Emerging Markets
13 June 2016

MonitorING Turkey

Buoyant momentum for now

Private demand remained the main driver of GDP growth in 1Q16 and has strengthened markedly in comparison to the previous quarter, along with support from public demand and inventories, while exports weigh. We think that the economy will start slowing from 2Q16 as highlighted by recent indicators.

- We envisage further momentum loss in the second half of this year, with the likely revival of political uncertainty arising from debate about the constitution and tourism sector difficulties to be more apparent in the high season, given a sharp drop in tourist inflows. However, following the resilient performance in 1Q16, we now assess full-year growth in 2016F to be more than expected earlier, and revise it up to 3.9%.
- The recent inflation data suggests that downside risks have increased, in our view, with more-than-expected weakness in food prices since the beginning of this year and a strengthening downtrend in core inflation. Therefore we cut our end-year forecast, from 7.8% to 7.5%.
- The CBT signalled that the easing via upper band cuts might slow, though the current pace of disinflation has provided further grounds to lower the O/N lending rate by 50bp in coming months.

FX and money markets: The TRY recorded a rebound on the back of the smooth transition to the new government, with no major change in the economic management team and some respite for EMs, dampening prospects for early Fed policy tightening. We think that this rebound is likely to be short-lived, given ongoing political uncertainty about the future direction of the country, with a referendum and/or elections likely.

Domestic debt and rates: We see limited potential for nominal bonds and rates, given Turkey's ongoing idiosyncratic risks and little scope for Fed action, given that the current very modest pricing of the tightening cycle should limit appetite for yields. However, the expected easing might be supportive for the short end of the curve.

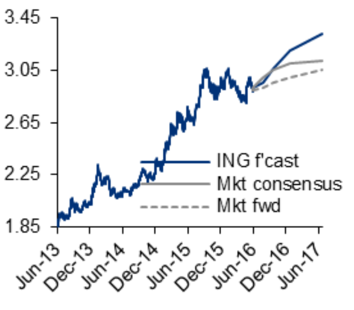
External debt: The TURKEY US$ rally since mid-May has been impressive, amid a resurgence of risk appetite on soft US data. Risks of oil prices consolidating in 3Q16 suggest further support for the assets, but we are concerned about a deteriorating public spending trend (notwithstanding glowing headlines), going into August rating reviews and Brexit risks in the short term. We continue to prefer TURKEY EUR to USD, particularly in the '23 segment. Relative-value wise, as argued in our previous edition, given a scenario of consolidating/correcting oil prices, we prefer TURKEY US$ 6.25% '22 vs INDO 3.75% '22.

Quarterly forecasts

	4Q15	1Q16	2Q16F	3Q16F	4Q16F	1Q17F	2Q17F	3Q17F
Real GDP (%YoY)	5.7	4.8	3.9	3.0	4.1	3.5	3.9	3.7
CPI (%YoY) eop	8.8	7.5	6.9	6.8	7.5	7.7	7.9	7.7
Policy interest rate (%) eop	7.50	7.50	7.50	7.50	7.50	7.50	8.00	8.00
3-month interest rate (%) eop	11.75	11.34	9.96	9.80	9.66	9.81	9.96	10.11
10-year yield (%) eop	10.74	9.95	9.31	9.84	9.94	10.15	10.55	10.50
Exchange rate (USDTRY) eop	2.92	2.82	2.92	3.06	3.20	3.26	3.33	3.39
Exchange rate (EURTRY) eop	3.17	3.21	3.22	3.37	3.52	3.75	3.89	4.00

Source: Macrobond, ING estimates

USD/TRY

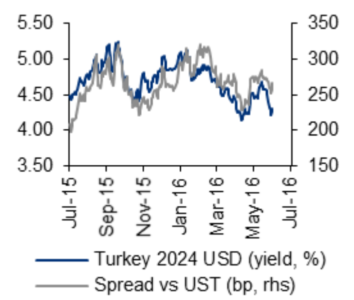


Source: Macrobond, ING estimates

Local 10Y yields

Source: Macrobond, ING estimates

US$ Eurobond 10Y



Source: Bloomberg, Reuters

Latest indicator surprises

Output	Negative
Consumption	Positive
Inflation	Lower
External	Neutral
Budget	Neutral

