

DenizBank Economic Update

April 2019

- **Economy**
- **Financial Markets**
- **Banking Sector**

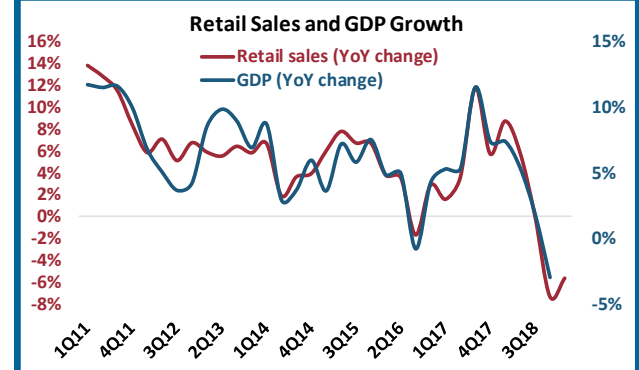
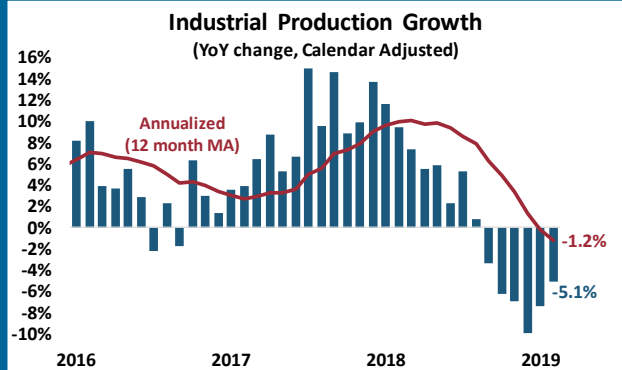


DenizBank Economic Research and Strategy

DenizBank Economic Update

Economy (I)

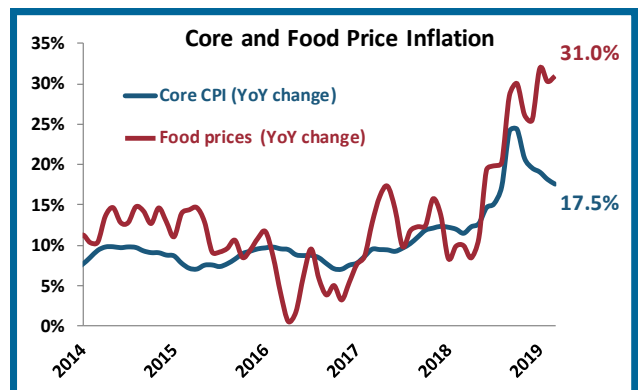
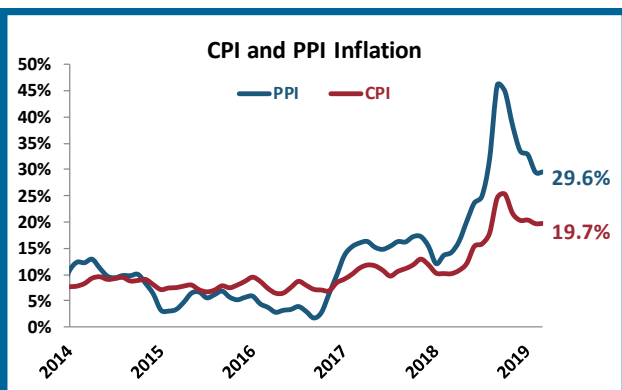
Growth



