DenizBank Economic Update

August 2018

- Economy
- Financial Markets
- Banking Sector

Economic Research and Strategy
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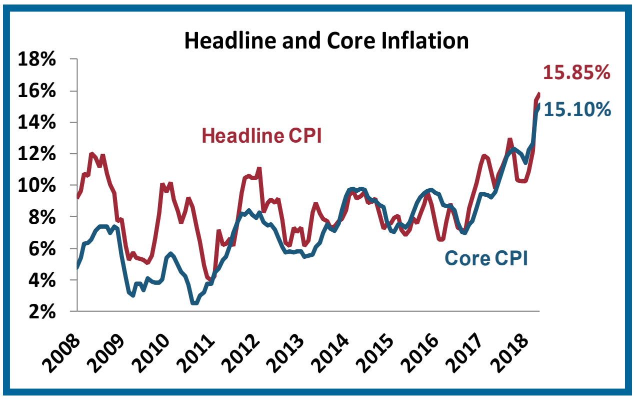
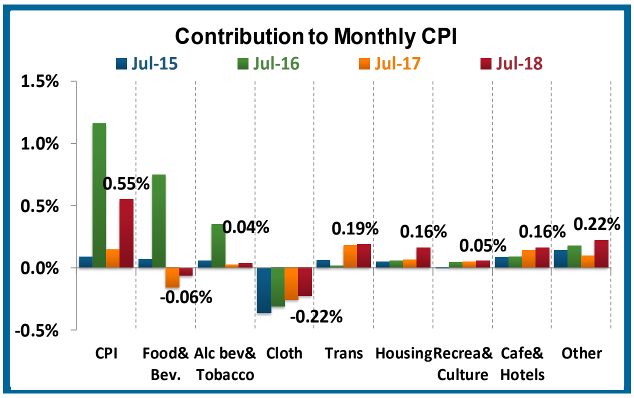
DenizBank Economic Update

Economy (I)

Monetary Policy





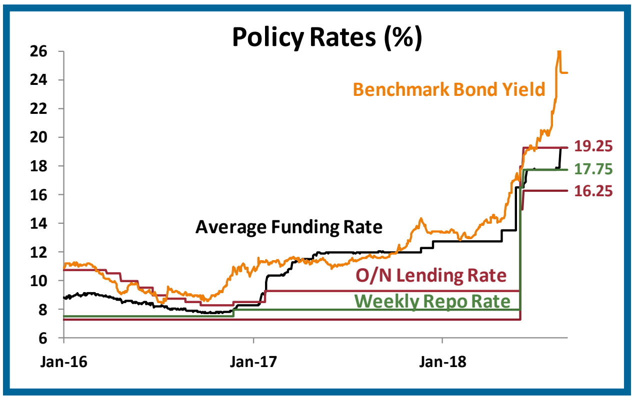
Upward trend in inflation continues...

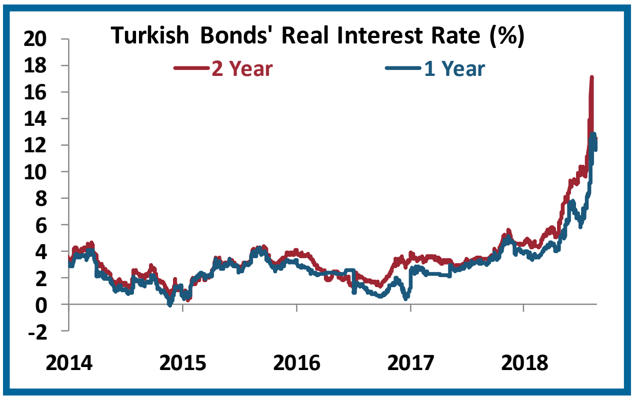
● Monthly inflation came at 0.55% in July, lower than market expectations (1.0%) due to the correction in unprocessed food prices (-0.06% vs 10.8% MoM in June).

● Despite downward surprise in monthly imprint, annual inflation rose further to 15.85% in July (June: % 15.4), all time high of 2003 based index. Core inflation climbed to 15.1% in line with FX-push increase in core good prices (20% YoY), suggesting further deterioration in pricing behaviour. Moreover, annual PPI reached all time high to 25% and set to rise further, indicating further cost-push pressures on inflation outlook.

● Given the sharp 26% MoM depreciation in TL in August, exchange rate pass-through is likely to accelerate and continue for a prolonged period of time. Aggravated with administrative price hikes in electricity, natural gas and oil, we expect inflation to soar towards 20% in next two months and remain elevated in 18-20% range until mid-2019.In this environment, we think that the Central Bank would deliver additional tightening.

Inflation





Central Bank takes technical measures to contain currency depreciation...

● While keeping the policy rate (1w repo rate) unchanged at 17.75% since the hefty 500 bps tightening in 2Q18, by not opening the 1-week repo auctions Central Bank of Turkey (CBT) raised the effective funding rate to the ON lending rate of 19.25% in August.

