Economics

14 September 2015

MonitorING Turkey

Increasing risks of a rating cut

Fitch is scheduled to complete its regular review of Turkey's sovereign rating on September 18. Although the agency noted current political and security risks, a still significant external deficit and vulnerability to Fed normalization as major risk factors, we do not expect a rating change. We think that Fitch would prefer to see the outcome of early elections in the beginning of November before making any significant change. Turkey's strong fiscal performance is a relief factor. Ongoing political uncertainty, geopolitical deterioration, institutional framework problems and sensitivity to shifts in capital flows mean that odds for a negative rating action is increasing.

Key points:

- We have revised up our 2015 GDP growth forecast to 3.0% from 2.9% on the back of higher than expected 2Q growth and the upward revision of the 1Q figure.
- Given the upside surprise in August inflation and weakening bias in the currency, we have increased our end-2015 CPI inflation forecast to 7.9% from 7.7%.
- The CBT has already signaled that when the Fed starts its hiking cycle, it will start hiking the 1-week repo rate and maintain the cycle with gradual moves. We expect that the first move to a single rate - by adjusting the 1-week repo rate upwards towards the centre of the corridor - might take place in October.
- Turkey's ongoing idiosyncratic risks that have undermined investor confidence significantly in recent months lead us to revise USD/TRY from 2.80 to 2.95 for 2015F and from 3.00 to 3.25 for 2016F.

Strategy:

FX: USD/TRY has depreciated c.30% in 2015, while the 50:50 USD:EUR basket has fallen to all-time lows, down by more than 25%. Accordingly, TRY REER is at its lowest levels since 2003 and significantly below its long term average. We expect the elevated political and geopolitical risks to prevent any major improvement in TRY, even though it seems to be somewhat undervalued.

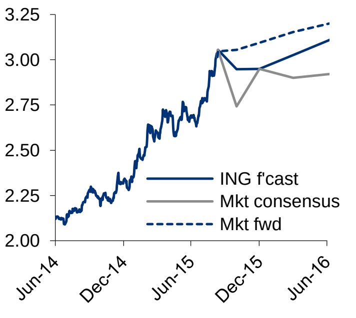
Local debt: Turkey has underperformed other EM peers, with significant increases in rate expectations translating into 337bp and 265bp higher rates in 2Y and 10Y benchmark bonds since the beginning of this year. With domestic issues the major drivers of rate movements, we expect yields o remain high and possibly to rise further.

Quarterly forecasts

	1Q15	2Q15	3Q15F	4Q15F	1Q16F	2Q16F	3Q16F	4Q16F
Real GDP (%YoY)	2.5	3.8	3.4	2.2	2.3	2.8	3.5	3.7
CPI (%YoY) eop	7.6	7.2	7.5	7.9	6.8	6.7	7.1	6.8
Policy interest rate (%) eop	7.50	7.50	7.50	8.00	8.50	9.50	9.50	9.50
3-month interest rate (%) eop	10.50	11.34	11.19	11.20	11.64	12.38	12.66	12.40
10-year yield (%) eop	8.44	9.36	10.59	9.77	10.55	11.72	11.18	10.97
Exchange rate (USDTRY) eop	2.60	2.68	3.00	2.95	3.03	3.10	3.18	3.25
Exchange rate (EURTRY) eop	2.79	2.99	3.30	3.10	3.09	3.04	3.18	3.32

