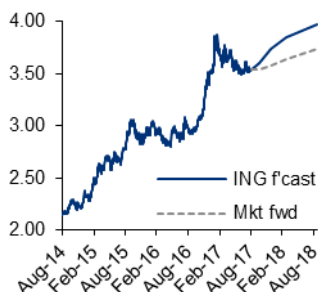


Emerging Markets

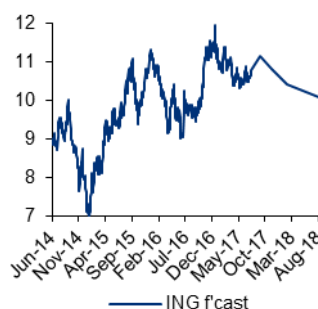
10 August 2017

USD/TRY



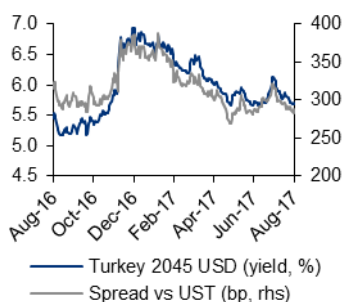
Source: Reuters, ING estimates

Local 10Y yields



Source: Reuters, ING estimates

US\$ Eurobond 30Y



Source: Reuters, ING estimates

Latest indicator surprises

Output	Negative
Consumption	Negative
Inflation	Higher
External	Negative
Budget	Negative

Source: Bloomberg

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Inflation outlook against early easing

The CBT has raised its 2017 inflation forecast, reducing the gap to consensus, though it remains wide even after the revision, while the forecast interval sees a risk of headline inflation exceeding the 11% level in 4Q. Elevated inflation that weighs on expectations and leads to stronger inertia as well as higher core in July are major arguments against any premature easing.

- Inflation showed an improvement in recent months on the back of a correction in food prices, the return of TRY stability and some administrative decisions on taxes. However, it remains a major concern given continuing producer-driven cost pressures, and no meaningful improvement in core figures. Accelerating activity, still high food price pressure and still strong producer price-driven pressure remain as major concerns in the near term. We forecast 9.4% for this year and 7.9% for 2018.
- The CBT has been raising the effective cost of funding since end-2016 providing a lift to TRY along with a supportive global backdrop. Given this backdrop, the CBT will likely remain prudent and continue to observe the inflationary developments and the course of core market yields before easing its liquidity stance.
- Economic activity remains on an improvement track given the supportive fiscal policy and easing macro prudential measures as well as robust external demand. So, we expect 4.4% this year with strength in 2Q base effects in 3Q. However, sustainability of this performance remains to be seen given momentum loss in volume growth with deceleration in lending via the Credit Guarantee Fund and expiration of tax incentives towards the end of this year. We forecast 3.9% growth for 2018.

FX and Money Markets: Since January, TRY has performed relatively well against USD, thanks to CBT's significant liquidity tightening as well as general USD weakness, despite bouts of volatility with changing risk appetite towards EM assets and domestic factors. Higher volatility adjusted carry and REER close to the recent lows portray an attractive picture for TRY. But, strong sensitivity to global fluctuations and a likely change in the course of inflation in the near term argue for a cautious approach, in our view.

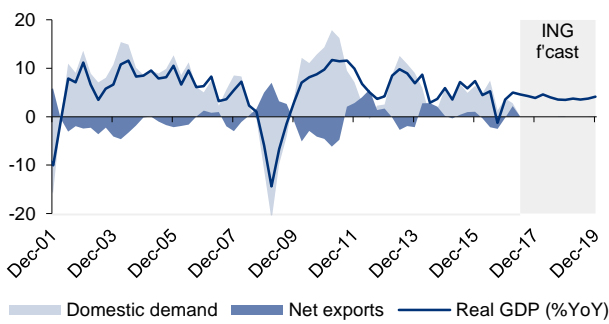
Domestic Debt and Rates: Inflows into domestic debt have continued with significant acceleration in July thanks to foreign appetite in the Treasury auctions. In fact, the total amount invested in Turkish local bonds has reached US\$1.8bn last month (US\$5.6bn YTD including repos), after US\$6.4bn in 2016. We see limited room for a sharp rally in bonds in the near term given no room for the CBT for early easing with less favourable than expected July inflation print and return to double digits in coming months as well as the vulnerability of TRY assets to external shocks in general.

