

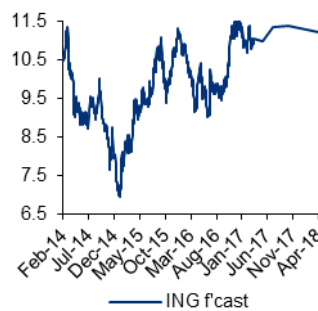
Emerging Markets
10 April 2017

USD/TRY



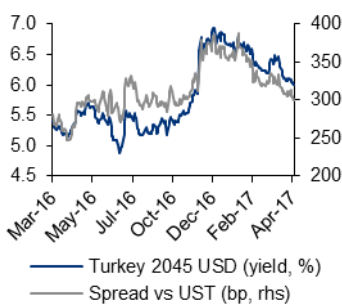
Source: Reuters, ING estimates

Local 10Y yields



Source: Reuters, ING estimates

US\$ Eurobond 30Y



Source: Reuters

Latest indicator surprises

Output	Negative
Consumption	Neutral
Inflation	Higher
External	Positive
Budget	Neutral

Source: Bloomberg

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MonitorING Turkey

Politics on top

Politics will be on top of the agenda this month, given the referendum on 18 proposed amendments of the constitution. The amendments envisage a shift of executive power to the president in 2019, following simultaneous presidential and parliamentary elections but, early elections, which are a major issue for the markets, can take place despite the outcome of the referendum.

- We pulled our growth forecast for 2017 from 2.5% up to 3.1%, given the better-than-expected growth performance in the last quarter of 2016 and recent recovery in some indicators like PMI, consumer confidence, business confidence and lending growth.
- The inflation outlook has seen deterioration beyond expectations in the last four months, with a significant uptrend in annual inflation on the back of TRY weakness and volatility in food prices, despite transitory tax reductions, while we are likely to see further increases in inflation in a few months, on the back of a low base and further reflections of FX pass-through. We revise our end-2017 forecast to 9.4%.

The release of the second inflation report for the year, towards the month end, is due to give more clues on how the CBT sees the inflation outlook, while the April MPC will show how the CBT is responding to the further strengthening of price pressures in the wake of the referendum of 16 April.

FX and money markets: Despite recent weakness, with geopolitical risks in the forefront again, TRY has recovered since mid-January, as significant undervaluation, the CBT's unorthodox tightening by introducing new tools and the recent improvement in flow dynamics having contributed to the performance. TRY is likely to be supported, given high carry and less risk of unexpectedly aggressive Fed tightening, though the upcoming referendum will be key in the near term.

Domestic debt and rates: The yield curve that has been inverted, given the ongoing uptrend in inflation and the CBT's consequent response of policy tightening, is likely to remain so in the coming period. Despite a conducive external backdrop, investors are expected to be cautious ahead of the referendum.

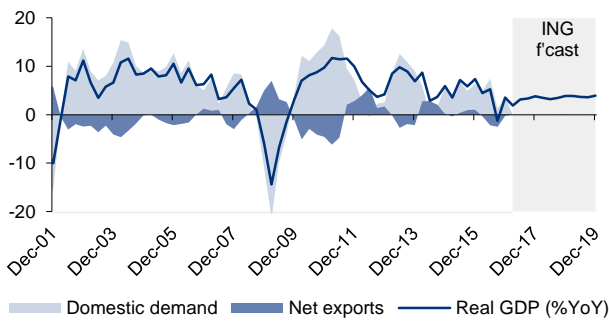
External debt: The back end of the TURKEY USD curve has had a strong run. Notwithstanding the outcome of the referendum, a material break below 300bp to the US requires more positivity on the credit story, which is a tad unlikely in the near term, given the recent re-elevation of geo-political risks in a region where Turkey remains a key player.

