DenizBank Economic Update

October 2018

- Economy
- Financial Markets
- Banking Sector

Economic Research and Strategy
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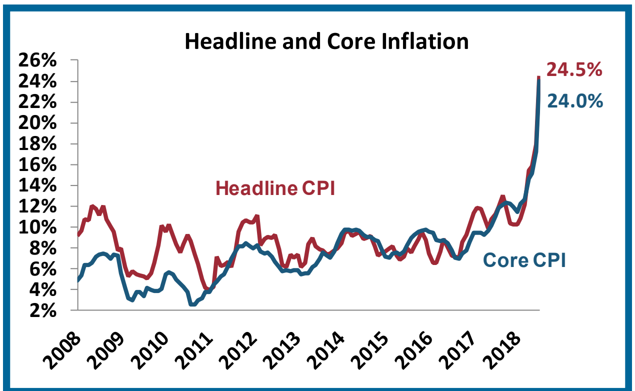
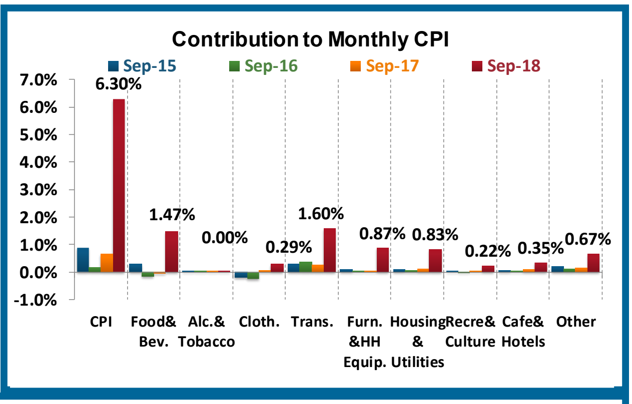
DenizBank Economic Update

Economy (I)

Inflation





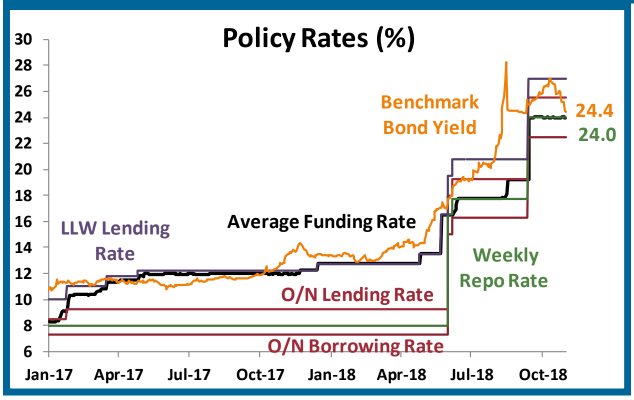
Annual inflation soared to 15-year high in September...

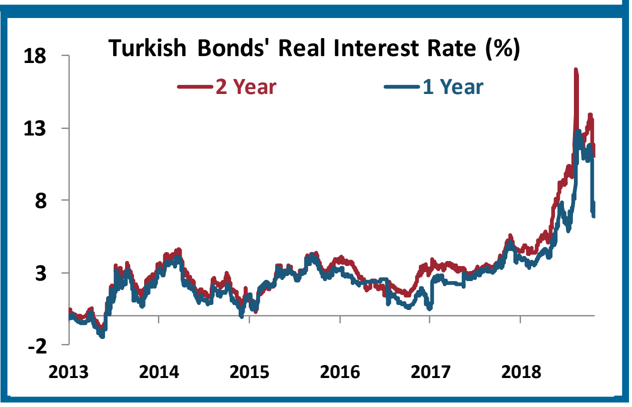
● In September, consumer prices rose sharply by 6.3% MoM, almost double the market expectations of 3.4%. Price hikes spread across all subcategories, while being more pronounced in exchange rate sensitive core goods (transportation and household equipment), food and energy. Moreover, following the 25% plunge in TL basket (.5USD+.5EUR) in August, exchange rate pass through was immediate and more severe on producer prices, which rose MoM by 11%

● September price hikes took annual inflation to 24.5% from 17.9%, its highest level since 2003. Core inflation also accelerated to 24% with a 35% surge in core good prices indicating deterioration pricing behaviour in general. Cost-push pressures strengthened remarkably as PPI inflation soared up to 46% from 32%.