Source: Bloomberg

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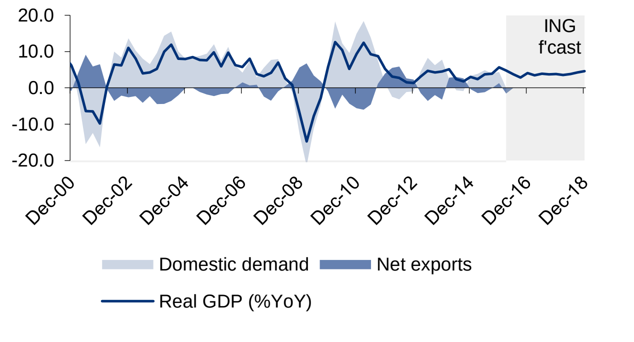
Fig 1 Real GDP (%YoY) and contributions (ppt)

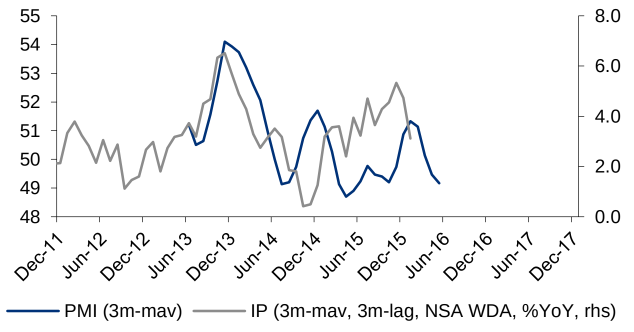


Source: Macrobond, ING estimates

Upside surprise in 1Q16 growth

- Economic activity was better than expected in 1Q16, with 4.8% YoY growth. Private demand, once again, stood out as the main contributory factor, adding 4.8ppt to the headline, while public consumption continued growing fast, pulling the headline up by 1.2ppt, the highest since the global crisis. The momentum is due to wage hikes, with the implementation of election promises, reduced political uncertainty following November elections and the contribution of Syrian refugees. Investments weakened again, on the back of elevated interest rates and lower credit impulse.
- Net exports that dragged growth in 2015, reduced the headline by 1.5ppt. Volatile inventories pulled GDP growth up by 0.3ppt.

Fig 2 IP vs PMI

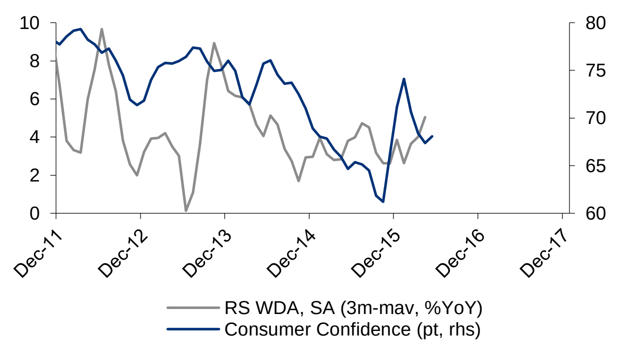


Source: Macrobond, ING estimates

Further momentum loss in April IP

- The IP index (calendar adj.) recorded a lower than expected 0.7% YoY increase in April and lost significant momentum over the previous monthly readings. Following a contraction in March by 0.5%, the seasonal and calendar adjusted (SA) IP index dropped by 1.1% on a sequential basis, the highest since Jul-15.
- The data hints at some momentum loss in 2Q16, given ongoing geopolitical developments, domestic political uncertainty and still-weak global trade dynamics. Apart from IP data, other indicators highlighting the weakening are: PMI in contraction territory, stagnant confidence indicators at relatively low levels, recent sluggish white goods and vehicle sales and a significant drop in tourism revenue.