Quarterly forecasts

	4Q16	1Q17	2Q17F	3Q17F	4Q17F	1Q18F	2Q18F	3Q18F
Real GDP (%YoY)	3.5	1.9	3.1	3.3	3.8	3.5	3.2	3.5
CPI (%YoY) eop	8.0	11.29	11.1	11.0	9.4	7.5	7.5	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	11.05	11.58	10.35	10.52	11.22	10.70
10yr yield (%) eop	11.39	10.93	11.09	11.65	10.63	10.90	11.59	11.06
Exchange rate (USD/TRY) eop	3.53	3.63	3.61	3.68	3.80	3.86	3.93	3.99
Exchange rate (EUR/TRY) eop	3.70	3.92	3.79	4.05	4.26	4.37	4.48	4.59

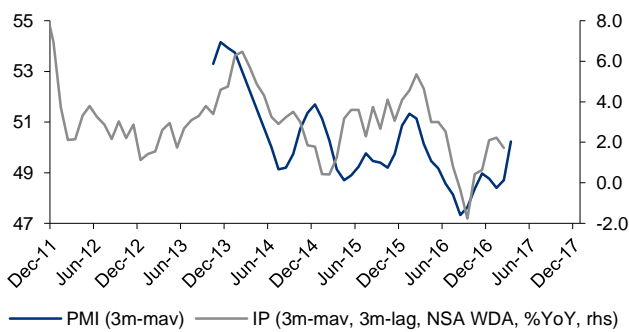
Source: ING estimates

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



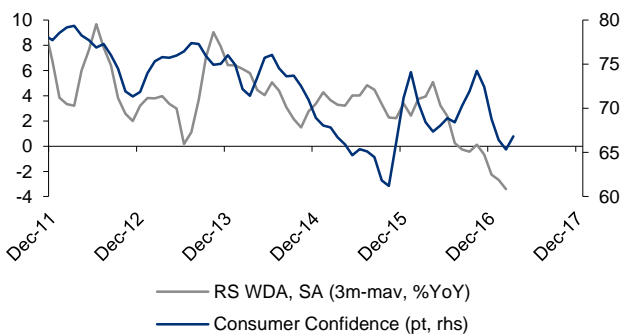
Source: TurkStat, ING estimates

Fig 2 IP vs PMI



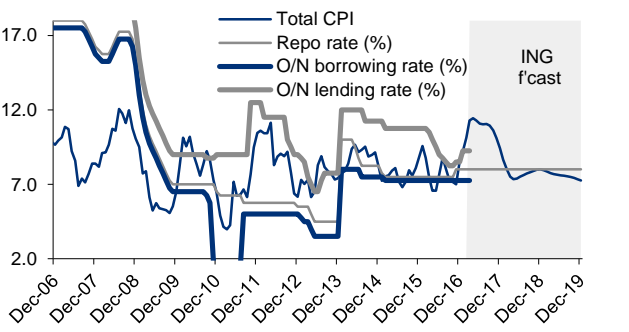
Source: Markit, TurkStat, ING estimates

Fig 3 Retail sales vs consumer confidence



Source: TurkStat, ING estimates

Fig 4 CPI vs policy rate



Source: CBT, ING estimates

Upside surprise in 4Q16 growth

- Economic activity was higher than expected in 4Q16, with 3.5% YoY growth, vs market consensus of 2.3%. Accordingly, following a contraction in 3Q16, for the first time since the global crisis, growth has rebounded, pulling annual GDP expansion in 2016 to 2.9%, still lower than the government's 3.2% projection. TurkStat made some backward revisions and changed the 3Q16 contraction -1.3%, from -1.8% previously.
- Economic growth reverted to positive territory in 4Q16, following political tensions and a shock to the tourism sector. The rebound seems to be stronger than anticipated, with a sharp recovery in private consumption and net exports.

IP loses momentum in February

- The industrial production index (calendar adjusted) was below market consensus at 3.1% (vs our 3.5% call), with a mere 1.0% YoY increase in February. On the other hand, the seasonal and calendar adjusted (SA) IP index recorded a -0.4% contraction.
- Following an improvement in 4Q16, the volatile IP figures show a continuation of the recovery in economic activity, as evidenced by improvements in white goods and lending expansion, though economic growth in 1Q17 is likely to be sub-par again. We think risks to the economic outlook are balanced, given the pro-growth fiscal stance of the government vis-à-vis ongoing political issues, geopolitical developments and a volatile global backdrop.