Contraction in economic activity continued at a slower pace in 1Q19

- Following the sharpest GDP contraction (3% YoY) of last 9 years in 4Q18, leading indicators signal modest recovery in economic activity in 1Q19. Decrease in industrial production (IP) moderated to 5.1% in February, being on average 6.2% down in the first two months of 2019 compared to 7.3% in 4Q18. Moreover, PMI (Purchasing Managers' Index) manufacturing increased to 8-month high (47.2) in March and capacity utilization rate rose to 6-month high (74.7%) in April supported by the pick up in credit growth, signaling a milder decline in IP.
- Hard data on 1Q19 shows signs of similar upturn in domestic demand, as well. Retail sales were down 5.6% YoY on average in Jan-Feb' 19, compared to 7.3% YoY fall in 4Q18. Decline in auto (-36%), white goods (-6%) and house sales (-5%) moderated in March, yet demand for durable still remains muted. On the other hand, external demand was sluggish in 1Q18 with exports up only by 2.8% (4Q18: 7.3%), signaling lower contribution to growth from net exports.
- Overall, leading indicators suggest 2.5% YoY contraction in GDP in 1Q19. We expect consumption and investment to recover moderately in 2Q19, before turning into positive in the 2H19 with the help of low base effect and looser financial conditions. Our 2019 growth expectation is 1%.

Inflation



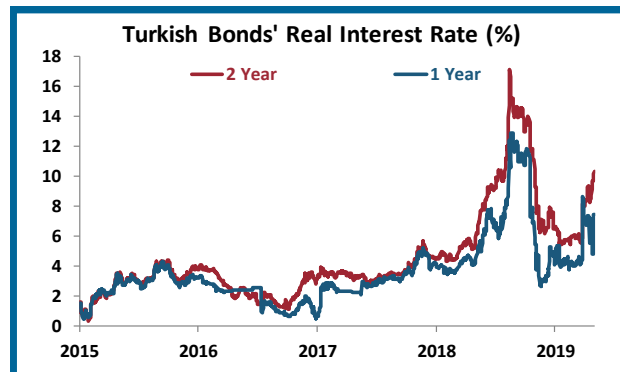
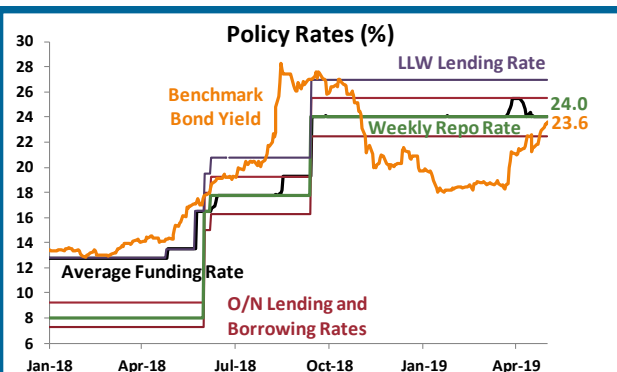
Headline inflation remains flat with core inflation on a downward trend

- Headline (annual) inflation remained flat at 19.7% in March, in line with market expectations. Sticky food inflation (31%) and higher energy prices were the main drivers of headline inflation, while core inflation fell to 17.5% from 18.1% as underlying inflationary pressures were partially subdued by weak domestic demand. Vegetable sales by municipalities proved to be ineffective in allaying inflation with vegetable prices still up YoY by 90%. Core goods inflation moderated to 19.9% from a peak of 35% six months ago due to weak demand for durable goods, while services inflation remained flat at 15.2%.
- Retreat in producers' price inflation (PPI) came to a halt in March with the depreciation in TL and rise in energy prices. Cost-push pressures on headline inflation prevail with PPI inflation elevated at 29.6% and 11% depreciation in TL in the last two months.
- We expect inflation to remain around 20% before starting a downward trend in June (with possible extension of tax cuts on white goods, furniture and automotive) on the back of favorable base effect. Our 2019 year-end inflation expectation is 15%, with upside risks due to exchange rate pass-through.