Quarterly forecasts

	1Q17	2Q17	3Q17F	4Q17F	1Q18F	2Q18F	3Q18F	4Q18F
Real GDP (%YoY)	5.0	4.6	4.2	3.9	4.6	4.0	3.5	3.5
CPI (eop, %YoY)	11.3	10.90	10.7	9.4	7.5	7.6	8.0	7.9
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, %)	12.12	12.71	12.73	11.40	11.20	10.90	10.64	10.41
10yr yield (eop, %)	10.93	10.53	11.15	10.57	10.42	10.22	10.05	9.98
USD/TRY exchange rate (eop)	3.63	3.52	3.61	3.80	3.86	3.93	3.99	4.05
EUR/TRY exchange rate (eop)	3.92	3.94	4.26	4.37	4.44	4.71	4.87	5.06

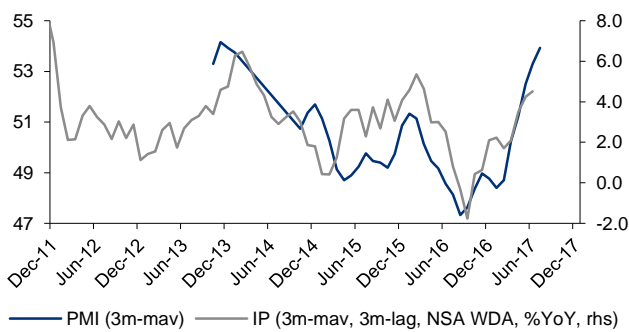
Source: Macrobond, ING estimates

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



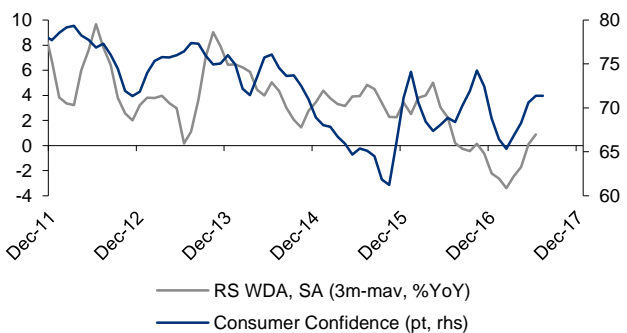
Source: TurkStat, ING estimates

Fig 2 IP vs PMI



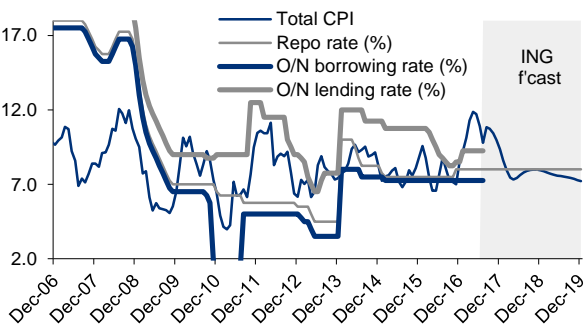
Source: Markit, TurkStat, ING estimates

Fig 3 Retail sales vs consumer confidence



Source: TurkStat, ING estimates

Fig 4 CPI vs policy rate



Source: CBT, ING estimates

Growth momentum remains in 2Q17

- Strong growth performance likely continues in 3Q due to support from fiscal policy measures including increase in public investment and consumption. Consumer demand maintains recovery given higher consumer confidence and growing consumer lending. Net exports seem to support growth, given accelerating exports attributable to upbeat EU economic performance this year.
- Lending growth accelerated with supportive macro prudential measures and accommodative government incentives. The acceleration in TRY commercial loans on the back of lending via the Credit Guarantee Fund facility has attracted attention in 2Q, though there are signals of momentum loss lately.

Sequential quarterly IP growth accelerated in 2Q

- The industrial production index (calendar adjusted) was close to market consensus at 3.4% with a 3.6% YoY increase in June, in line with our call. On the other hand, following a relatively weak reading in May, the seasonal and calendar adjusted (SA) IP index recorded another negative print at -0.44% in the first six months of the year. However, the QoQ change in the 3-month average IP (SA) stood at +1.7%, a momentum gain from 1.2% in 1Q when the growth stood at 5.0% YoY.
- Overall, the recovery that started in the last quarter of 2016 with government measures remains on track in 2Q given a strong performance in April, despite some weakening in May and June.