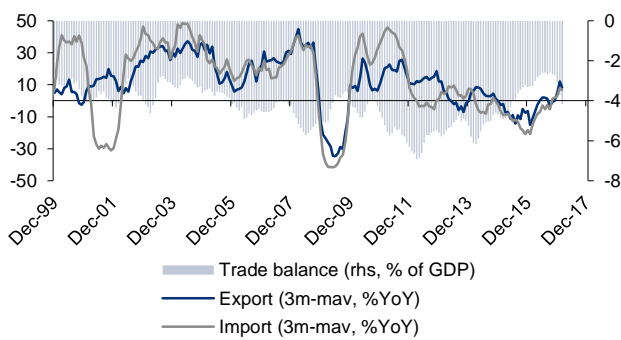
Further increase in the unemployment rate

- On a seasonally adjusted (SA) basis, the unemployment rate stood at 12.0% in Dec-16, the highest in close to seven years, and maintained its uptrend from 9.9% in 1Q16. The deterioration in labour market conditions has been attributable to sluggish employment generation, while the labour force continues to expand, with the participation rate close to all-time highs at 52.4%.
- On a sequential basis, job creation was negative at -36K MoM, driven by industry (-51K) and construction (-28K), while agriculture and services recorded some gains at 39K and 4K, respectively. The breakdown of labour data reveals that the youth unemployment rate (SA) has remained elevated at 22.5%, the highest since mid-2009.

Annual inflation maintained uptrend

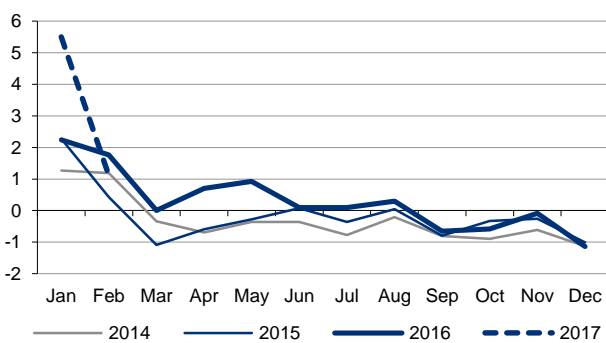
- The March CPI, at 1.02% MoM was, once again, worse than market consensus of 0.6%. The figure pulled annual inflation further to 11.3%, the highest in close to nine years, from 10.1% a month earlier. This is attributable to volatile food prices, TRY weakness and negative base effects.
- Regarding core inflation, the 'C' indicator in the set recorded a 1.25% change in March, the highest since the inception of the '2003=100' index. As a result, annual inflation in this indicator jumped to 9.46% and maintained its upward movement. The lagged structure in the FX pass-through from earlier TRY weakness still implies further pressure on the core inflation outlook.

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



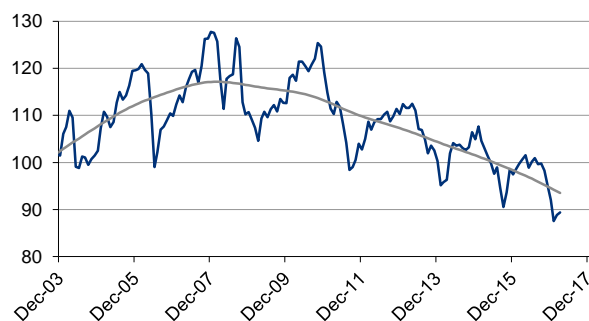
Source: TurkStat, ING estimates

Fig 6 Budget performance YTD (% of GDP)



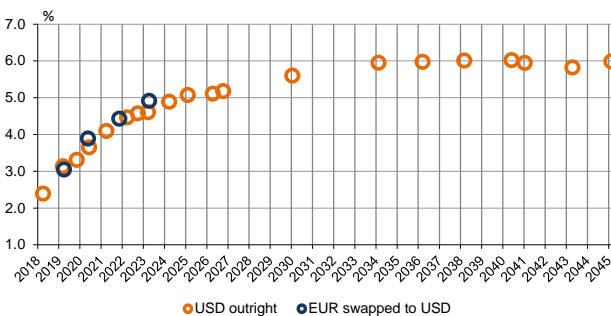
Source: Ministry of Finance, ING estimates