● As exchange-rate depreciation will continue to pass onto CPI, we expect headline inflation to peak in 1Q19 and remain above 20% in 1H19. Anti-inflationary campaign of government and recently announced tax cuts could limit the prices to go up further in some categories as a temporary solution. On the other hand, the removal of the cap on fuel pump prices may put further pressure on inflation in 2019. In light of higher-than-expected September imprint, we revise our 2018 and 2019 inflation expectations to 25% and 16%, respectively.

Monetary Policy





Central Bank remained on hold in October meeting…

● Following the 625 bps hike in the policy rate (1-week repo rate) in September meeting, Central Bank (CB) kept the policy rate constant at 24% in October meeting, in line with the market expectations.

● The tone of the statement was hawkish, acknowledging the significant risks on the pricing behaviour despite weaker domestic demand. CB kept its tightening bias by reiterating that the tight monetary stance will be maintained decisively until inflation outlook displays a significant improvement and promising further monetary tightening if needed. In the last inflation report of 2018, Central Bank revised up its inflation forecasts to 23.5% in 2018 and 15.2% in 2019, keeping its policy guidance unchanged.

● September inflation print (24.5%) eroded the real policy rate buffer provided by sharp rate hike in September, and ex-post real policy rate turned once again to negative territory. Yet recent appreciation of 8% in TL since the last meeting and signs of contraction in economic activity provided a case for CB against an immediate further rate hike. However, we think further tightening still cannot be ruled out, and CB will observe closely the upcoming inflation data. Given the elevated levels of inflation expectations, we expect the CB to keep the policy rate at least at current levels until the end of 1H19.

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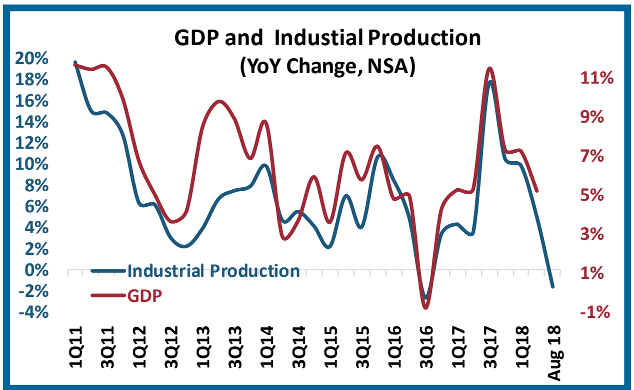
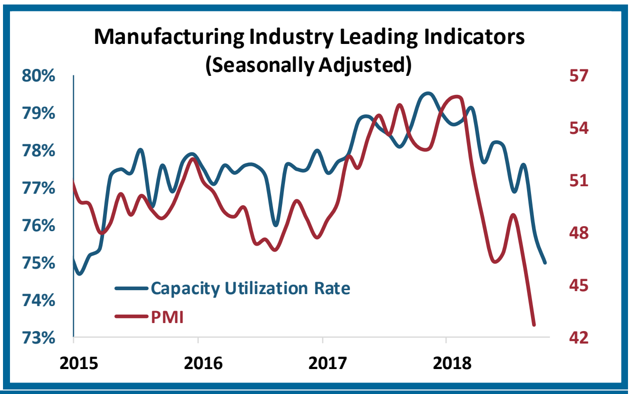
Economy (II)