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Economy (II)

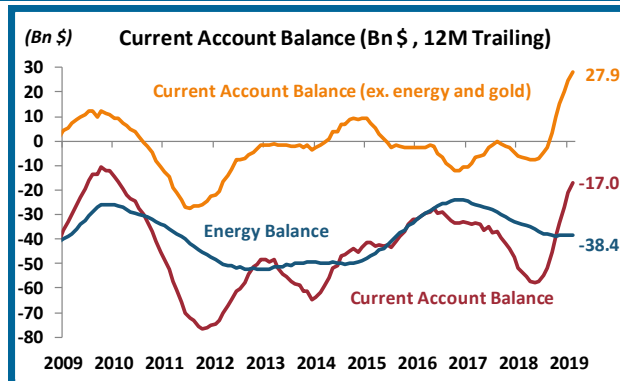
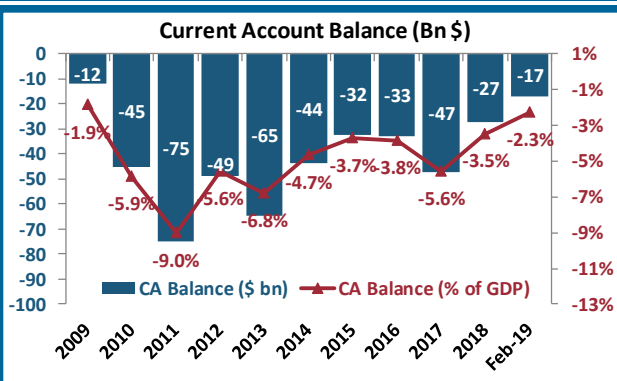
Monetary Policy



Central bank reiterates its commitment to keep tight monetary policy

- Central Bank (CB) kept the policy (one-week repo) rate unchanged at 24% in April, as widely expected. In the decision note, CB kept its hawkish policy guidance with emphasis on risks to price stability and commitment to maintaining tight monetary policy stance until inflation outlook improves significantly. Yet CB removed the tightening bias after ten months, increasing the expectations of a rate cut in June or July meeting.
- In the second inflation report of 2019, Central Bank kept its year-end inflation projection unchanged at 14.6%, compared to the market expectation of 16.2% (CB Survey of Expectations). Although forecasts for food and energy prices were revised upwards, headline forecast was left intact due to improvement in the underlying trend of inflation and downward revision in administered price/tax assumptions. In order to avoid any implication of easing, Governor Cetinkaya stressed that removal of tightening bias from decision note doesn't imply change in policy stance and CB stands ready for further tightening if needed.
- Given CB's guidance and our inflation trajectory, we expect CB to start rate cuts in 3Q19, with a total of 400 bps cut (200 bps in 3Q19+200 bps in 4Q19) in 2019. An unexpected surge in exchange rate and resulting upside pressure on inflation may postpone monetary easing.

External Sector



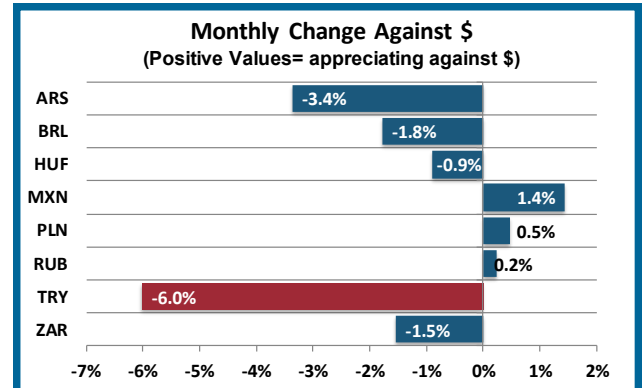
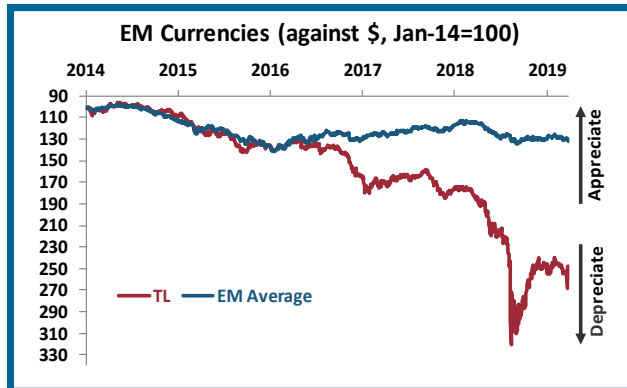
External rebalancing continues with current account deficit shrinking rapidly below 2% of GDP