Fig 3 Retail sales vs consumer confidence

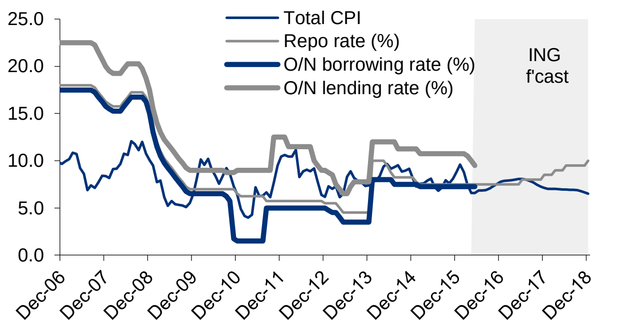


Source: Macrobond, ING estimates

Unemployment rate (SA) declining since Oct-15

- The adjusted (SA) unemployment rate that deteriorated between Apr-15 and Oct-15, from 10.0% to 10.5%, has been improving since then, dropping to 9.9% as of Feb-16. The participation rate (SA) also contributed to the drop in unemployment rate, receding from an all-time high of 51.6% to 50.8% in the same period.
- Job creation was moderate at 45K (in sequential terms), down from 95K a month ago. In the breakdown, the non-agricultural sector emerged with an increased number of jobs (50K MoM), driven by construction (19K) and services (55K), vs a decline in industry (-24K). The negative and positive drivers of sectoral employment were the same as in January.

Fig 4 CPI vs policy rate

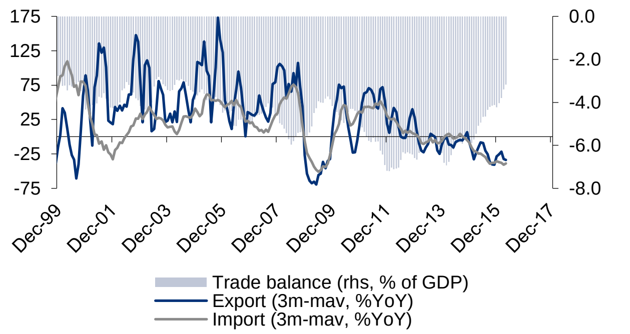


Source: Macrobond, ING estimates

Core inflation outlook improved in May

- The CPI grew by 0.58% last month, below market consensus of 0.78% (INGF: 0.60%), albeit annual inflation that peaked at close to double digit levels in January and declined in the following three months significantly remained unchanged at 6.6%.
- The inflation outlook has improved further in May with a continuation in the disinflationary trend of core indicators. The data suggests that downside risks have increased, in our view, with more-than-expected weakness in food prices since the beginning of this year and a strengthening downtrend in core inflation. However, continued TRY stability would be key for the outlook, along with the lagged impact of recent wage adjustments.

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

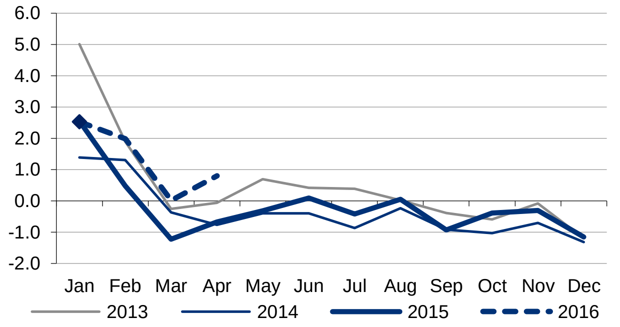


Source: Macrobond, ING estimates

12M rolling trade deficit maintains downtrend

- The foreign trade deficit, at USD4.2bn in April, hit the 12M rolling deficit figure further, from USD60.2bn to USD59.4bn, the lowest in more than five years on a 12M rolling basis, and maintained the protracted improvement trend since end-2013.
- The contraction is, again, due to lower oil prices and Eurozone recovery supporting penetration into EU markets, despite weakening demand from major oil exporters, the impact of ongoing geopolitical risks and sharp drops in gold traded. It is worth noting that the 12M rolling core trade deficit (excluding gold and energy) also improved, with a strong recovery in exports on the back of better demand dynamics in Europe.

