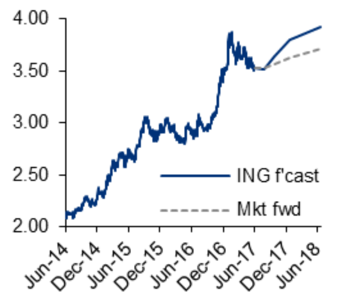
Emerging Markets
9 June 2017

USD/TRY

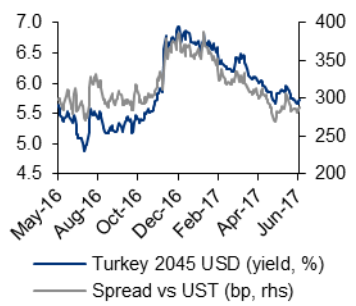


Source: Reuters, ING estimates

Local 10Y yields

Source: Reuters, ING estimates

US$ Eurobond 30Y



Source: Reuters

Latest indicator surprises

Output	Positive
Consumption	Neutral
Inflation	Higher
External	Neutral
Budget	Negative

Source: Bloomberg

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Fiscally under pressure

Slower growth and weakening revenue have weighed on fiscal performance. The weak growth outlook also forced the government to increase nominal spending, with a consequent jump in the annual deficit to its highest since the beginning of 2010. The government measures are to expire by year-end, with likely improvement in budget metrics next year, though currently increasing the Treasury's borrowing requirement.

- According to the Ministry of Finance, the budget deficit will be c.TRY61.1bn at end-2017 (translating into 2% of GDP, vs 1.9% already as of April, on a 12M rolling basis), implying that stimulus measures like VAT cuts on certain consumer durables, deferral of social security premiums for new hirings, etc, will not be extended. Given that most of these measures are temporary in nature, we are likely to see an improvement in fiscal performance next year, while early elections, ruled out by the government so far, remains a key risk. The debt-to-GDP ratio, on the other hand, is envisaged at c.30%, still comparing favourably with other emerging markets.
- TurkStat is due to release 1Q17 GDP data next week. We expect a continuation of the recovery that started in the last quarter of 2016. Recently released indicators hint at some further acceleration in 2Q17 economic activity, with higher PMI in tandem with rising CUR. Improvement in sectoral and consumer confidence after the referendum should also contribute to the recovery.

FX and money markets: Following the significant deterioration in recent months, with the lagged spill-overs from TRY depreciation and volatility in food prices, inflation showed a modest improvement in May, from the peak realised in April. However, we think that May inflation will not make any significant impact on CBT behaviour. The central bank is likely to refrain from early easing and keep the current tight liquidity stance for a while, until recovery in the inflation outlook becomes apparent. Apart from the CBT's liquidity tightness, the continued supportive global environment and a REER close to the lowest level realised since the 2001 financial crisis are likely to support TRY in the near term. Significant external financing needs are likely to remain a source of weakness in the longer term.

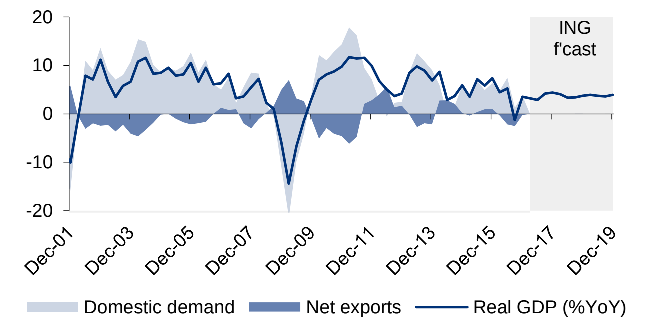
Domestic debt and rates: Elevated inflation and the CBT's consequent policy tightening have kept the yield curve inverted in recent months, while an improving domestic climate after the referendum has accelerated debt inflows since mid-April, though foreign ownership of domestic debt remained low. Following a c.150bp rally in the long end from the peaks realised at the beginning of this year, we do not expect further strong performance.

Quarterly forecasts

	4Q16	1Q17	2Q17F	3Q17F	4Q17F	1Q18F	2Q18F	3Q18F
Real GDP (%YoY)	3.5	3.2	2.9	4.2	4.4	4.1	3.3	3.4
CPI (eop, %YoY)	8.5	11.29	11.3	11.1	9.5	7.6	7.4	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, %)	9.90	12.12	11.96	11.48	11.00	10.93	10.74	10.36
10yr yield (eop, %)	11.39	10.93	10.43	10.52	10.72	10.70	10.54	10.19
USD/TRY exchange rate (eop)	3.53	3.63	3.50	3.64	3.80	3.86	3.93	3.99
EUR/TRY exchange rate (eop)	3.70	3.92	3.92	4.18	4.37	4.44	4.71	4.79