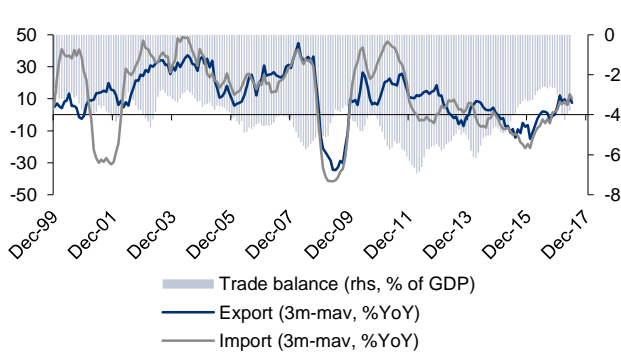
Downtrend in the unemployment rate continues

- Measures taken to support the labour market are paying off as the seasonally adjusted figure has maintained the recovery started this year with another drop from 11.5% in Mar-17 to 11.3% in Apr-17, while the participation rate stood at 52.6%, close to all-time high levels. On the flipside, the adjusted unemployment rate in Apr-17 recorded an increase to 10.5% from 9.3% a year ago, showing ongoing weakness in the labour market.
- Overall, with the stronger than expected recovery in growth in recent months, the unemployment rate has adopted a downtrend with four consecutive drops from the highest rate in close to seven years at end-2016.

Annual inflation temporarily in single digit

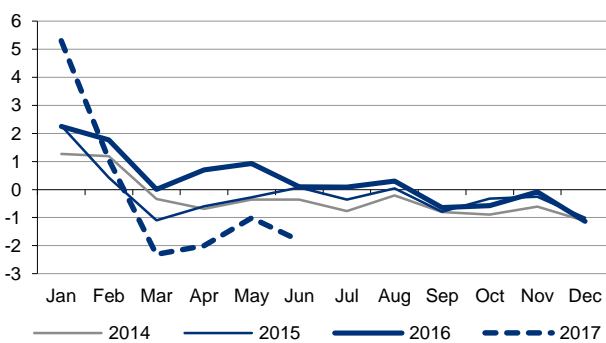
- CPI at 0.15% MoM in July pulled the annual change down to 9.8%, from at 10.9% a month ago. So, annual inflation maintained its downtrend, attributable to volatile food prices and clothing, while the government decision not to apply the usual mid-year tax hike on tobacco also contributed. We will likely see volatility and double digits in the remainder of 2017 until December.
- Domestic PPI changed course and rose again to 15.5% on a YoY basis. Despite a further price drop in utilities with negative annual inflation as of July, widespread price increases in a large number of groups due mainly to the lagged effects of TRY weakness showed that producer-driven cost pressures remained elevated.

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



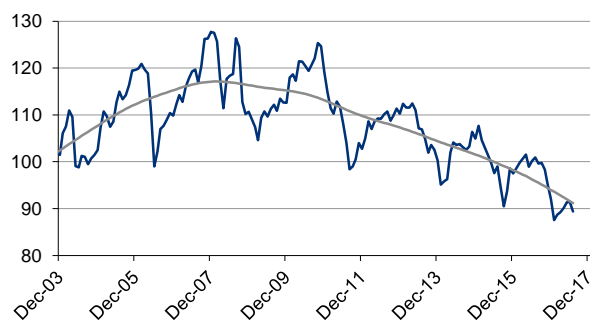
Source: TurkStat, ING estimates

Fig 6 Budget performance YTD (% of GDP)



Source: Ministry of Finance, ING estimates

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



Source: CBT, ING estimates

Modest contraction in 12M rolling trade deficit

- The foreign trade deficit came at US\$6.0bn in June, while the annual deficit stood at US\$58.9bn with a modest improvement over the previous month. The data shows the impact of a deterioration in the gold trade, despite a continuing recovery in the core trade deficit (excluding gold & energy) to the lowest level since Aug-10.
- Going forward, given that gold imports have been high for the last six months including July, we'll likely see a normalisation in coming months, while energy imports should also lose momentum, as we witnessed in June. We expect the deficit to modestly increase this year as price competitiveness from the TRY slide should largely compensate for the impact of strength in domestic demand.

Another weak budget outcome in June

- The monthly central administration budget saw a marked deterioration in June, with a further increase in the deficit YoY on the back of a jump in primary expenditures and sluggish revenue generation despite significant contraction in interest expenses.
- Weakness in revenues is driven by plunging non-tax income with contraction in privatisation receipts as collection of revenues from early deals has been deferred with difficult market conditions in early 2017. On the spending side, expansion in primary spending is still high, driven by current transfers, while personnel costs and capital expenditures recorded lower or negative growth rates, limiting the expansionary effect of current transfers, to some extent.

The CBT keeps all rates on hold in July, as expected

- At the June rate-setting meeting, the CBT has not made any meaningful change and kept its defensive stance.
- The statement reiterated main policy guidance that a "tight stance in monetary policy will be maintained until the inflation outlook displays a significant improvement" while "inflation expectations, pricing behaviour and other factors affecting inflation will be closely monitored and, if needed, further monetary tightening will be delivered". It should be noted that despite keeping a tightening bias in the statement, markets were pricing a 100bp cut with around a 100% probability until end-March at that time, though attached somewhat lower probability lately.

