Economics

13 July 2015

MonitorING Turkey

Protracted political uncertainty

Turkey is considered vulnerable by investors due to still-large external financing requirements (despite improvement in recent years), lower reserve coverage than most EM peers (a source of more concern especially after a marked drop since the beginning of 2015), currency risk carried by the corporate sector, elevated inflation, and below-potential growth. Given the new political landscape after the election, uncertainty is likely to remain even after a coalition government is formed, with further drag in the structural agenda, which, along with a challenging macro environment, is set to weigh on risk appetite.

Key points:

- We do not expect the CBT to make any moves in July prior to any further clarity on the government-formation process, though we continue to see scope for further tightening towards 4Q15F, given a large c/a deficit weighing on TRY performance, still high headline inflation and the continuing impact of exchange-rate developments on core indicators and a challenging global backdrop, with a Fed rate lift-off getting closer.
- However, in recent days, we have seen that markets seem to be re-pricing the timing and extent of the Fed hiking cycle, with a revival of deflation fears driven by the decline in commodity prices and other global developments, which might also impact CBT behaviour going forward.
- The main focus in the month ahead is likely to be the July MPC and the release of the third inflation report for 2015.

Strategy

FX: TRY outperformed other EM peers in recent weeks, with increasing signs of understanding between potential coalition partners. But we continue to expect the TRY to remain under a weakening bias going forward, given Turkey's macro imbalances and a more volatile political scene, due to inherently unstable coalition governments.

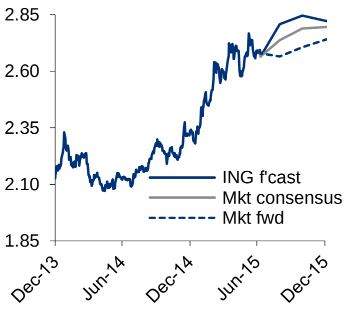
Local debt: After a higher-than-expected drop in food prices, with a consequent significant decline in headline inflation, money market rates remained high on the back of global developments and political uncertainty. Short-end rates should remain high, given the CBT's tight liquidity policy. Rates on the long-end of the curve edged lower after the elections, but we see little scope for further decline.

Quarterly forecasts

	1Q15	2Q15	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F
Real GDP (%YoY)	2.3	4.8	2.7	2.6	2.9	3.2	3.6	3.8
CPI (%YoY) eop	7.6	7.2	7.2	7.7	6.6	6.5	7.2	6.8
Policy interest rate (%) eop	7.50	7.50	8.00	8.00	8.50	8.50	9.00	9.00
3-month interest rate (%) eop	10.50	11.34	11.70	11.11	10.63	10.46	10.64	10.84
10-year yield (%) eop	8.44	9.36	10.09	9.29	9.51	9.51	9.77	10.08
Exchange rate (USD/TRY) eop	2.60	2.68	2.85	2.80	2.88	2.93	2.97	3.00
Exchange rate (EUR/TRY) eop	2.79	2.99	2.99	2.80	2.74	2.63	2.76	2.85

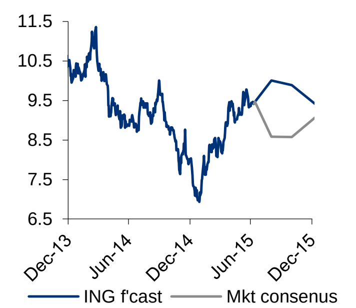
Source: EcoWin, ING estimates

USD/TRY



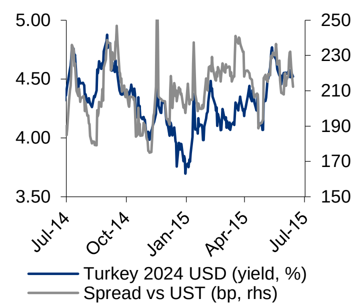
Source: EcoWin, ING estimates

Local 10Y yields (%)



Source: EcoWin, ING estimates

US$ Eurobond 2024



Source: Bloomberg

Latest indicator surprises

Output	Neutral
Consumption	Positive
Inflation	Lower
External	Negative
Budget	Neutral

Source: Bloomberg

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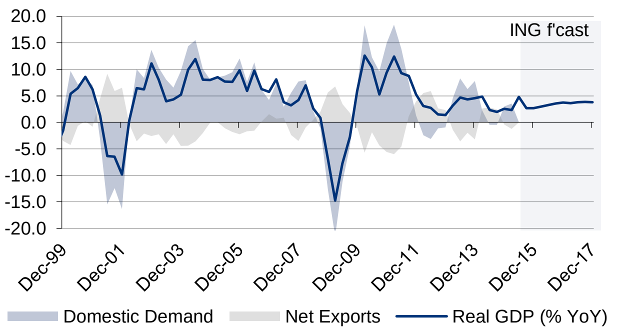
Fig 1 Real GDP (%YoY)and contributions (ppt)