Source: ING estimates

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

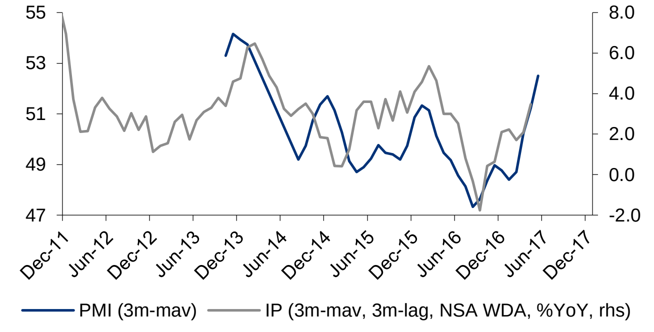


Source: TurkStat, ING estimates

Economy remains on a recovery path

- Economic activity continues to recover, thanks to fiscal easing, given stimulus measures such as VAT cuts in some consumer durables and social security premium cuts and significant lending acceleration; credit growth (13-week MA, FX-adjusted and annualised) has converged to 25% on the back of contributions from the Guarantee Fund. As a result, commercial loans can be the main driver of improved economic activity this year.
- Given this backdrop, we expect 3.7% YoY GDP growth in 2017, while higher interest rates, given the CBT's current tightening stance, are likely to weigh on investment and consumption demand and limit recovery in activity to some extent.

Fig 2 IP vs PMI

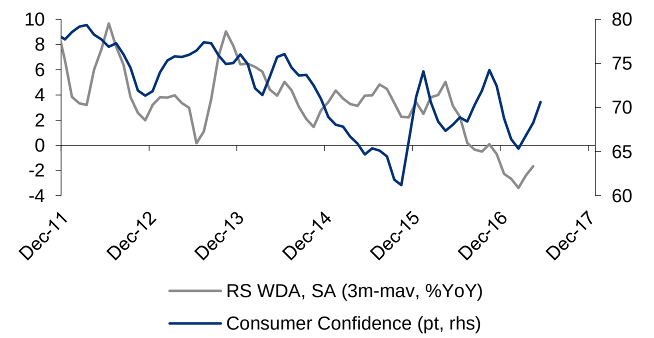


Source: Markit, TurkStat, ING estimates

IP gains momentum in April

- The industrial production index (calendar adjusted) was above consensus, with a sharp 6.67% YoY increase in April. The seasonal and calendar adjusted (SA) IP index has been on the rise at an accelerating pace, recording 2.27% MoM expansion.
- Within broad economic categories, durable consumer goods maintained growth, though with significant moderation in sequential growth, reflecting the fading impact of the VAT cut in 1Q17. Capital goods production surged by 12.2%, showing that investment decisions delayed due to political uncertainty were reinstated consequent to the better political environment, while the boost in credit expansion has also contributed.

Fig 3 Retail sales vs consumer confidence

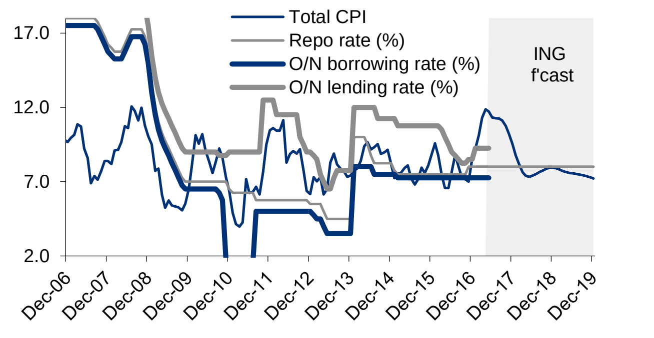


Source: TurkStat, ING estimates

A downtrend in unemployment is in the making

- Despite a further increase in the participation rate to an all-time high of 52.7% in Feb-17, the seasonally adjusted figure witnessed another recovery in the same month at 11.7%, with significant employment generation, after the drop in Jan-17 over end-2016. On a sequential basis, job creation was at 143K MoM, driven by construction (61K) and services (83K), while agriculture recorded a modest gain at 22K. Industry, on the other hand, has remained weak with a 23K drop, pulling the share of the sector in total employment down to 19%.
- A downtrend in unemployment is in the making, with two consecutive drops from its highest rate in close to seven years at end-2016, given government measures to support the labour market.