Growth



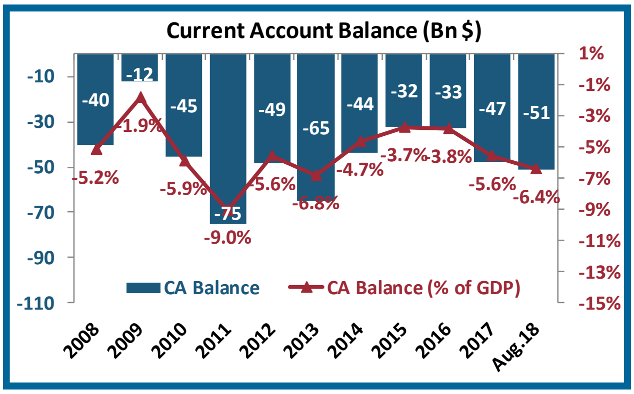


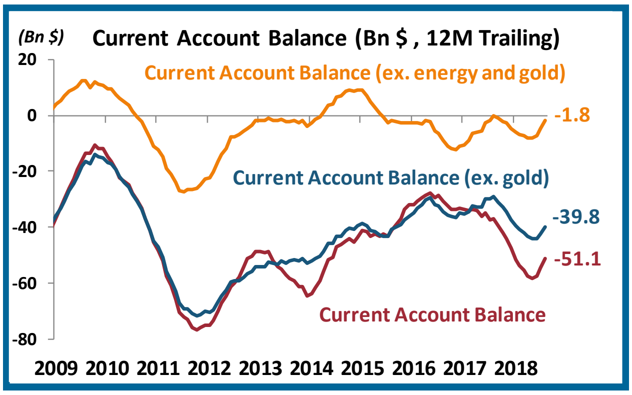
Slowdown in economic activity deepens…

●Turkey's economic growth was robust at 5.2% YoY in 2Q18 (7.8% annualized) thanks to strong private consumption. Yet leading indicators demonstrate a significant downturn in economic activity in 3Q18. Industrial production decreased YoY by 1.6% in July-August period and manufacturing PMI decreased further to 42.7 in September (lowest since 2009), indicating IP growth could turn to negative territory in 3Q18. Imports, 85% of which consists of capital and intermediate goods, declined by 22% in August and 18% in September, also pointing out a significant slowdown in industrial production. Moreover, house, automotive and white goods sales were down by 9%, 68% and 37% respectively, reflecting the contraction in domestic demand.

● As credit growth turned to negative (-7.4%, see page:5) with higher interest rates, we expect a deeper contraction in economy in 4Q18. This is evident in survey-based indicators, as real sector and consumer confidence indices plunge to 9 year-low in October and manufacturing industry capacity utilization rate decreases further to 75% from 76.8% in 3Q18. As contraction in economic activity deepens in 4Q18, we expect 2018 full-year growth rate to decrease to 1-1.5%.

External Sector





Improvement in external balances becomes more visible…

● As the economy entered an adjustment period in 3Q18, external balances started to improve. In August, due to sharp decrease in imports and high tourism revenues, current account recorded a monthly surplus for the first time since 2015. 12-month trailing current account deficit (CAD) decreased to $51.1 bn (6.4% of 2018 GDP forecast) from a peak of $58.3 in May.

● Due to the slowdown in domestic demand, core CAD (exc. energy and gold) declined to $1.8 bn (May: 8.2 bn) and net gold imports decreased to $11.3 bn (May: $14.3 bn) annually in August. On the other hand, upward trend in energy deficit continued due to the higher oil prices (Brent oil $77/bbl in August 2018 vs. 52 $/bbl in August 2017), and annual energy deficit climbed to $38 bn.

● On the financing side, reserve assets ($20.1 bn anually) together with net errors and omissions ($20 bn) have been the main source of financing. Portfolio investment ($2 bn annually) outflows accelerated in August and FDI ($7.4 bn) remained weak.

● Significant decrease in trade deficit ($1.9 bn compared to $8.2 bn a year ago) points to a current account surplus in September as well. Supported by contraction in domestic demand in 4Q18 and stronger exports due to the weak currency, we expect CAD (% of GDP) to decrease to 5% by the end of 2018.

