Emerging Markets

6 September 2016

MonitorING Turkey

Momentum loss

Despite resilient consumer confidence in August, with a jump to the highest level since the November elections, other data releases show a relatively downbeat macro picture: (1) the PMI at its lowest level since the global crisis; (2) a continuing drop in tourist arrivals; (3) sluggish business sentiment; (4) a further drop in manufacturing capacity utilisation; and (5) a weak trend in exports and imports.

- We envisage growth in 2Q to be 3.2%, following higher-than-expected performance in 1Q. The 2H of this year is likely to show a slowdown, and we expect 2016 growth to be 3.5%, with more visible downside risks lately.
- Despite benign August data, average annual inflation has continued to fluctuate in the 7.5-8.0% range for a long while, hinting at inertia around these levels. We think headline annual inflation will end the year at c.8.2%.
- There are increasing signals of macro prudential easing, as suggested by the BRSA plan to relax consumer finance loan terms and remove the ban on CC instalments for mobile phones. The CBT is also likely to remain on a policy path focussed on growth, accompanied by lower real policy rates and a weaker currency.

Moody's review of Turkey's rating, announced on 18 July, remains ongoing, with plans to conclude it any time before mid-October. An early release of the decision is likely to impact markets this month.

FX and Money Markets. TRY has recovered almost all of its post 15 July losses, with support from the benign global risk appetite and the search for yield. Going forward, the Fed rate normalisation cycle and the CBT's inclination to keep real rates at low levels continue to be major drivers, likely keeping the TRY under pressure in the medium term, while Moody's decision remains key in the short term.

Domestic debt and rates. Local bonds recovered some of their losses after the 15 July events, though the recovery was not as pronounced as in TRY spot. This partly reflects ongoing uncertainty about the rating outlook and the ongoing Moody's credit rating review. If Moody's decides not to downgrade, TURGBs are likely to outperform, while any adverse decision can weigh on the yields.

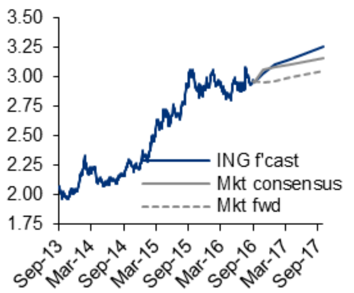
External debt. TURKEY US$ paper is still trading c.30bp (in Z-spread terms) above pre-coup levels. Further recovery is likely to be hampered by the risk of a downgrade by Moody's in the weeks ahead. That said, the front-end of the curve (2-5Y) remains steep relative to EMEA peers, and still trades at a significant discount vs BRAZIL (particularly in the 2-3Y area).

Quarterly forecasts

	1Q16	2Q16	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F	4Q17F
Real GDP (%YoY)	4.8	3.2	2.4	3.8	3.4	3.8	3.8	3.9
CPI (%YoY) eop	7.5	7.6	8.1	8.2	8.7	8.5	7.9	7.5
Central bank key rate (%) eop	7.50	7.50	7.50	7.50	7.50	8.00	8.00	8.50
3m interest rate (%) eop	11.07	9.50	9.13	9.12	9.26	9.40	9.54	9.67
10yr yield (%) eop	9.95	9.22	10.13	9.79	10.85	10.59	10.59	11.18
Exchange rate (USD/TRY) eop	2.82	2.88	2.99	3.10	3.15	3.20	3.25	3.30
Exchange rate (EUR/TRY) eop	3.20	3.16	3.23	3.41	3.53	3.68	3.84	3.96

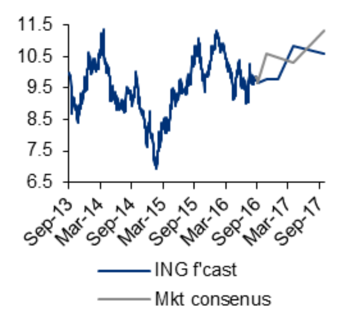
Source: Macrobond, ING estimates

USD/TRY



Source: Macrobond, ING estimates

Local 10Y yields



Source: Macrobond, ING estimates

US$ Eurobond 10Y

Source: Bloomberg, Reuters

Latest indicator surprises

Output	Negative
Consumption	Neutral
Inflation	Lower
External	Neutral
Budget	Neutral

