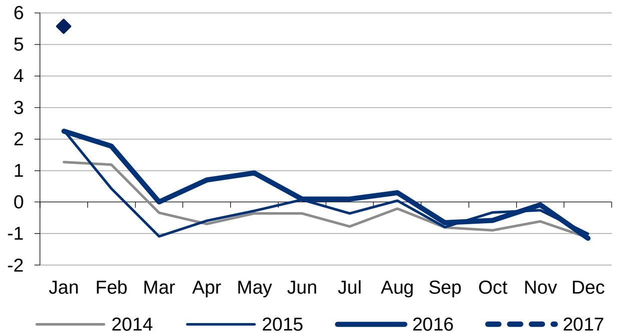


Source: TurkStat, ING estimates

12M rolling trade deficit expands marginally

- The foreign trade deficit, at USD4.3bn in Jan-17, pulled the annual deficit slightly up, to USD56.5bn. Following a modest expansion in imports by 2.3% MoM in Dec-16, we saw a strong 15.9% YoY change, while exports maintained higher growth at 18.1% YoY, translating into a 10% expansion of the merchandise trade deficit over the same month of the previous year.
- Coverage of imports by exports on a 12M rolling basis rose to 71.9% in Jan-17, vs 71.8% a month earlier, showing the impact of the recovery in the core trade deficit (excluding gold and energy) and net gold trade, despite marked deterioration in the energy deficit in the same period, given rising oil prices.

Fig 6 Budget performance YTD (% of GDP)

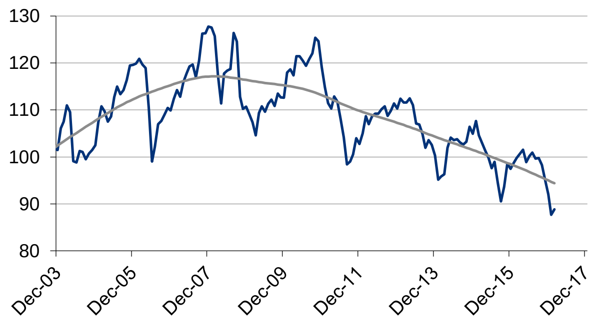


Source: Ministry of Finance, ING estimates

Strong start to the year on the fiscal side

- The budget balance recorded a TRY11.4bn surplus in Jan-17, significantly up vs the same month of last year. Having strong seasonality, the first month of the year generally sees a significant budget surplus, but Jan of this year attracts attention with a more than 25% YoY jump in revenue, while primary spending turned out to be modest, with a slightly higher than 10% YoY increase. The primary surplus surged by 84%, pointing to the extent of the improvement.
- Overall, the central administration showed a strong start to this year, though sustainability of this performance is yet to be seen, given the momentum loss in domestic demand and some new investment and incentive schemes introduced by the government.

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

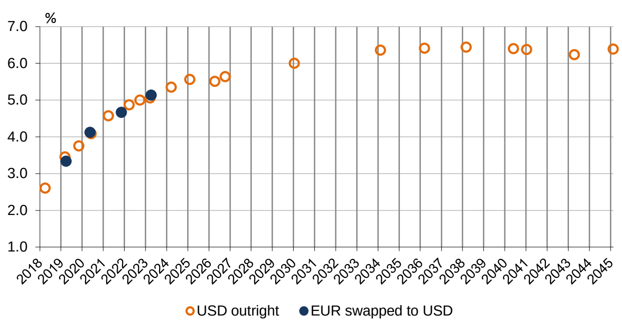


Source: CBT, ING estimates

CBT decision on discount credits supports TRY

- The CBT has introduced a new tool, a swap facility, while starting to direct banks to even more expensive channels of funding: the late liquidity window. It has increased flexibility again, with a bias for significant discretion in policy implementation. Accordingly, the c.bank forced banks to use the O/N lending facility and late liquidity window, setting a new corridor. As a result, the effective cost of funding reached 10.4%, from 8.3% in the beginning of this year.
- The CBT also announced that it would temporarily allow repayment of rediscount credits available to exporters to be made in TRY at exchange rates as of 2 Jan 2017, when the USD/TRY exchange rate was at 3.53.

Fig 8 TURKEY USD lines (vs EUR swapped to USD)



Source: Macrobond, ING estimates

USD TURKEY 10-20yr segment preferred for longs

- TURKEY USD trades a tad cheap versus fair value, by c.30bp in the 10yr, which, as a result, still leaves room for performance. The better tone for the TRY since the turn of the year has seen local currency products outperform, but the TURKEY USD is a better route for Turkey exposure, in our opinion. The spread remains generous versus comparables and is without FX risk.
- The 275bp 10yr spread versus US Treasuries is the place to be, and we would also look at fading USD RUSSIA longs into USD TURKEY in this area for a 155bp pickup. To switch from 10yr to the long end, we need 100bp (with the Treasury 10/30yr at 60bp), and that is attainable currently on extension to the 20yr.