Fig 4 CPI vs policy rate

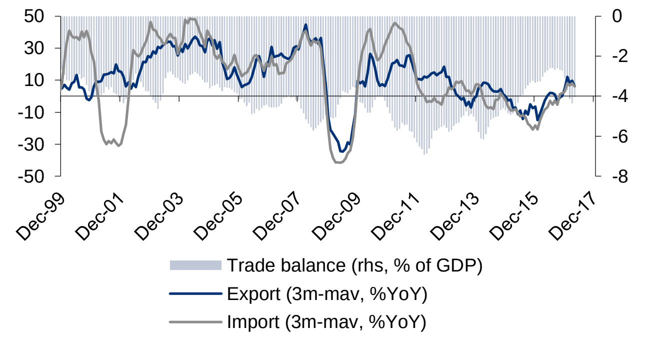


Source: CBT, ING estimates

Annual inflation edged down in May

- CPI at 0.45% MoM was slightly above consensus of 0.35%. The figure pulled annual inflation down to 11.7%, from the high of 11.9% (since Oct-08) seen a month ago. Domestic PPI, on the other hand, rose by 0.52%, while annual inflation ended its continuous uptrend since Sep-16 and dropped to 15.3%.
- Regarding core inflation, the 'C' indicator recorded a 1.33% change, below the average of May changes. This is another sign of weakening, following a moderation of the strong upward pressure last month. Annual inflation as per this indicator inched down to 9.38%, from 9.42% a month ago. But, core figures remain elevated despite falling momentum, given a fading FX pass-through.

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

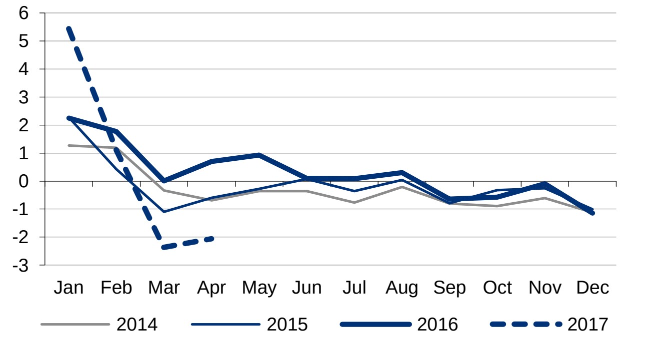


Source: TurkStat, ING estimates

Modest expansion in 12M rolling trade deficit

- The foreign trade deficit, at USD4.95bn in April, pulled the 12M rolling deficit, which had remained in a USD56-57bn range after recording its lowest level since mid-2010 in Aug-16, out of this range with a slight expansion, to stand at USD57.3bn. As a result, coverage of imports by exports on a 12M rolling basis recorded a marginal drop to 71.9%, though remaining close to the high (since end-2009) of 72.0%.
- The data shows the impact of the deterioration in the energy deficit in the same period, reflecting the impact of oil prices and less supportive net gold trade, despite a continuing recovery in the core trade deficit (excluding gold and energy) since Nov-16.

Fig 6 Budget performance YTD (% of GDP)

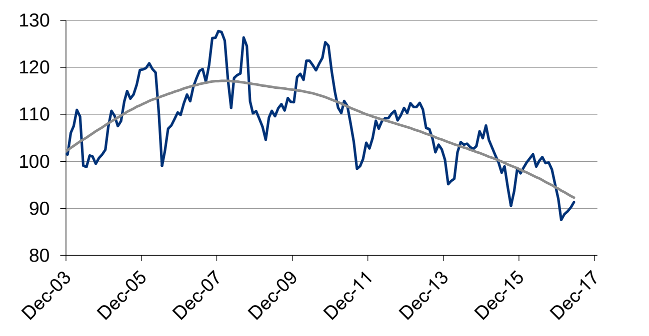


Source: Ministry of Finance, ING estimates

Weak fiscal performance continues

- In the first four months of 2017, fiscal performance has shown significant deterioration, given government efforts to provide a lift to growth. In April alone, the central administration budget balance turned to a TRY3.0bn deficit, vs a TRY5.4bn surplus in the same month of last year.
- On a cumulative basis, the budget balance was in deficit by TRY17.9bn in the first four months of the year, vs a TRY5.4bn surplus in the same period of 2016. The primary surplus also declined by 83%, showing the extent of the deterioration. We see an ongoing expansion in the core deficit, excluding non-tax revenue and interest expenditure, translating into 3.9% of GDP on a 12M rolling basis, with a continuous uptrend since Mar-16.

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



Source: CBT, ING estimates

Likely at the peak of a tightening cycle

- Since the beginning of this year, the CBT has increasingly used unorthodox tools. By utilising the late liquidity window, a facility to cover emergency needs of the banks, the CBT significantly tightened liquidity and hiked the effective cost of funding by c.370bp to close to 12.0%. Additionally, the bank has introduced a new tool by opening an FX-deposits-against-TRY-deposits market, a swap facility with 1-week maturity. Utilisation of the tool has reduced the volatility in the excess TRY liquidity in the offshore markets and helped achieve stabilisation in the TRY.
- The CBT still hints at more tightening, though we do not expect a further move this month, given that inflation peaked in April.