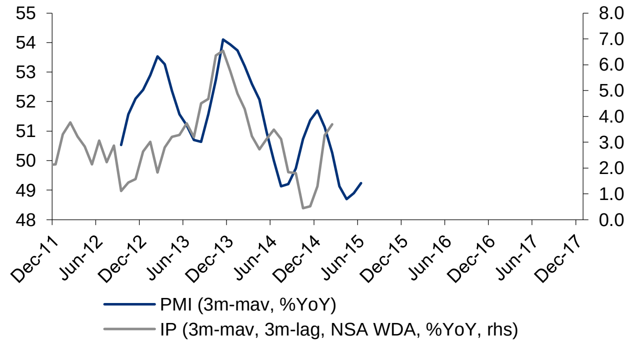


Source: EcoWin, ING estimates

Growing downside risks to the growth outlook

- Given that a flat June IP MoM reduced the increase in 2Q15 to a mere 0.7% from 1.1% in 1Q15, downside risks to economic growth become more pronounced, with weak May performance. Other early indicators on the supply side are a PMI reverting to a below-50 threshold again in June and no signs of recovery in business confidence, although a gradual increase in CUR recently also implies that economic activity may turn out to be lower in 2Q15 than envisaged earlier.
- It should also be noted that continuing uncertainty in local politics, intensifying Greek risks and a Fed rate lift-off looming closer indicate further risks to an already-modest growth outlook for 2015F.

Fig 2 IP vs PMI

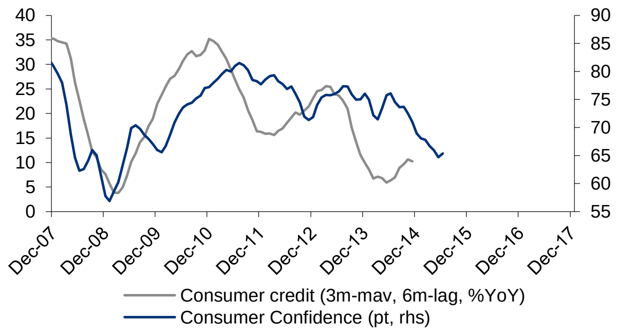


Source: EcoWin, ING estimates

Weakening IP print in May

- IP dropped markedly by 2.0% on a sequential basis, hinting at a setback, after strong readings in February and March. The most significant development was a sharp contraction in production of durable goods by 4.9% MoM, attributable to the impact of protests/strikes in automobile and parts manufacturing sectors.
- As a result automotive, the major contributor to IP in the last five months, pulled the headline number slightly down. An increase in the share of negative contributors to 43% also shows that the monthly drop in IP is relatively broad-based. On the flip side, pharmaceuticals and coke and refined petroleum products stood out as the major positive contributors, with 0.73ppt and 0.76ppt, respectively.

Fig 3 Consumer confidence versus credit

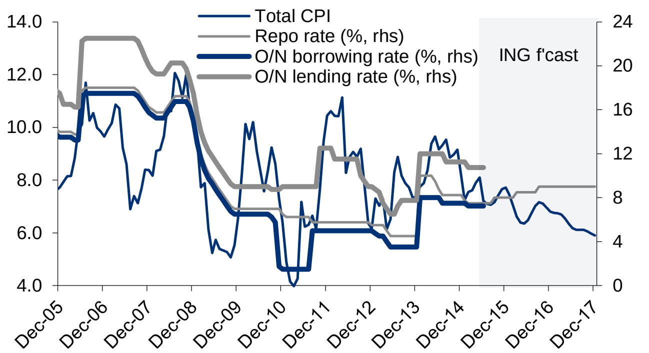


Source: EcoWin, ING estimates

Unemployment to remain elevated

- The seasonally-adjusted unemployment rate dropped to 10%, the lowest level in the last three quarters and gradually improving since Nov-14. Labour-force participation (SA), on the other hand, recovered slightly to 50.9%, and remained close to an all-time high of 51.0%. After a strong uptrend since the beginning of 2012, labour participation seems to have stagnated at c.50.9-51.0% in the last six months, also assisting in the decline in the unemployment rate.
- With the ongoing uncertainty after the elections and increasing probability of further tightening in financial conditions, domestic demand recovery should be more sluggish than earlier envisaged, which, in turn, should weigh on the labour market.