- Sharp slowdown in domestic demand combined with increased competitiveness of exports led to a rapid improvement in Turkey's external balances starting in 2H18. As of February 2019, annual current account deficit (CAD) decreased more than two thirds to \$17 bn (2.3% of GDP) from a peak of \$58 bn (7.3% of GDP) in 1H18, its lowest level in nine years.
- As imports decreased by 23% YoY since August due to weak domestic demand, core CAD (exc. energy and gold) gave an all-time high annual surplus of \$28 bn (3.7% of GDP). Moreover, annual energy deficit remained stable at \$38 bn as oil prices remains unchanged compared to a year-ago.
- Following a capital outflow of \$17 bn in the 2H2018, early 2019 was characterized by a temporary portfolio inflow of \$8 bn (\$6.6 bn bond issuance). Yet, on annual basis, net errors and omissions (\$19 bn) together with reserve drawdowns (\$8 bn annually) have been the main source of CAD financing. Other investment (loans and deposits) outflows amounted to \$21 bn annually as banks' external debt roll-over ratio decreased to 73%. On the bright side, annual FDI inflows rose to \$10.5 bn.
- In March, trade deficit decreased further by \$3.7 bn with a sharp decrease in imports suggesting CAD shrinking below 2% of GDP. As domestic demand remains muted 2Q19 and oil prices remain at 2018 levels until 4Q19, we expect CAD/GDP to decrease further towards 1% of GDP in 2019.

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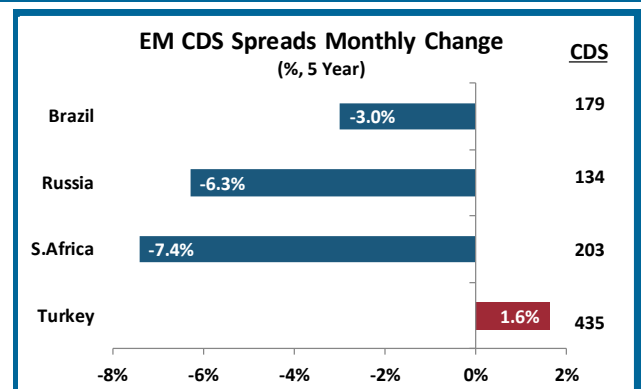
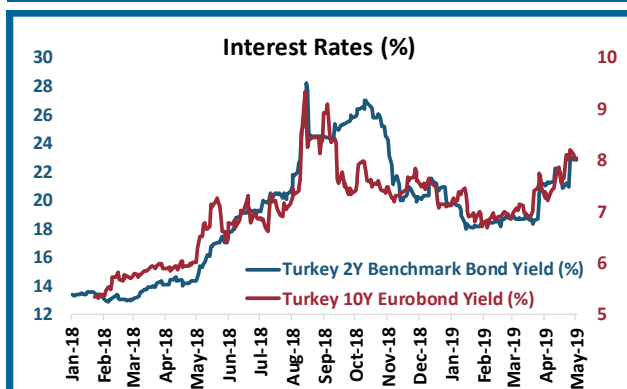
Financial Markets