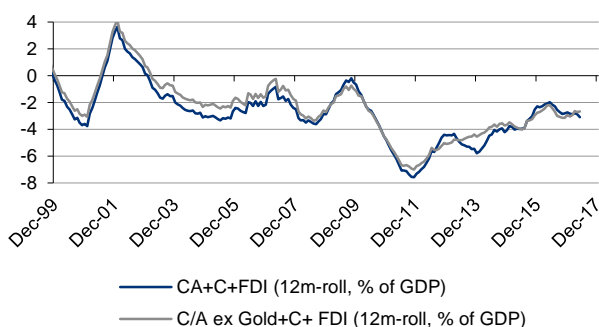
Fig 8 Main recent macroeconomic releases

Indicator	Previous -2	Previous -1	Actual	Surprise	Consensus
Capacity Utilisation (%)	May 78.8	Jun 79	Jul 78.7		-
Industrial Confidence	May 109.2	Jun 112.4	Jul 109.5		-
Industrial Production (SA WDA; MoM%)	Apr 2.2	May -1.4	Jun -0.4	-	0.4
Industrial Production (WDA; YoY%)	Apr 6.7	May 3.5	Jun 3.4	-	3.6
Consumer Confidence	May 72.8	Jun 70.0	Jul 71.3		-
Unemployment Rate (%)	Feb 12.6	Mar 11.7	Apr 10.5	-	11
GDP (YoY%)	Q3 -1.3	Q4 3.5	Q1 5.0	+	3.7
GDP (WDA; YoY%)	Q3 -0.9	Q4 3.3	Q1 5.2	+	3.9
Core CPI (YoY%)	May 9.4	Jun 9.2	Jul 9.6	+	9.1
CPI (YoY%)	May 11.7	Jun 10.9	Jul 9.8	-	9.9
PPI (YoY%)	May 15.3	Jun 14.9	Jul 15.5	+	14.3
1W Repo Rate Announcement (%)	Apr 8.00	Jun 8.00	Jul 8.00		8.00
Overnight Borrowing Rate Announcement (%)	Apr 7.25	Jun 7.25	Jul 7.25		7.25
Overnight Lending Rate Announcement (%)	Apr 9.25	Jun 9.25	Jul 9.25		9.25
Trade Balance (US\$bn)	Apr -4.9	May -7.3	Jun -6.0	-	-6.0
Current Account (US\$bn)	Mar -3.0	Apr -3.6	May -5.2	-	-5.0

Source: Bloomberg

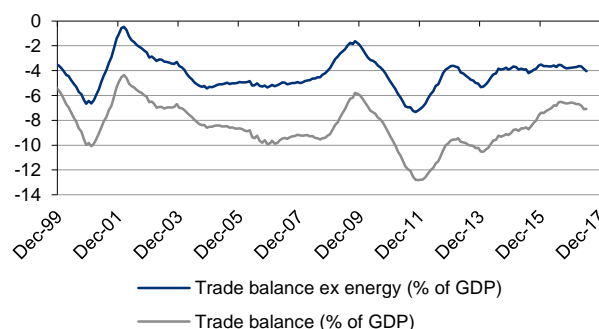
Additional charts

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



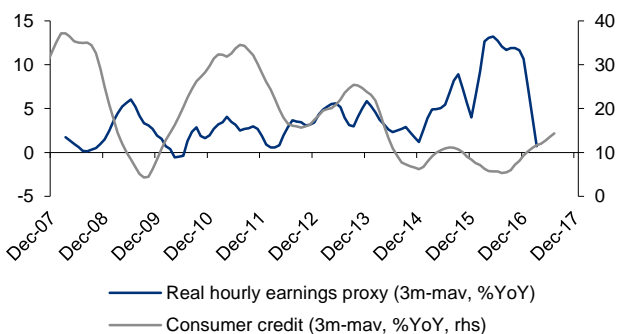
Source: CBT, ING estimates

Fig 10 Trade balance (annual; % of GDP)



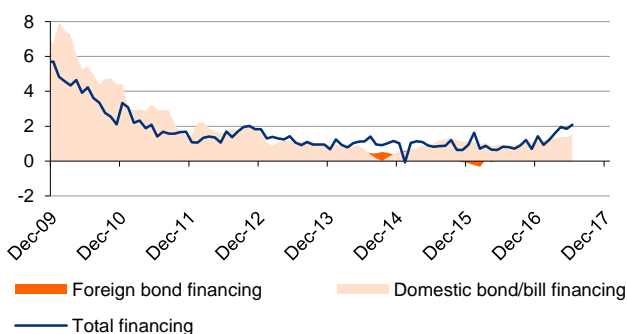
Source: TurkStat, ING estimates

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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