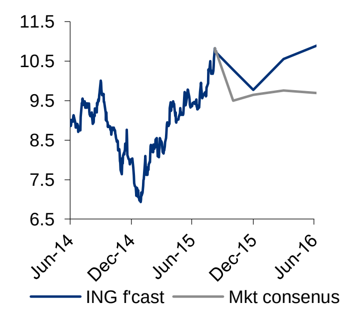
Source: MacroBond, ING estimates

USD/TRY



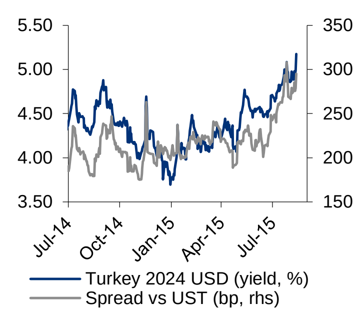
Source: MacroBond, ING estimates

Local 10Y yields



Source: MacroBond, ING estimates

US$ Eurobond 2024



Source: Bloomberg

Latest indicator surprises

Output	Negative
Consumption	Negative
Inflation	Higher
External	Neutral
Budget	Neutral

Source: Bloomberg

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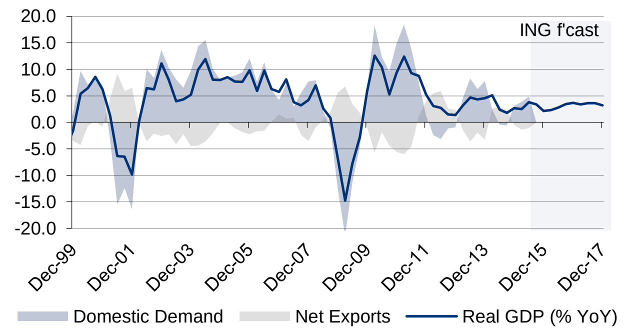
Fig 1 Real GDP (%YoY)and contributions (ppt)

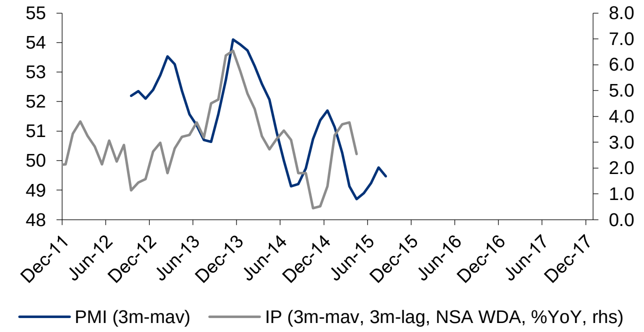


Source: MacroBond, ING estimates

Upside surprise in 2Q15 growth

- Economic activity was better than expected in 2Q5, with 3.8% YoY growth. This corresponds to strong sequential growth of 5.5% (QoQ SA annualized), close to 6.0% in Q1 and above 4.0% in Q4.
- Private consumption and investment stood out as the major drivers, with 3.6ppt and 2.3ppt contributions to GDP growth respectively. Public demand, a drag in the previous two quarters, turned positive again, reflecting accelerating growth in consumption and negligible contributions from investment. Net exports reduced the 2Q headline by 1.1ppt, attributable to the impact of weak exports. Inventories dragged GDP growth down by a significant1.9ppt.

Fig 2 IP vs PMI

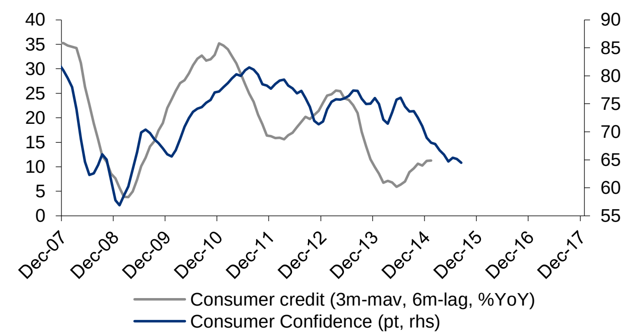


Source: MacroBond, ING estimates

Weak start to 3Q

- While IP growth has remained in positive territory since a negative reading in January, it turned out to be worse than expected in July with a mere 0.3% YoY increase.
- The most significant development was a sharp 11.3% MoM contraction in production of durable goods, following significant volatility in recent months. This is attributable to protests or strikes at automobile and parts manufacturers in May, as well as weakening consumption demand due to currency weakness and tighter financial conditions. Heavyweight intermediate goods turned out to be -1.73% MoM, an indicator of the relatively weak growth outlook in 3Q.