Currency Market



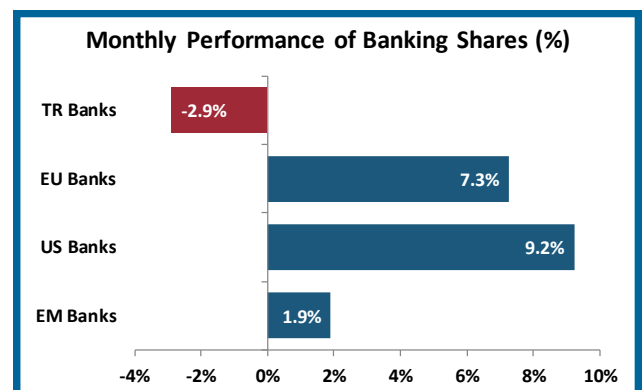
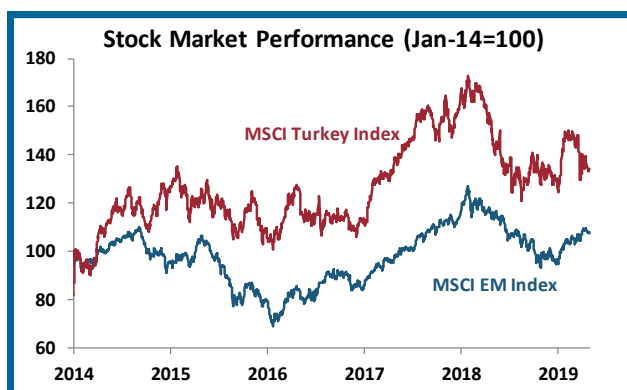
Turkish lira, which has been steady in the first two months of the year, has depreciated 11% since the beginning of March, becoming the weakest performing EM currency on year-to-date basis after Argentine Peso.

Debt Market



Accordingly, Turkey's risk premium and funding cost rose to late 2018 levels. Turkey's 2-year benchmark TL bond yield jumped 500 bps up to 23.6% in two months while 10-year eurobond yield increased 100 bps to 8.0%.

Stock Market

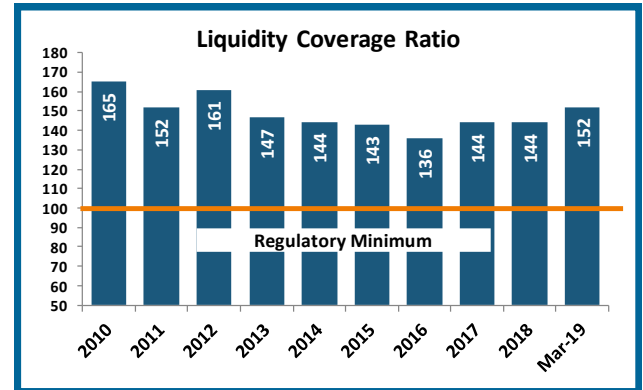
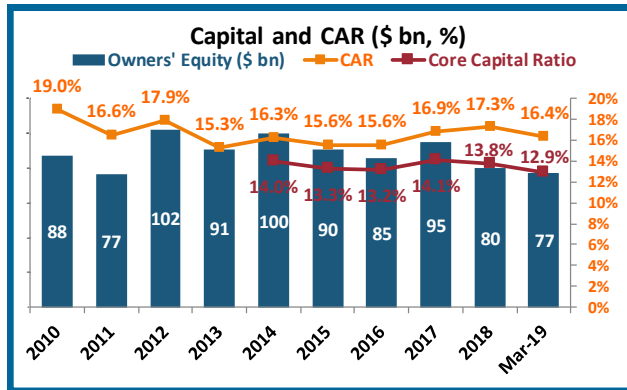


MSCI Turkey index was down 10% (in TL terms) since the beginning of March as well, dragging year-to-date gains to 3% (compared to MSCI EM index, which was up 12%).