Fig 4 CPI versus policy rate

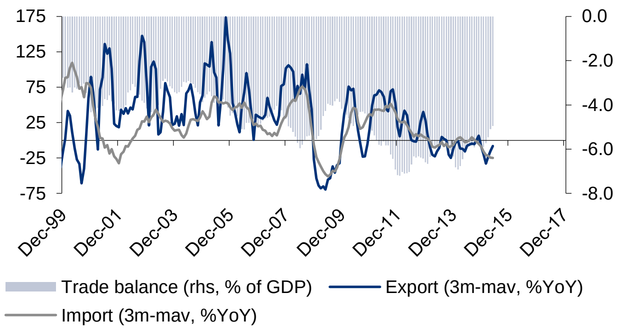


Source: EcoWin, ING estimates

Easing food prices pushed headline inflation down

- The CPI dropped 0.51% last month, helped by softening food prices and to some extent by benign clothing prices. Accordingly, annual inflation moved to 7.20%, from 8.09% in May, also due to base effects and ended an uptrend that began in Jan-15.
- After ending a five-month downward course in May, core inflation indicators in June now hint at a continuing impact from exchange rate developments.
- Although food prices have lost momentum from May onwards, inflationary pressures should be a concern, given that annual non-food inflation remained broadly unchanged in June, following a marked increase in the previous two months.

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

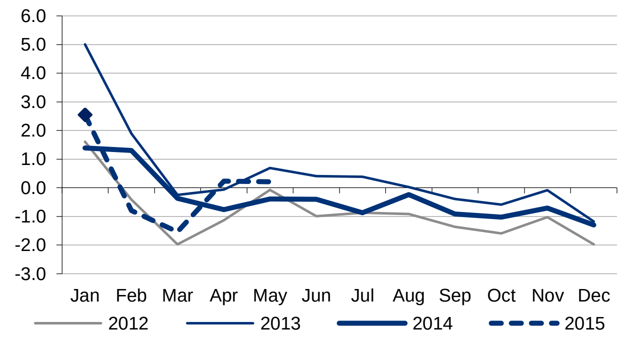


Source: EcoWin, ING estimates

Trade deficit shrunk in May

- The foreign trade deficit was USD6.75bn in May, pulling the annual deficit that has followed a downtrend since end-2013, down to USD79.7bn, from USD80.2bn a month ago.
- May data reflects the impact of exchange rate movements, commodity prices, and geopolitical risks in neighbouring countries. Exports to the EU in euro remain supportive. The favourable impact of lower oil prices on the trade balance is expected to continue in the coming period, despite lower demand from oil-exporting countries. Additionally, the Eurozone, which is crucial to external demand for Turkish exports, shows signs of recovery and should contribute to the improvement trend.

Fig 6 Budget performance YTD (% of GDP)

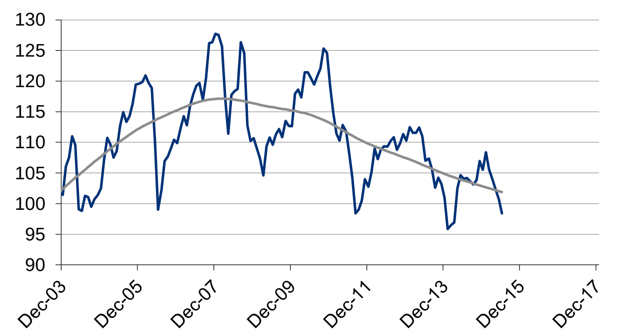


Source: EcoWin, ING estimates

Treasury borrowing to be light over the rest of 2015

- The budget deficit stood at TRY2.4bn in the first five months of the year, down from the TRY2.8bn in the same period of 2014. The primary surplus increased by 15.7% YoY to TRY25.6bn.
- Interest expenditure that grew more than 35% during Jan-Apr, normalised, given the uneven payment structure of the Treasury and consequent volatility monthly payments.
- As of June, the Treasury had completed 67.5% of its borrowing requirement. For the rest of the year, the redemption schedule is relatively light, likely a relief factor in times of volatility in financial markets. This might also provide support for rates in the secondary market, given a relatively lower supply of bonds.

Fig 7 FX: REER versus trend (index)



Source: EcoWin, ING estimates

CBT to fine-tune liquidity policy in the near term

- Turkey is considered to be vulnerable by investors, due to still-large external financing requirements, despite significant improvement in recent years, lower reserve coverage than most EM peers (a source of more concern, especially after a marked drop since the beginning of 2015), currency risk carried by the corporate sector (although broadly stable since end-2013), elevated inflation and below-potential growth.
- Against this backdrop, we continue to expect the TRY to remain under a weakening bias and likely to intensify pressure on the CBT to adjust policy rates, although it has been more inclined to adjust liquidity conditions and macro-prudential tools, so far.