Source: Bloomberg

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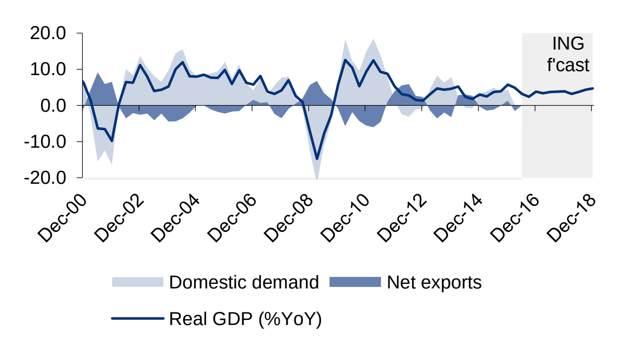
Fig 1 Real GDP (%YoY) and contributions (ppt)

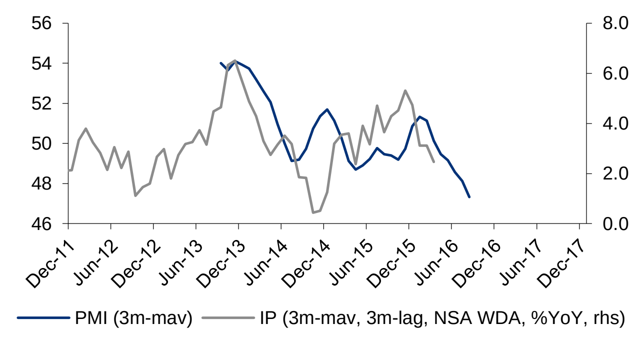


Source: Macrobond, ING estimates

The government's easing policies to support demand

- Fitch affirmed Turkey's rating at investment grade, but lowered the outlook to 'negative' from 'stable', with little impact on market indicators. Moody's, on the other hand, is reviewing its Baa3 long-term FC debt rating, which it's likely to conclude by 18 October.
- Private demand turns out to be the major factor behind relatively buoyant growth in 1Q, despite weak investment appetite. However, there has been evidence of a loss of economic momentum recently. The government is already working on alternative ways to stimulate demand. Loss of an investment grade rating may lead to the introduction of further measures to help confidence normalise and consumption recover, going forward.

Fig 2 IP vs PMI

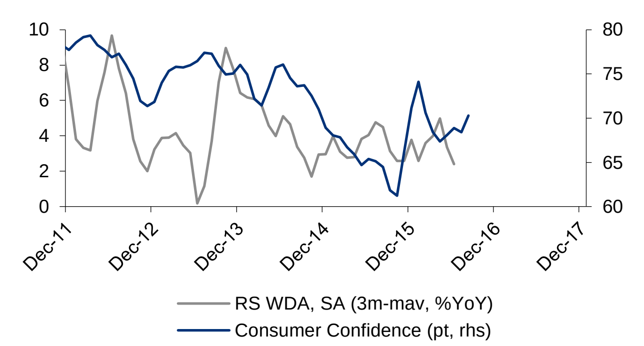


Source: Macrobond, ING estimates

IP weakness in 2Q

- The QoQ change in the 3-month average IP (SA) stood at -0.6%, a deterioration from 1.4% in the first quarter of 2016, driven mainly by negative growth in the production of heavyweight non-durable goods. Production in all broad economic groups show momentum loss over the previous quarter, while for intermediate goods – another heavy-weight group – growth in production also turned negative, in addition to that of non-durable goods. Only energy production remained in positive territory, with a 0.5% QoQ increase.
- In all, contraction in consumption goods hints at a lower contribution from private demand to 2Q growth, in comparison with a quarter ago, while investment appetite has remained weak.