Fig 3 Consumer credit vs consumer confidence

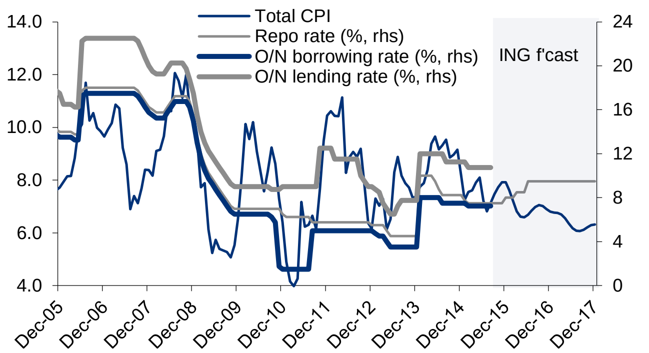


Source: MacroBond, ING estimates

NPL ratio for consumer loans at 2.9%

- Credit growth slowed below the CBT's 15% reference rate in FX adjusted terms, after a yearly average of 30% a few years ago. We expect loan growth to be 15%-18% in nominal terms in the coming period, attributable to macro-prudential measures introduced by the BRSA and monetary tightening. Sector asset quality, on the other hand, has remained reasonably stable at 2.8-2.9%, with the exception of an increase in CC NPLs following BRSA regulatory changes to control credit expansion. The NPL ratio in this banks asset class increased from 5.0% at end-2013 to 7.1% at the beginning of Sep-15. The consumer NPL ratio moved from 2% from 2.9% in the same period, but is not at worrying levels.

Fig 4 CPI vs policy rate

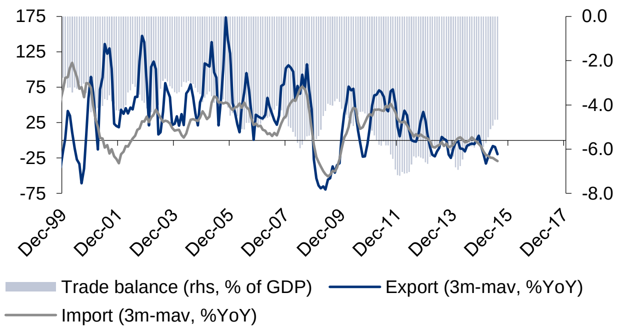


Source: MacroBond, ING estimates

Inflationary pressures strong in August

- CPI rose 0.4% last month, above the consensus at 0.1%. Strong food prices at higher than the August average of the last 10 years and FX pass-through impacted the monthly reading, mitigated by favourable clothing and energy prices. Annual CPI increased to 7.1%, from 6.8% a month ago (the lowest level in more than two years, also influenced by some cyclical factors).
- Of core indicators, prices in H&I indicators for August rose 0.34% and 0.24%, respectively. Annual H&I inflation jumped to 7.83% and 7.66%, from 7.60% and 7.31%. The data hints at the impact of FX pass-through, as evidenced by continuing increases in automobile and white-good prices.