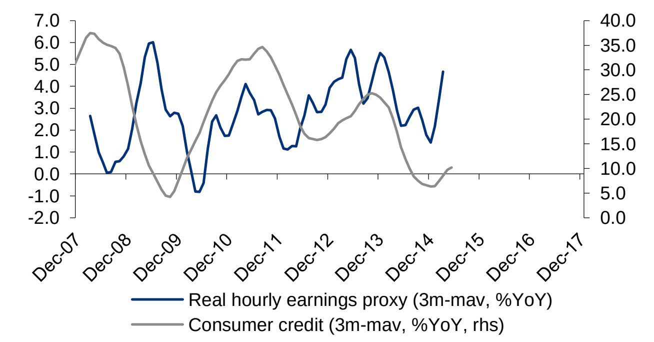
Fig 8 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilization (%)	Apr	74.1	May	74.9	Jun	75.1		-
Industrial Confidence	Apr	107.9	May	109	Jun	104.9		-
Industrial Production (SA WDA, MoM%)	Mar	2.2	Apr	0.0	May	-2.0	-	-0.8
Industrial Production (WDA, YoY%)	Mar	4.8	Apr	3.94	May	2.4	+	2.2
Consumer Confidence	Apr	65.4	May	64.3	Jun	66.4		-
Unemployment rate (%)	Jan	11.3	Feb	11.2	Mar	10.6	-	10.9
GDP (SA WDA, QoQ%)	Q3	0.4	Q4	0.8	Q1	1.3	+	0.7
GDP (YoY%)	Q3	1.9	Q4	2.6	Q1	2.3	+	1.7
GDP (WDA, YoY%)	Q3	1.9	Q4	2.5	Q1	2.4	+	1.7
Core CPI (YoY%)C	Apr	7.0	May	7.5	Jun	7.5	-	7.6
CPI (YoY%)	Apr	7.9	May	8.1	Jun	7.2	-	7.8
PPI (YoY%)	Apr	4.8	May	6.5	Jun	6.7	+	6.7
1W Repo Rate Announcement (%)	Apr	7.50	May	7.50	Jun	7.50		7.50
Overnight Borrowing Rate Announcement (%)	Apr	7.25	May	7.25	Jun	7.25		7.25
Overnight Lending Rate Announcement (%)	Apr	10.75	May	10.75	Jun	10.75		10.75
Trade balance (US$bn)	Mar	-6.2	Apr	-5.0	May	-6.8	-	-6.6
Current account (US$bn)	Mar	-5.0	Apr	-3.5	May	-4.0	-	-3.5

Source: Bloomberg

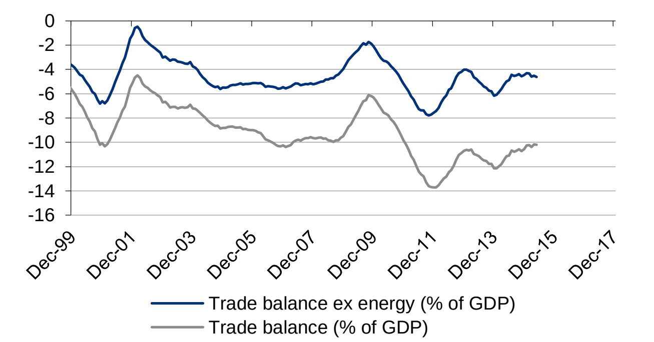
Additional charts

Fig 9 Wages and credit growth



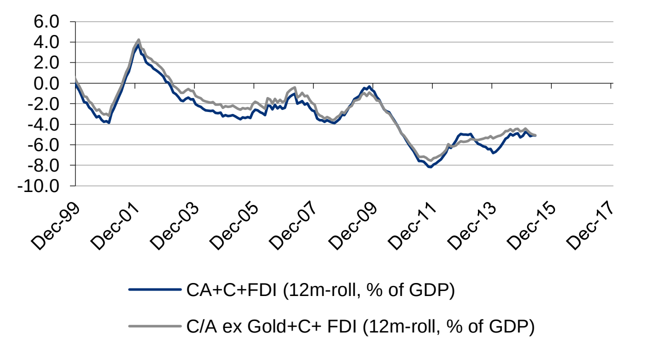
Source: EcoWin, ING estimates

Fig 10 Trade balance (annual)



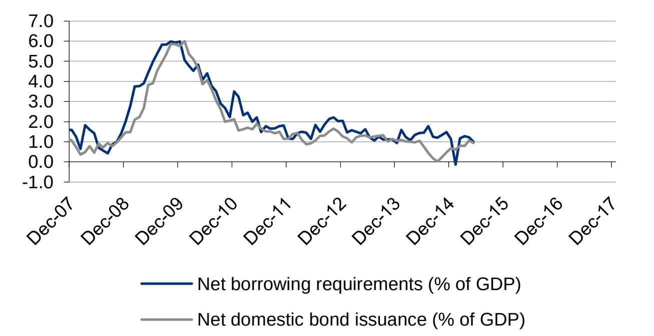
Source: EcoWin, ING estimates

Fig 11 Current and capital accounts + net FDI



Source: EcoWin, ING estimates

Fig 12 Govt central borrowing requirements (annual)



Source: EcoWin, ING estimates

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