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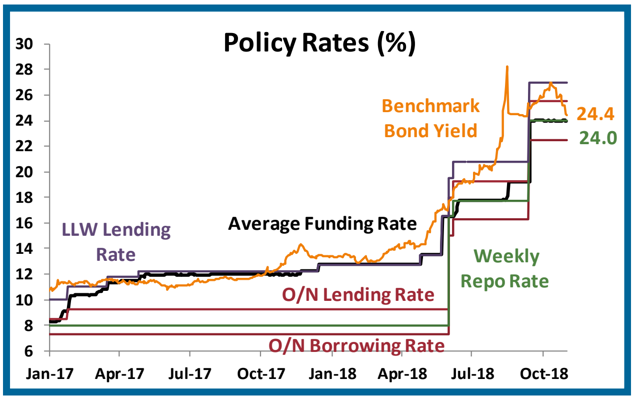
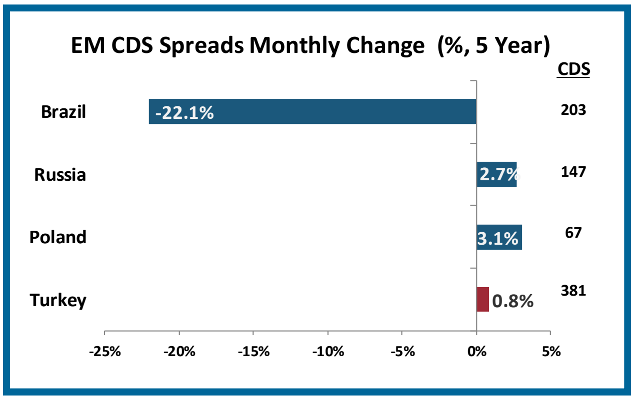
Financial Markets

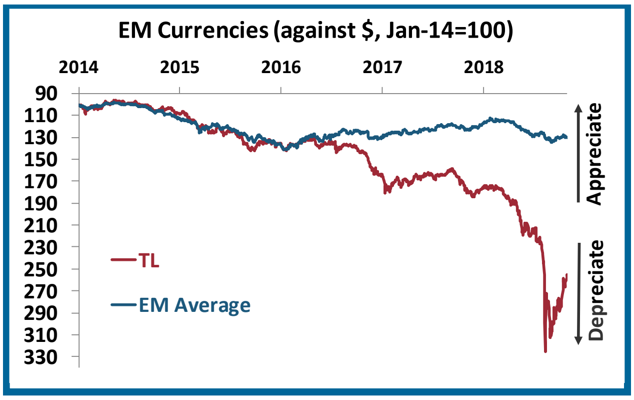
Debt Market

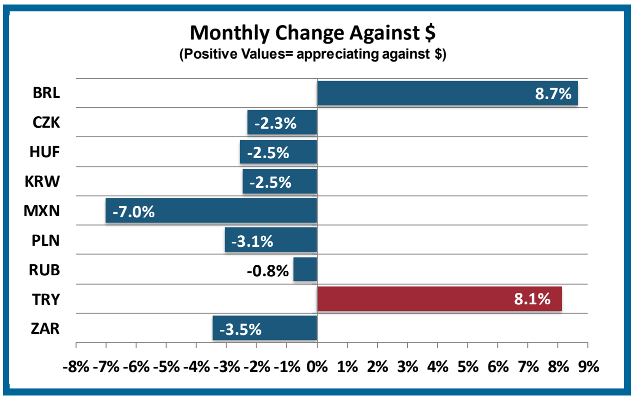




Turkey's CDS (380) remained flat in October, in line with EM peers. 2-year benchmark bond yield decreased moderately by 140 bps to 24.4%.