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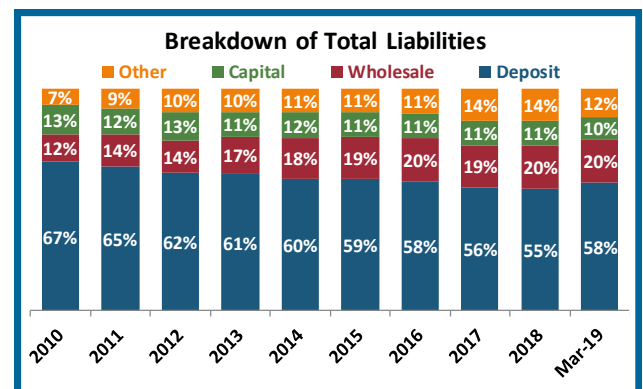
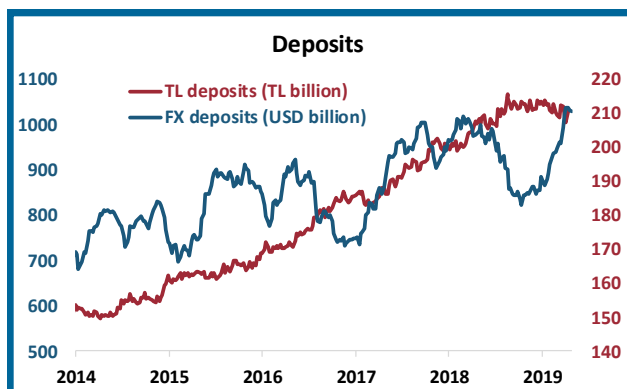
Banking Sector (I)

Capital



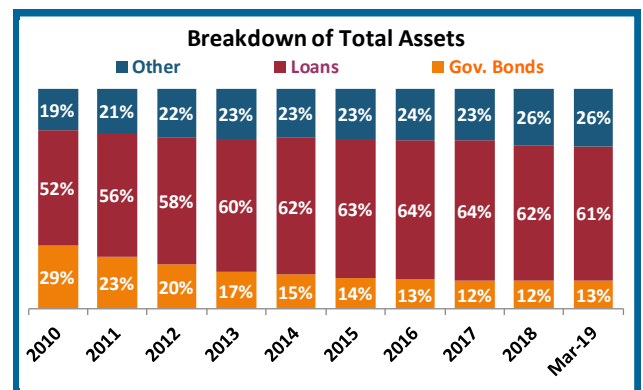
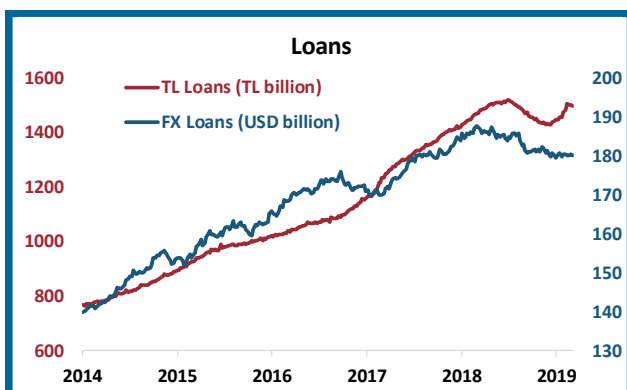
Turkish banking sector has a strong capital base. Capital adequacy ratio is at 16.4% as of 1Q19.

Funding



FX deposits went up by 11% since the beginning of 2019 while TL deposits remained flat.

Lending

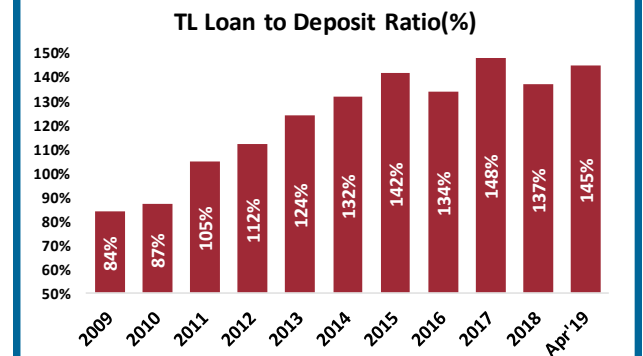
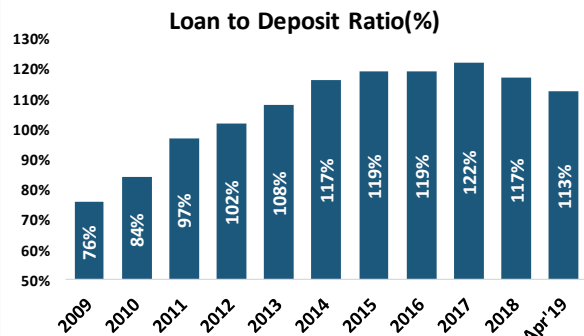


As loan growth picked up in February and March, total loans increased 5.9% (2.0% net-of-currency) since the beginning of the year.