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



Source: CBT, ING estimates

Fig 8 TURKEY USD bonds vs EUR swapped to USD



Source: Macrobond, ING estimates

Modest widening in 12M rolling trade deficit

- The foreign trade deficit, at USD4.3bn in Feb, pulled the annual deficit slightly up to USD57.0bn.
- Looking at the breakdown by the top 20 chapters, automotive growth was attributable to better EU demand. Iron & steel and energy, with recovering commodity prices, supported exports, though plunging gold exports weighed on the performance. Excluding gold, export growth was 5% (vs -1.9% actual). Coupled with close to tripled gold imports, net gold trade turned out to be less positive in February on a 12M rolling basis. On the imports side, contractions in boilers & machines, automotive, aircraft and electrical equipment partially offset surges in energy and gold.

Budget performance weakened in February

- The central administration budget balance recorded a TRY6.8bn deficit in February, significantly down vs the same month of last year with a +TRY2.4bn reading. The monthly outcome shows weakness in revenue generation (a mere 4.8% YoY), elevated primary spending at 27.4% YoY growth and a jump in interest expenditure (by 23.3% YoY) due to the uneven distribution of the Treasury's repayment schedule. Accordingly, the primary balance also turned to a deficit of TRY1.8bn, from a TRY6.5bn surplus.
- Fiscal policy has seen some loosening since mid-2015, to offset a slowdown in private investment, as the 12M rolling budget deficit reached its highest since end-2012.

The CBT delivered LLW tightening

- In the second rate-setting meeting of the year, the CBT hiked the late liquidity window (LLW) rate by 75bp to 11.75%, while keeping other relevant rates unchanged.
- In the statement, a relatively hawkish tone prevailed, as the bank sounded more concerned about the inflation outlook, given that core indicators have seen deterioration beyond expectations in the last three months. The CBT envisages the uptrend to remain in place in the short term, on the back of "lagged pass-through and the base effect in food prices". So, the current problematic outlook indicates a challenging year for the CBT on the price stability front, with an ongoing uptrend in inflation expectations.

TURKEY USD back end to pause at 300bp

- The back end of the TURKEY USD curve has had a strong run, helped by a decent move lower in the US long bond yield. The latter has managed to nudge back below 3% and the 25bp move that brought it there has been matched by a 50bp move in the TURKEY 45s. A key ingredient in the weeks ahead will be whether support holds at 2.3% in the US 10yr. Any break lower will bring back-end TURKEY down with it. However, the implied beta of 2x is unlikely to be repeated, with the absolute spread now back to 300bp. Notwithstanding the referendum outcome, a material break below 300bp requires more positivity on the credit story, which is a tad unlikely in the near term, given the recent re-elevation in geopolitical risks in a region where Turkey remains a key player.

Contribution from Padhraic Garvey, Global Head of Rates and Debt Strategy

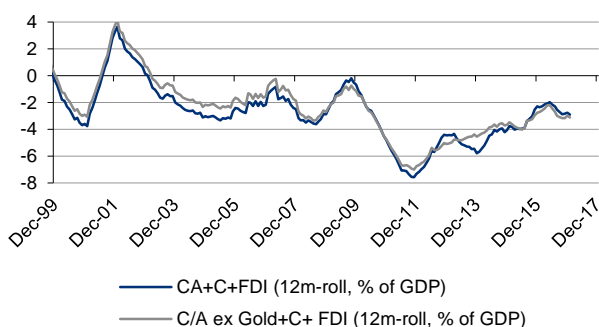
Fig 9 Main recent macroeconomic releases