Fig 6 Budget performance YTD (% of GDP)

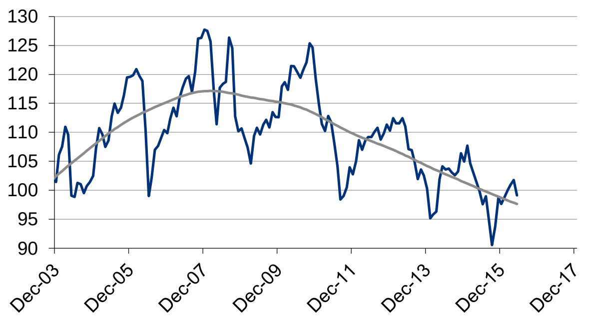


Source: Macrobond, ING estimates

Strong performance in the April budget

- The central administration budget balance recorded a strong TRY5.4bn surplus in April, versus a TRY1.4bn surplus in Apr-15, due to hefty revenue generation and contraction in interest expenditure, though primary spending maintained an uptrend. Accordingly, we see further improvement in the primary balance on an annual basis.
- Creating concerns about fiscal discipline, non-interest expenditure grew rapidly, driven by personnel expenditure (reflecting additional hiring and adjustments in public wages to deliver on election promises) and current transfers relating to health, retirement and social aid expenditure.

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

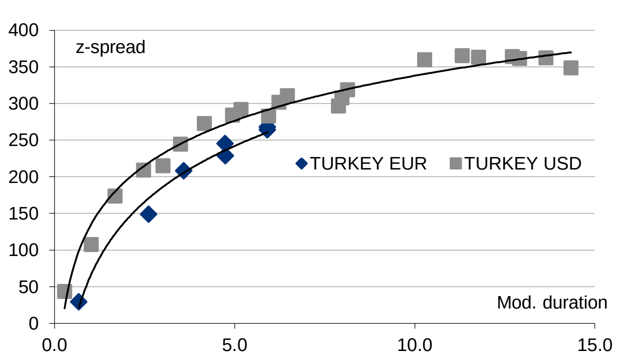


Source: Macrobond, ING estimates

The CBT continued cutting the lending rate

- In May, the CBT delivered a further cut of 50bp to the upper band to 9.5%, vs our call that it would pace the easing with a 25bp cut.
- The decision shows commitment to the simplification process, despite ongoing risks to the inflation outlook and recent swings in market perception on the pace and timing of the Fed's next rate hike. On the other hand, the CBT has kept the effective funding cost unchanged at 8.50%, on average, in May, despite significant TRY weakness. So, although the CBT claims that cuts in the marginal funding rate are not easing, but corridor simplification is, and vows the maintenance of a tight liquidity stance, it has been less responsive to currency weakness lately.

Fig 8 TURKEY US$ and EUR curves



Source: Macrobond, ING estimates

Caution, caution

- Turkey's US$-denominated debt has recovered strongly since mid-May, but not quite back to April's high. The very short end ('17/'18) has outperformed, with the '23-'26 segment also favoured vs the ultra-long end. The rally is partly attributable to diminished concerns following the change in AKP leadership and government reshuffle.
- The fiscal story remain good at the headline level, but higher interest payments and/or public wage hikes could prompt negative comments from rating agencies going into August's reviews. This and risks from persistent political noise surrounding constitutional amendments argue for a cautious positioning on TURKEY.
- But a potential slump in oil prices should act as a powerful buffer.

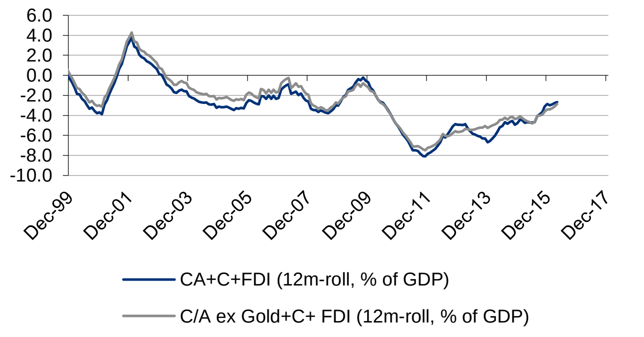
Fig 9 Main recent macroeconomic releases