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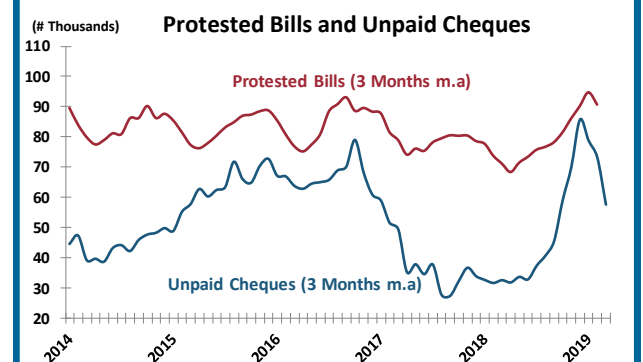
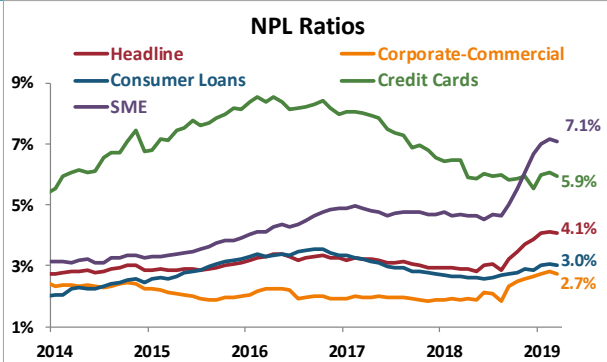
Banking Sector (II)

Loan to Deposit Ratios



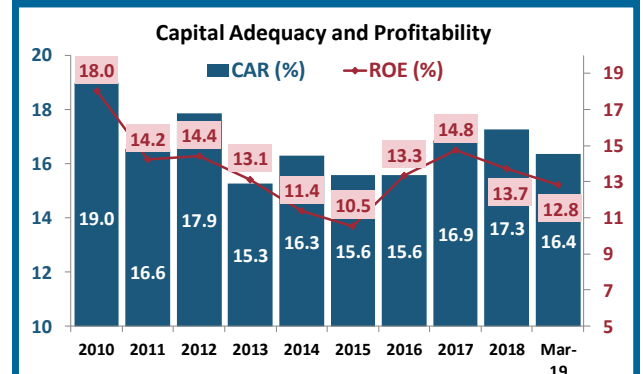
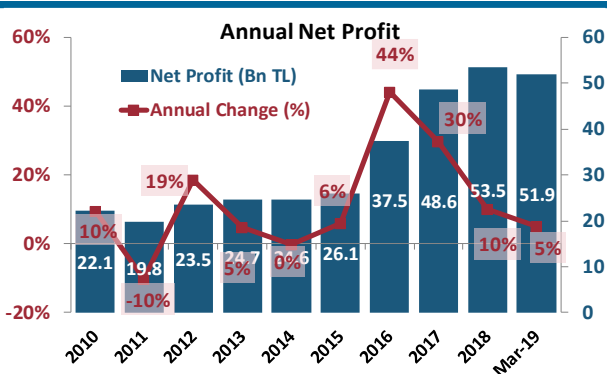
Total loan to deposit ratio (LDR) decreased to 113% while TL LDR increased to 145%.

Loan Quality



Headline NPL ratio for the banking sector rose moderately to 4.1% in 1Q19.

P & L



Banking sector's annual net profit increased marginally by 5% YoY to TL 52 bn in 1Q19. RoE of the sector decreased to 12.8%.