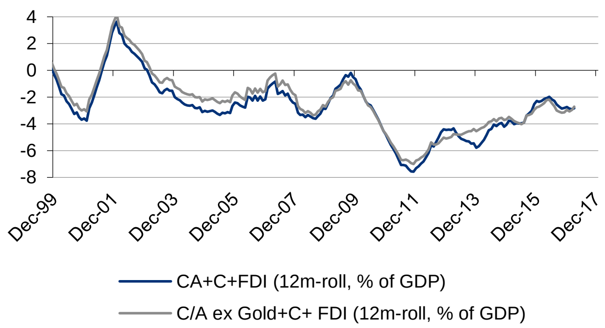
Fig 8 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Feb	76.8	Apr	78.4	May	78.8		-
Industrial Confidence	Feb	105.9	Apr	111.2	May	109.2		-
Industrial Production (SA WDA, MoM%)	Feb	-0.3	Mar	1.1	Apr	2.3	+	0.0
Industrial Production (WDA, YoY%)	Feb	1.0	Mar	2.6	Apr	6.7	+	4.1
Consumer Confidence	Feb	65.7	Apr	71.3	May	72.8	+	70.8
Unemployment Rate (%)	Dec	12.7	Jan	13.0	Feb	12.6	-	13
GDP (YoY%)	2Q	5.3	3Q	-1.3	4Q	3.5	-	3.7
GDP (WDA, YoY%)	2Q	5.4	3Q	-1.3	4Q	3.4	-	3.9
Core CPI (YoY%)	Feb	8.6	Apr	9.4	May	9.4	-	9.6
CPI (YoY%)	Feb	10.1	Apr	11.9	May	11.7	+	11.7
PPI (YoY%)	Feb	15.4	Apr	16.4	May	15.3	+	15.2
1W Repo Rate Announcement (%)	Jan	8.00	Mar	8.00	Apr	8.00		8.00
Overnight Borrowing Rate Announcement (%)	Jan	7.25	Mar	7.25	Apr	7.25		7.25
Overnight Lending Rate Announcement (%)	Jan	9.25	Mar	9.25	Apr	9.25		9.25
Trade Balance (US$bn)	Feb	-3.7	Mar	-4.5	Apr	-4.9	-	-4.9
Current Account (US$bn)	Jan	-2.7	Feb	-2.5	Mar	-3.1	+	-3.2

Source: Bloomberg

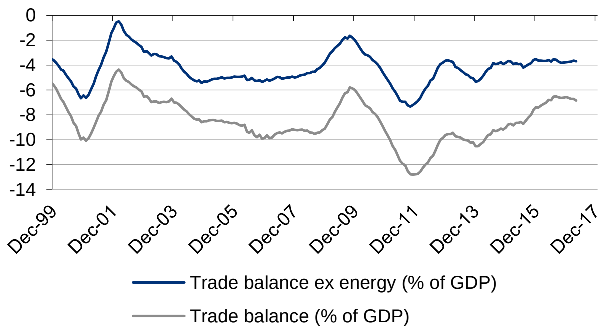
Additional charts

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



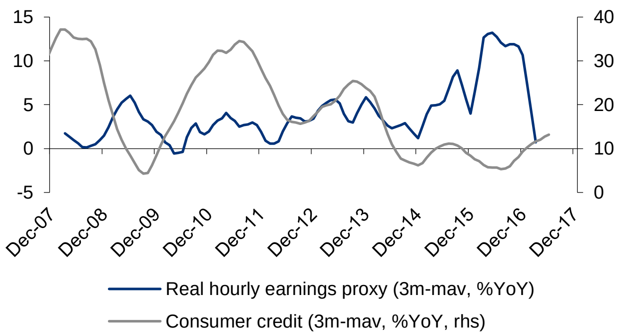
Source: CBT, ING estimates

Fig 10 Trade balance (annual; % of GDP)



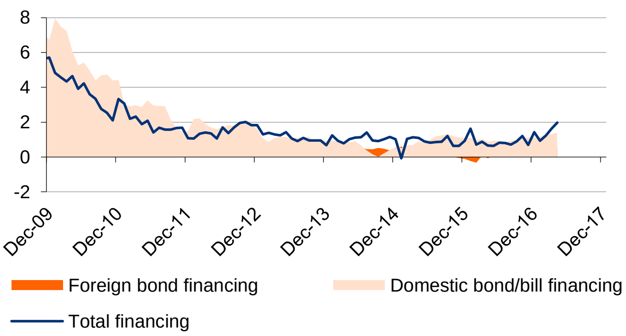
Source: TurkStat, ING estimates

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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