Contribution from Padhraic Garvey, Global Head of Debt and Rates Strategy

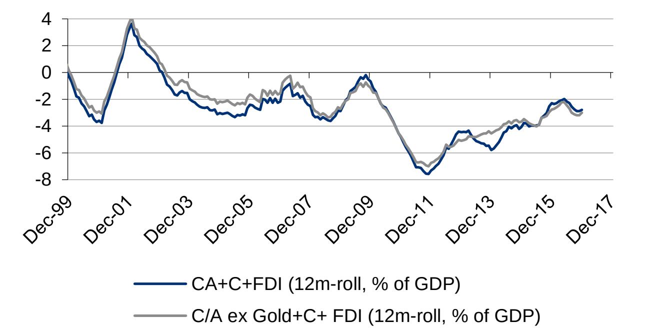
Fig 9 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Dec	76.5	Jan	75.5	Feb	75.4	+	74.7
Industrial Confidence	Dec	98.4	Jan	97	Feb	105.3		-
Industrial Production (SA WDA, MoM%)	Nov	-0.2	Dec	0.0	Jan	1.3	+	1.0
Industrial Production (WDA, YoY%)	Nov	2.6	Dec	1.6	Jan	2.6	+	1.8
Consumer Confidence	Dec	63.4	Jan	66.9	Feb	65.7	-	68
Unemployment Rate (%)	Sep	11.3	Oct	11.8	Nov	12.1	+	12
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%)	Dec	7.5	Jan	7.7	Feb	8.6	+	8.0
CPI (YoY%)	Dec	8.5	Jan	9.2	Feb	10.1	+	9.8
PPI (YoY%)	Dec	9.9	Jan	13.7	Feb	15.4	+	14.4
1W Repo Rate announcement (%)	Nov	8.00	Dec	8.00	Jan	8.00	-	8.50
Overnight Borrowing Rate announcement (%)	Nov	7.25	Dec	7.25	Jan	7.25	-	7.50
Overnight Lending Rate announcement (%)	Nov	8.50	Dec	8.50	Jan	9.25		9.25
Trade Balance (US$bn)	Nov	-4.1	Dec	-5.6	Jan	-4.3	-	-4.2
Current Account (US$bn)	Oct	-1.6	Nov	-2.2	Dec	-4.3	+	-4.5

Source: Bloomberg

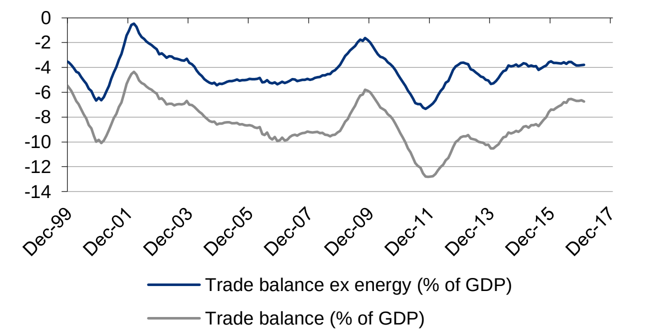
Additional charts

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



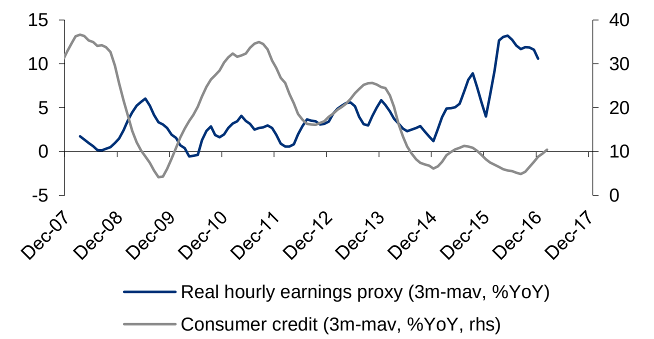
Source: CBT, ING estimates

Fig 11 Trade balance (annual; % of GDP)



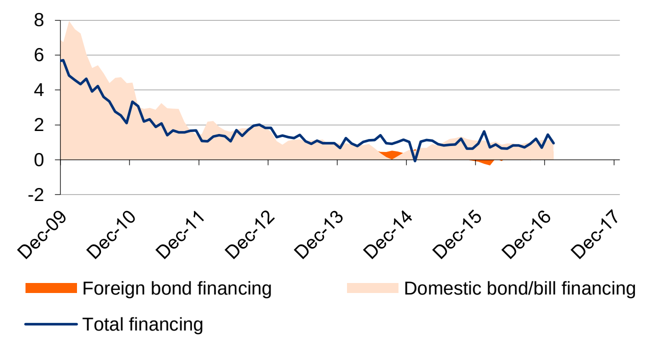
Source: TurkStat, ING estimates

Fig 12 Real wages growth (%)



Source: TurkStat, BRSA, ING estimates

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



Source: Treasury, ING estimates

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