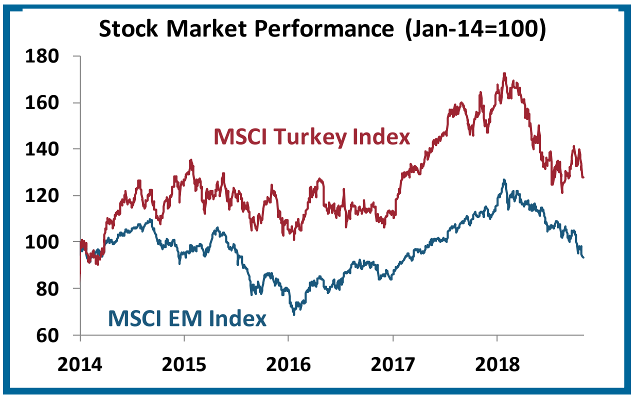
Currency Market

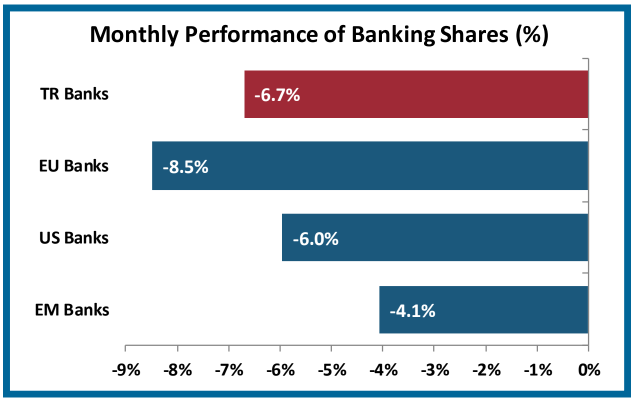




Following the 26% plunge against USD in August, TL appreciated by 20% thanks to strong monetary tightening, a prudent economic program and normalization in US-relations. YtD depreciation in TL is still high at 31%.

Stock Market





MSCI Turkey index was down MoM by 11% (in TL terms) in October, in line with EM peers. On YtD basis, MSCI Turkey index was down by 22%.

Data retrieved from Bloomberg as of 14:00 (GMT + 3), 31.10.2018

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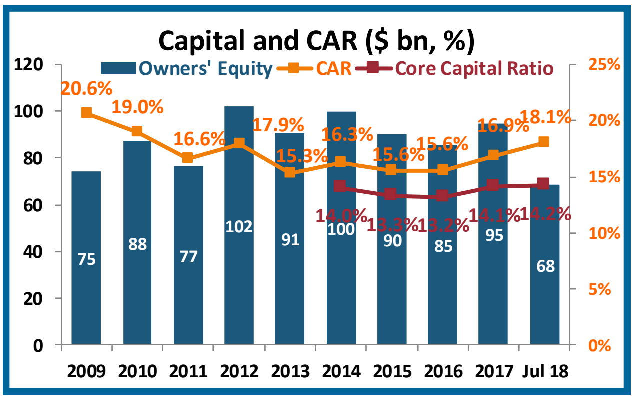
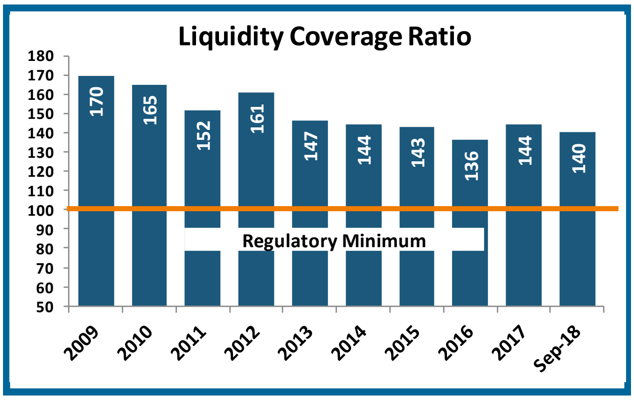
Banking Sector (I)