Indicator		Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilization (%)	Jan	75.5	Feb	75.4	Mar	74.9	-	75.3	
Industrial Confidence	Jan	97	Feb	105.3	Mar	108.1	+	103	
Industrial Production (SA WDA, MoM%)	Dec	0.0	Jan	1.3	Feb	-0.4	-	1.2	
Industrial Production (WDA, YoY%)	Dec	1.6	Jan	2.6	Feb	1.0	-	2.5	
Consumer Confidence	Jan	66.93	Feb	65.73	Mar	67.8	+	65.6	
Unemployment Rate (%)	Oct	11.8	Nov	12.1	Dec	12.7	+	12.4	
GDP (SA WDA, QoQ%)	Q2	1.7	Q3	-2.1	Q4	3.8	-	3.7	
GDP (YoY%)	Q2	5.3	Q3	-1.3	Q4	3.5	-	3.7	
Core CPI (YoY%)C	Jan	7.7	Feb	8.6	Mar	9.5	+	8.8	
CPI (YoY%)	Jan	9.2	Feb	10.1	Mar	11.3	+	10.7	
PPI (YoY%)	Jan	13.7	Feb	15.4	Mar	16.1	+	14.9	
1W Repo Rate Announcement (%)	Dec	8.00	Jan	8.00	Mar	8.00		8.00	
Overnight Borrowing Rate Announcement (%)	Dec	7.25	Jan	7.25	Mar	7.25		7.25	
Overnight Lending Rate Announcement (%)	Dec	8.50	Jan	9.25	Mar	9.25		9.25	
Trade Balance (\$bn)	Dec	-5.6	Jan	-4.3	Feb	-3.7	+	-3.7	
Current Account (\$bn)	Nov	-2.2	Dec	-4.3	Jan	-2.8	+	-2.9	

Source: Bloomberg

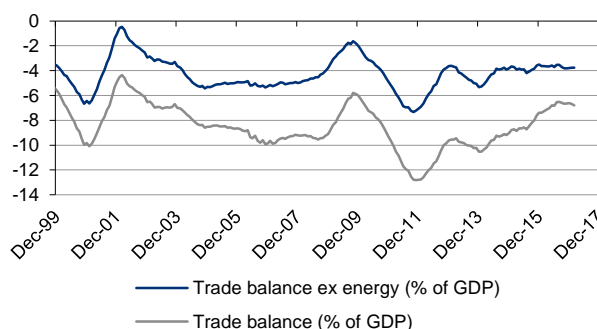
Additional charts

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



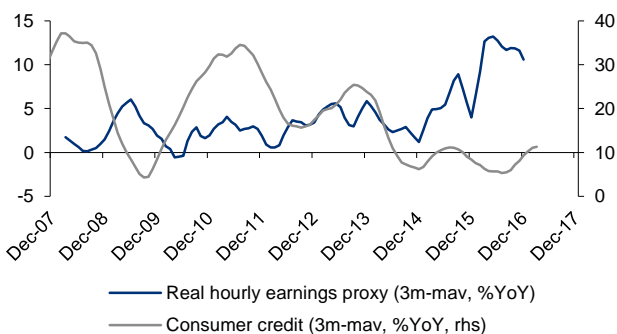
Source: CBT, ING estimates

Fig 11 Trade balance (annual; % of GDP)



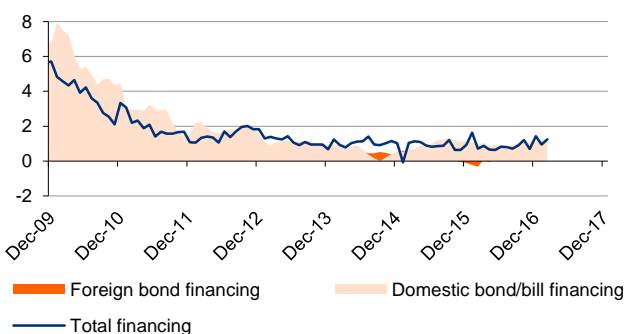
Source: TurkStat, ING estimates

Fig 12 Real wages growth (%)



Source: TurkStat, BRSA, ING estimates

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



Source: Treasury, ING estimates

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