Fig 3 Retail sales vs consumer confidence

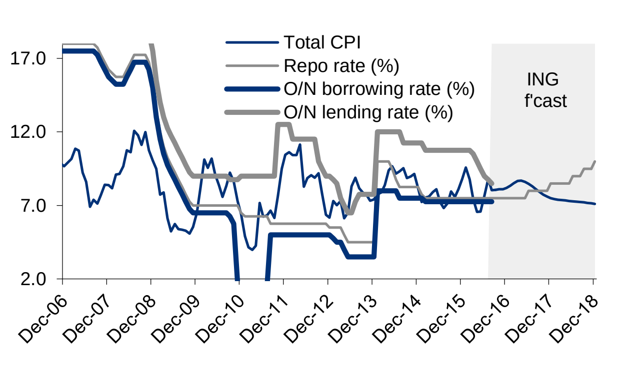


Source: Macrobond, ING estimates

Unemployment (SA) rose to the highest level this year

- The unemployment rate in May recorded a slight increase from 9.3% to 9.4% on a YoY basis, driven by continuing expansion in the labour force, underpinned by further increases in the participation rate.
- On a seasonally adjusted (SA) basis, the unemployment rate increased to 10.2%, the highest since end-2015, from 9.8% a month ago, the lowest in almost two years, following the downtrend between Oct-15 and Apr-16. The deterioration is mainly due to the rise in participation rate (SA) to an all-time high level of 52.1%, despite the number of employed remaining broadly flat. The breakdown reveals that the youth unemployment rate (SA) returned to end-2014 levels, with a significant increase from 17.5% in April to 19.1% in May.

Fig 4 CPI vs policy rate

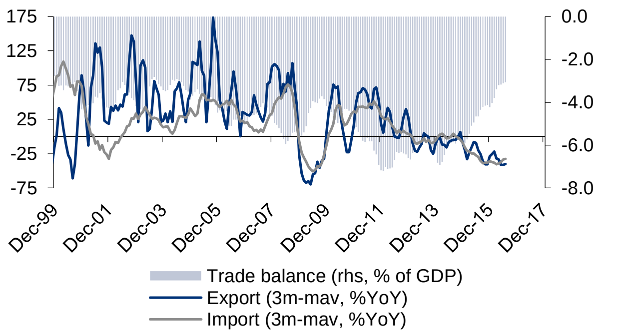


Source: Macrobond, ING estimates

Better-than-expected August inflation

- The CPI dropped by 0.29% in August, pulling annual inflation sharply down to 8.05%, from 8.79% a month ago. This is attributable to downward corrections in food prices and seasonal price declines in clothing. The Domestic Producer Price Index remained practically unchanged, while annual inflation dropped for the first time since March to 3.0%, indicating still moderate cost pressures, despite the expected impact of the significant minimum wage hike.
- Upside risks have remained, given the volatile nature of food prices. On the other hand, support from moderate domestic demand, restricting the pass-through impact and further downward correction in the food group, can be supportive of the inflation outlook.

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

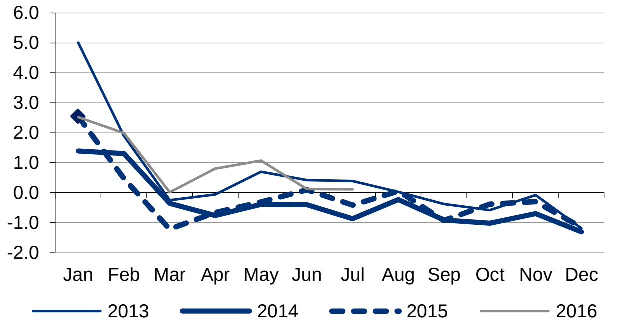


Source: Macrobond, ING estimates

The trade deficit contracted further in July

- The foreign trade deficit, at USD4.8bn in July, contracted the 12M rolling deficit to USD55.8bn, the lowest in six years, following an expansion a month ago for the first time since July 2015. As a result, coverage of imports by exports maintained its uptrend with 71.6%, reflecting the impact of the contribution from soft energy prices, better penetration into the Eurozone and strong gold trading, despite the adverse impact of geopolitical risks.
- The warming of relations with Russia and the consequent removal of sanctions implemented since the beginning of this year should contribute to the external balance, though catching up to trade levels before the downing of the Russian fighter plane may take time.