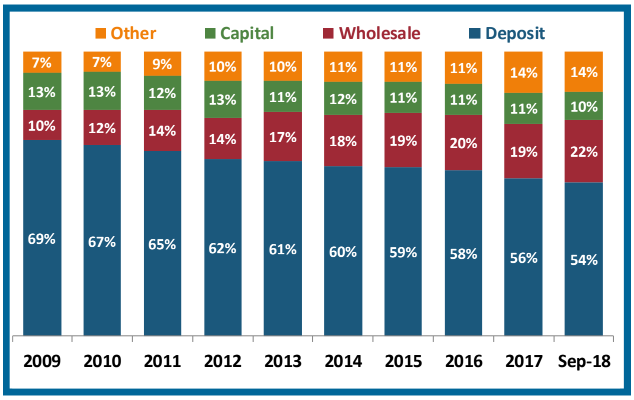
Capital

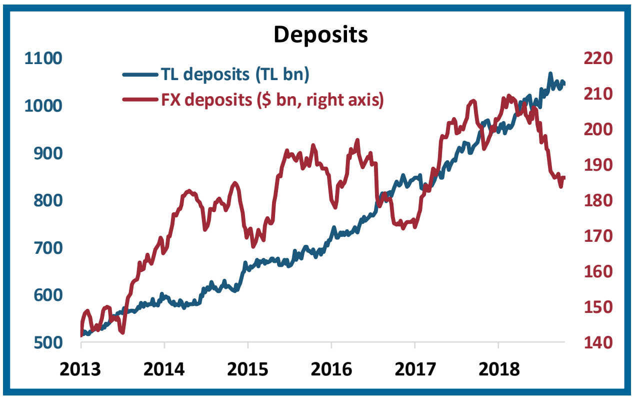




Turkish banking sector has a strong capital base. Capital Adequacy Ratio is at 18.1% as of 3Q18.

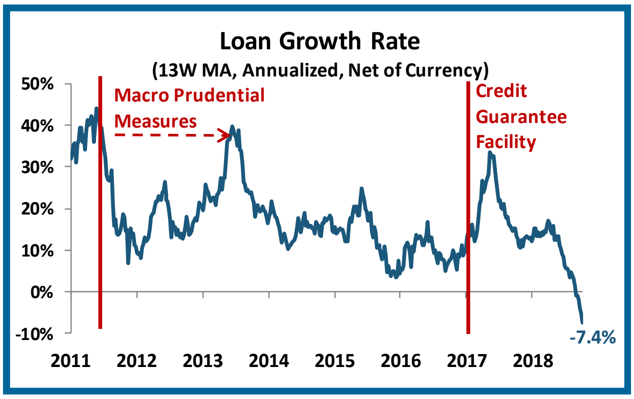
Funding

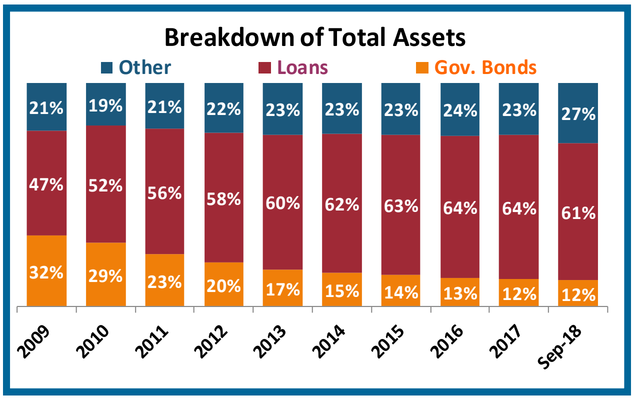




Deposits went up YoY by 25% (1.8% net-of-currency) to TL 2.1 trillion as of October 18. The share of deposits in funding is stable at 54%.

Lending





Annualized loan growth (13 week average net-of-currency) turned into a 7.4% contraction in October 18.

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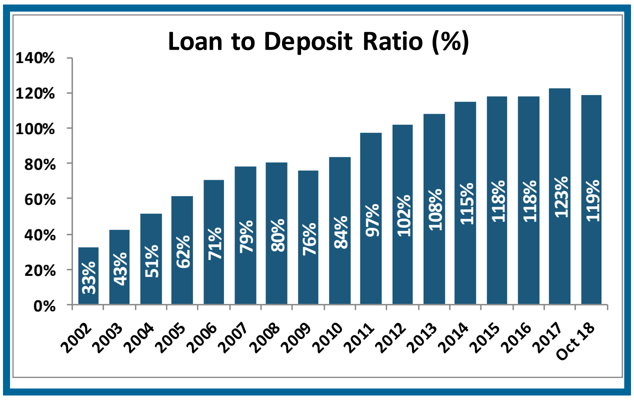
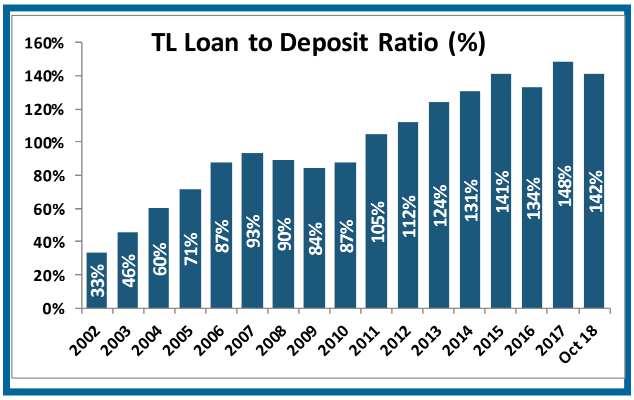
Banking Sector (II)