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

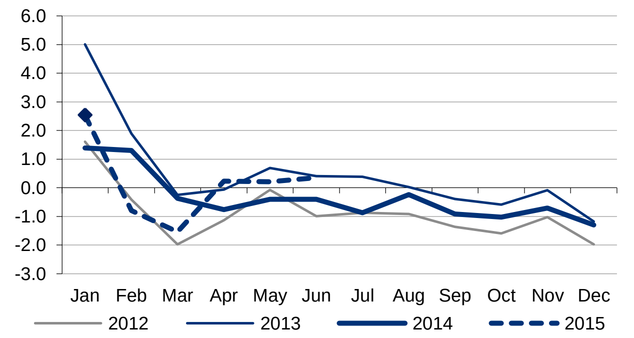


Source: MacroBond, ING estimates

Trade deficit expanded in July

- The trade balance came to USD7.0bn and pulled the 12M rolling deficit up to USD78.6bn. Despite a continuous decline in imports on the back of lower oil prices, weakness in exports driven by movements in EURUSD parity and geopolitical developments paved the way for a YoY increase in the July trade deficit.
- Contractions in mineral oil, plastics, iron & steel and chemicals imports were most significant, while significant growth in gold imports as well as expansion in automotive imports are notable. Regarding exports, major sectors declined markedly, while automotive, gold, iron & steel and mineral oil stood as the major contributors to the YoY contraction.

Fig 6 Budget performance YTD (% GDP)

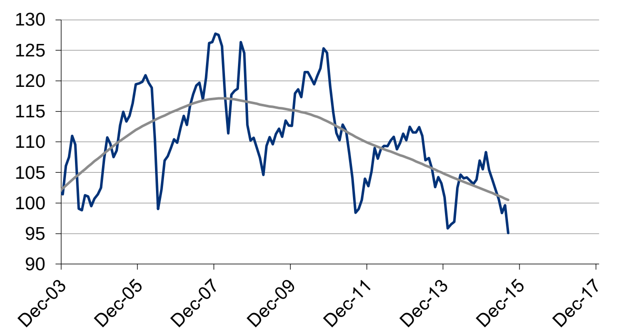


Source: MacroBond, ING estimates

Fiscal performance remains on track

- Since the 2001 financial crisis, fiscal performance has been one of the main strengths of the Turkish economy. This trend continued in the first half of 2015, reflecting improving tax revenues, despite growth in non-interest expenditures. Interest payments remained at double digit levels. Although we see significant volatility in monthly results, budget figures are generally in line with targets despite general elections held in the beginning of June
- Growth in 1H is domestically driven but, given political uncertainty and volatile and weaker capital flows as well as escalating geopolitical tension, downside risks to the growth outlook are increasing. This in return might weigh on revenue collection.

Fig 7 FX: REER vs trend (index)



Source: MacroBond, ING estimates

The CBT to squeeze liquidity further

- With the CBT roadmap to be implemented during global monetary policy normalization, related steps will correspond to neither tightening nor easing of current monetary conditions, so leaving domestic monetary conditions unchanged. Given this backdrop, TRY should remain under weakening bias, reflecting political issues, geopolitical developments and increasing domestic security concerns. We expect tight liquidity conditions to continue.
- TRY REER is close to the lowest levels seen since 2003 and is 13-14% below of its long term average. Given the recent movements, it might drop further in September.