Indicator	Previous -2		Previous -1		Actual		Surprise	Consensus
Capacity Utilisation (%)	Mar	74.3	Apr	75.3	May	75.7		-
Industrial Confidence	Mar	106	Apr	110.1	May	109.8		-
Industrial Production (SA WDA, MoM%)	Feb	0.5	Mar	-0.5	Apr	-1.2	-	0.1
Industrial Production (WDA, YoY%)	Feb	5.9	Mar	3.0	Apr	0.7	-	3.1
Consumer Confidence	Mar	67.0	Apr	68.5	May	68.8		-
Unemployment Rate (%)	Dec	10.8	Jan	11.1	Feb	10.9	-	11.1
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%)	Mar	9.5	Apr	9.4	May	8.8	-	9.1
CPI (YoY%)	Mar	7.5	Apr	6.6	May	6.6	-	6.7
PPI (YoY%)	Mar	3.8	Apr	2.9	May	3.3	+	2.6
1W Repo Rate announcement (%)	Mar	7.50	Apr	7.50	May	7.50		7.50
Overnight Borrowing Rate announcement (%)	Mar	7.25	Apr	7.25	May	7.25		7.25
Overnight Lending Rate announcement (%)	Mar	10.50	Apr	10.00	May	9.50		9.50
Trade Balance (US$bn)	Feb	-3.2	Mar	-5.0	Apr	-4.2	-	-4.2
Current Account (US$bn)	Feb	-1.9	Mar	-3.7	Apr	-3.0	+	-3.4

Source: Bloomberg

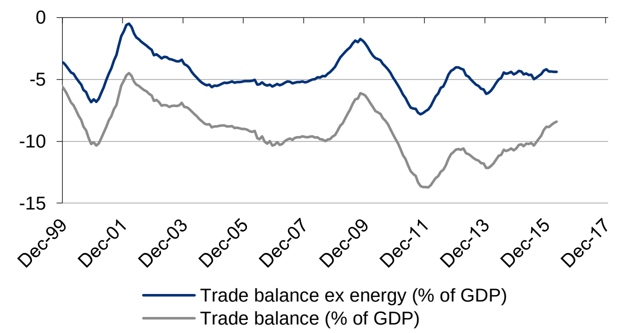
Additional charts

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



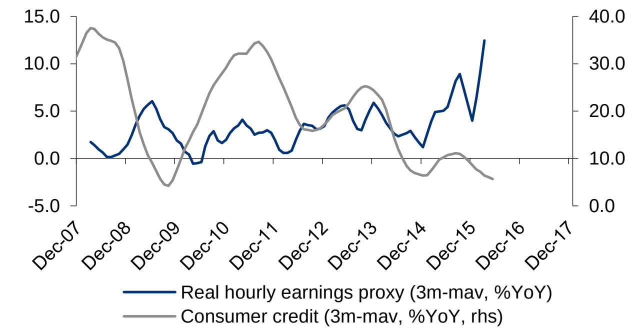
Source: Macrobond, ING estimates

Fig 11 Trade balance (annual; % of GDP)



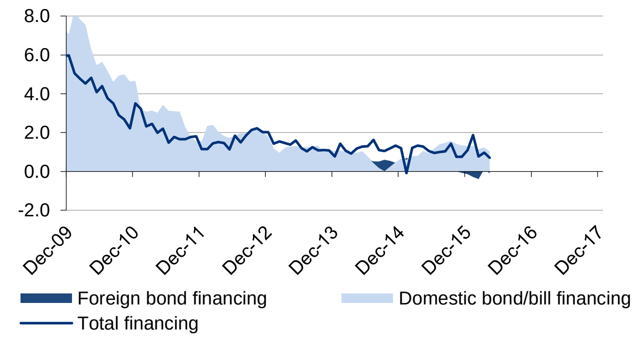
Source: Macrobond, ING estimates

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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