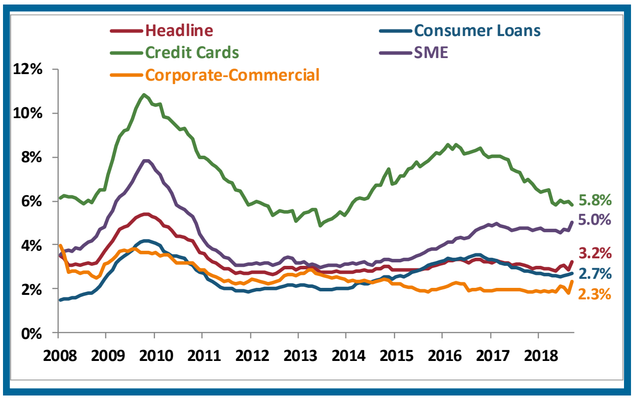
Loan to Deposit Ratios

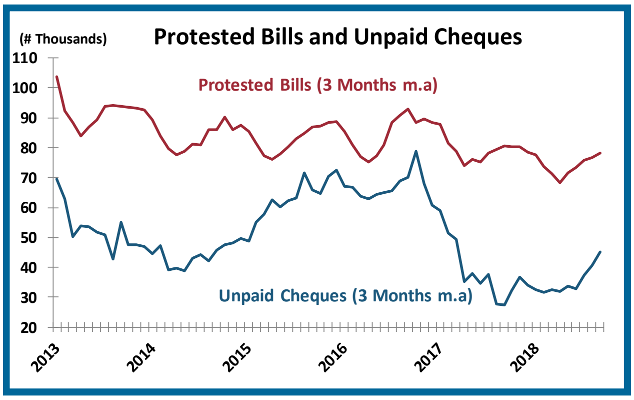




Loan to deposit ratio (LDR) and TL LDR decreased to 119% and 142%, respectively.

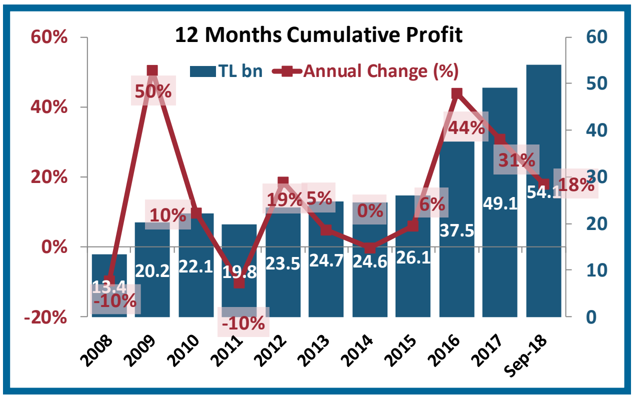
Loan Quality

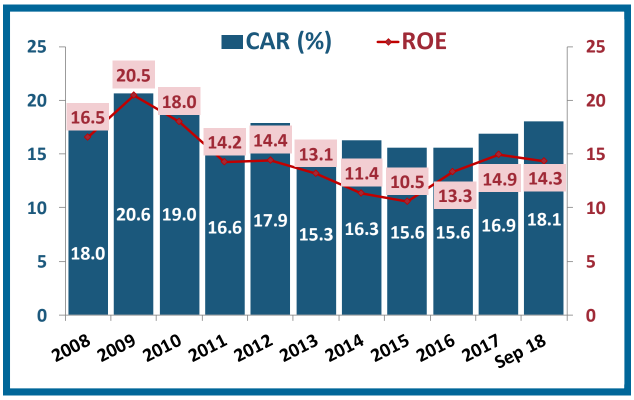




Headline NPL ratio for the banking sector rose moderately to 3.2%.

P & L





As of 3Q18, 12 months cumulative profit increased YoY by 18% to TL 54.1 bn. RoE of the sector decreased slightly to 14.3%.