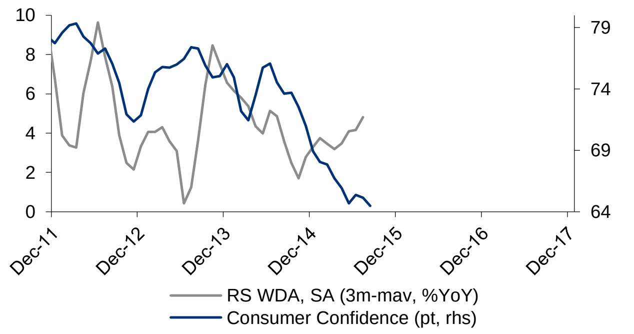
Fig 8 Main macroeconomic recent releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilization (%)	Jun	75.1	Jul	75.9	Aug	74.8		-
Industrial Confidence	Jun	104.9	Jul	105.4	Aug	103.7		-
Industrial Production (SA WDA, MoM%)	May	-1.9	Jun	2.0	Jul	-1.5	-	0.4
Industrial Production (WDA, YoY%)	May	2.4	Jun	4.9	Jul	0.3	-	3.7
Consumer Confidence	Jun	66.4	Jul	64.7	Aug	62.4	-	65
Unemployment Rate (%)	Mar	10.6	Apr	9.6	May	9.3	+	9
GDP (SA WDA, QoQ%)	Q4	1.0	Q1	1.5	Q2	1.3	+	0.7
GDP (YoY%)	Q4	2.7	Q1	2.5	Q2	3.8	+	3.1
GDP (WDA, YoY%)	Q4	2.6	Q1	2.6	Q2	3.8	+	2.9
Core CPI (YoY%)C	Jun	7.5	Jul	7.3	Aug	7.7	+	7.5
CPI (YoY%)	Jun	7.2	Jul	6.8	Aug	7.1	+	6.9
PPI (YoY%)	Jun	6.7	Jul	5.6	Aug	6.2	+	5.8
1W Repo Rate Announcement (%)	Jun	7.50	Jul	7.50	Aug	7.50		7.50
Overnight Borrowing Rate Announcement (%)	Jun	7.25	Jul	7.25	Aug	7.25		7.25
Overnight Lending Rate Announcement (%)	Jun	10.75	Jul	10.75	Aug	10.75		10.75
Trade Balance ($bn)	May	-6.8	Jun	-6.2	Jul	-7.0	-	-7.0
Current Account ($bn)	May	-4.3	Jun	-3.3	Jul	-3.2	+	-3.6

Source: Bloomberg

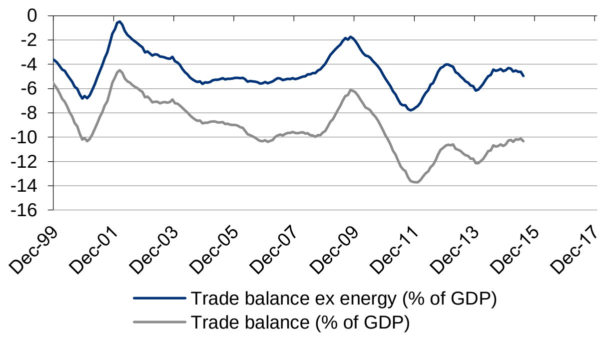
Additional charts

Fig 9 Retail sales vs consumer confidence



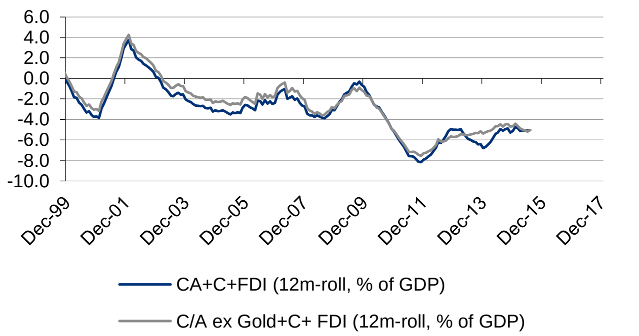
Source: MacroBond, ING estimates

Fig 10 Trade balance (annual)



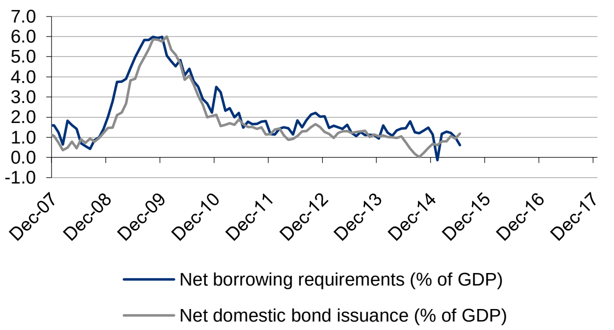
Source: MacroBond, ING estimates

Fig 11 Current & capital accounts +net FDI



Source: MacroBond, ING estimates

Fig 12 Gov't central borrowing requirement (annual)



Source: MacroBond, ING estimates

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