Fig 6 Budget performance YTD (% of GDP)

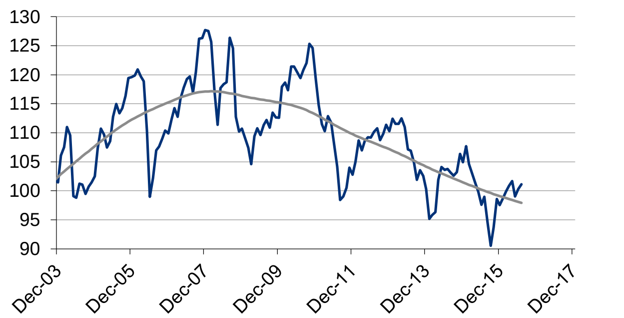


Source: Macrobond, ING estimates

Surging primary spending

- According to the budget performance in the first seven months, the outcome on the expense side reflects the government's efforts to offset a slowdown in private investment by relaxing macroeconomic policies and stimulating domestic consumption.
- Given this backdrop, the government passed legislation aimed at restructuring the debt of 6.3m citizens, amounting to TRY90bn (c.4.5% of GDP). The debt restructuring is likely to support budget performance this year and next. However, the frequent tax amnesties, which have contributed one-off revenue to the overall budget balance in recent years, are likely to have aggravated tax-avoidance issues.

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

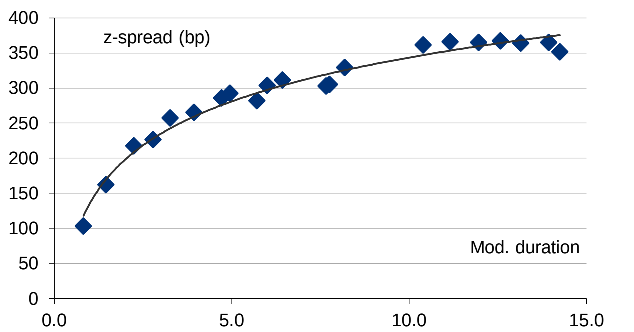


Source: Macrobond, ING estimates

Another cautious 25bp cut from the upper band

- The CBT continued the easing cycle with a 25bp cut from the upper band to 8.50%, while it kept the policy rate at 7.50% and the O/N borrowing rate at 7.25%. The CBT continued rate cuts with the sixth consecutive move (225bp in total since March), highlighting its dedication to policy simplification.
- The bank has not made any reference to simplification, apart from contributing to "the effectiveness of monetary policy". So, despite the determination to complete it in a "reasonable" amount of time, the current pace of cuts may require a few more months to finalise the process. Going forward, the CBT is likely to proceed while closely watching external and domestic conditions.

Fig 8 External debt: TURKEY US$ curve



Source: Macrobond, ING estimates

US$ paper not quite back to pre-coup levels

- TURKEY US$ paper has significantly recovered since July's attempted military coup. Yet, the Z-spread curve remains, on average, 30bp above its early-July level.
- Moody's pending review on Turkey (due by mid-October), alongside further deterioration in fiscal dynamics (vis-à-vis extra spending), should remain hindrances to TURKEY US$ paper returning to pre-coup levels in the short term, in our view.
- Shape-wise, the US$ curve is still steep in the 2-5Y segment, some 10-15bp vs EM peers, in our estimates. The front end of the curve (particularly the 2-3Y area) also continues to trade at a significant discount relative to Brazil.

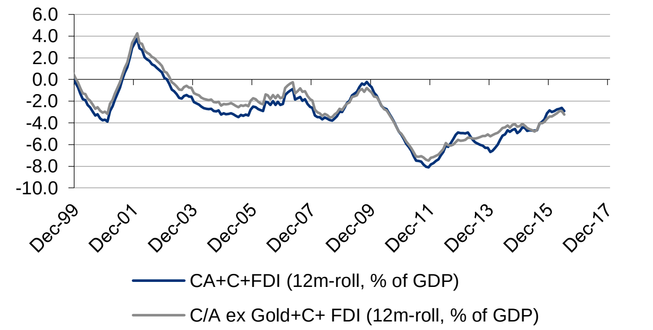
Fig 9 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Jun	76.1	Jul	75.7	Aug	75.2		-
Industrial Confidence	Jun	106.8	Jul	108	Aug	103.6		-
Industrial Production (SA WDA, MoM%)	Apr	-1.1	May	1.7	Jun	-1.4	-	0.6
Industrial Production (WDA, YoY%)	Apr	0.7	May	5.65	Jun	1.1	-	3.7
Consumer Confidence	Jun	69.43	Jul	67.03	Aug	74.4	+	66.5
Unemployment Rate (%)	Mar	10.1	Apr	9.3	May	9.4	+	9
GDP (SA WDA, QoQ%)	3Q	1.1	4Q	1.2	1Q	0.8	+	0.6
GDP (YoY%)	3Q	3.9	4Q	5.7	1Q	4.8	+	4.4
GDP (WDA, YoY%)	3Q	5.0	4Q	4.6	1Q	4.5	+	4.2
Core CPI (YoY%)	Jun	8.7	Jul	8.7	Aug	8.4	-	8.6
CPI (YoY%)	Jun	7.6	Jul	8.8	Aug	8.1	-	8.4
PPI (YoY%)	Jun	3.4	Jul	4.0	Aug	3.0	-	3.6
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	9.00	Jul	8.75	Aug	8.50		8.50
Trade Balance (US$bn)	May	-5.1	Jun	-6.6	Jul	-4.8	+	-4.8
Current Account (US$bn)	Apr	-3.1	May	-3.2	Jun	-4.9	-	-4.3

Source: Bloomberg

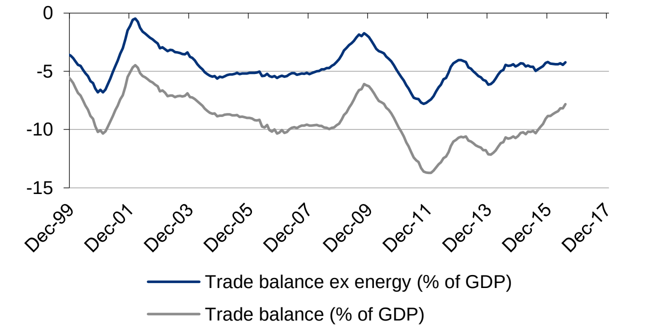
Additional charts

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



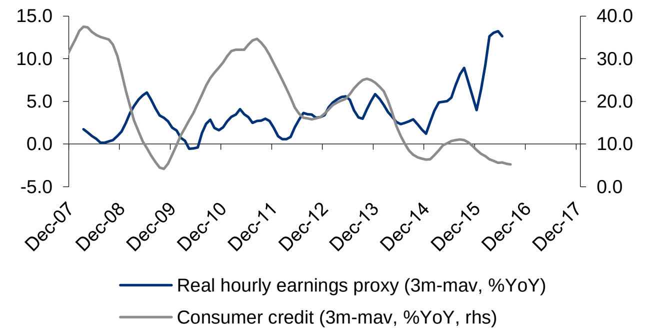
Source: Macrobond, ING estimates

Fig 11 Trade balance (annual; % of GDP)



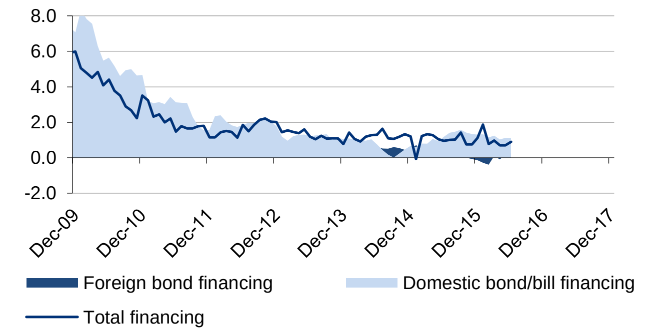
Source: Macrobond, ING estimates

Fig 12 Real wages growth (%)



Source: Macrobond, ING estimates

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



Source: Macrobond, ING estimates

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