● In reaction to extreme volatility in TL since the beginning of August, CBT in collaboration with the banking regulator (BRSA) took numerous technical measures to stabilize the currency as well. BRSA limited total amount of banks' currency swaps to 50% of the bank's regulatory capital, providing temporary relief for the lira. CBRT provided additional liquidity to financial system by cutting the reserve requirements for TL and non-core FX liabilities (TL10 bn, $6bn and $3bn equivalent of gold liquidity) and lowering upper limit on ROM ($2bn FX liquidity).

● Considering the recent simplification commitment of CBT, the 150 bps rise in average funding rate signals at least a 150 bps hike in 1w repo rate in CBT's September meeting. Given the sharp depreciation (26% since July meeting) in TL and inflation climbing towards 20% in coming months, CBT might deliver a further hike in funding rate (more than 150 bps in repo rate) in September meeting, building a stronger real policy rate buffer.

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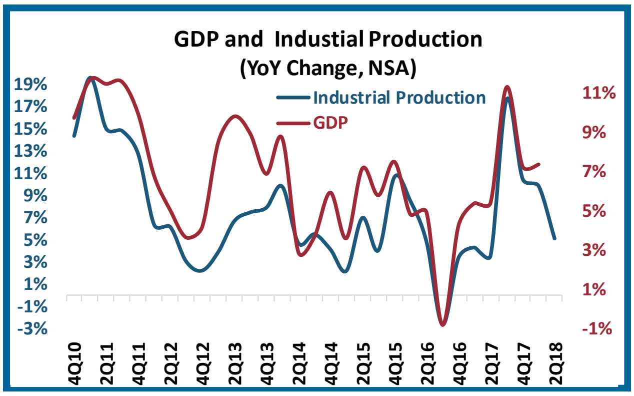
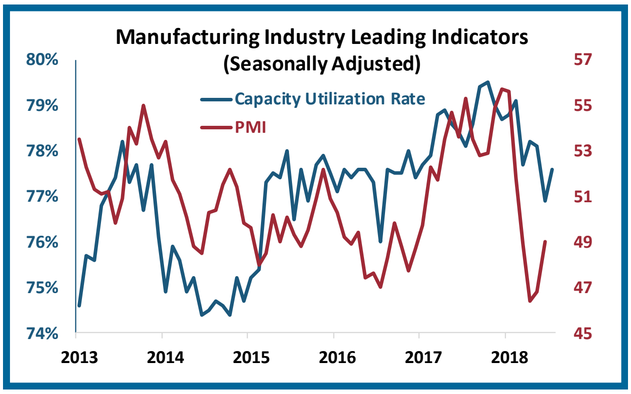
Economy (II)

Growth





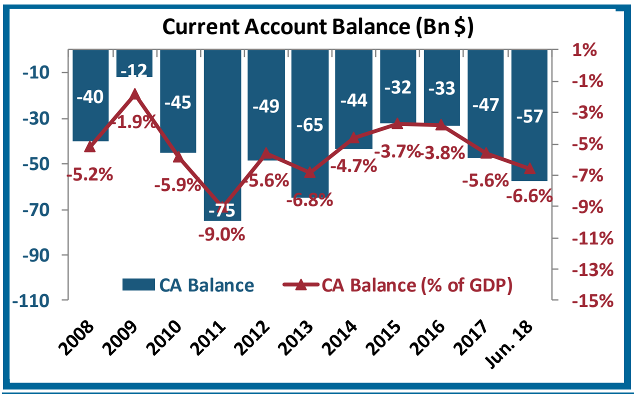
Economic activity rebalances in second half of 2018...

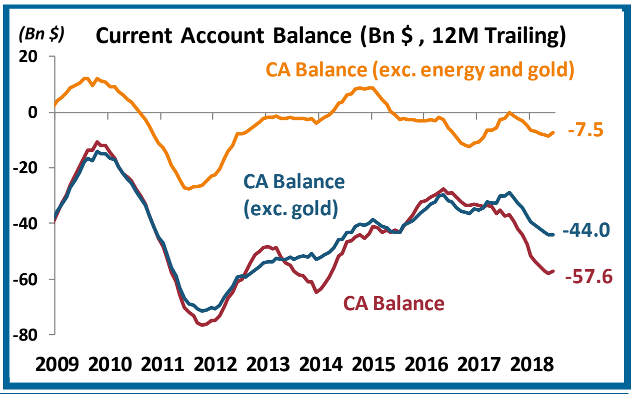
● Upon a strong 7.4% growth in 1Q18 (7.9% annualized), economic activity started to moderate in 2Q18. Industrial production (IP) grew YoY by 5.1% in 2H18 period compared to 9.9% in 1Q18, signaling an annual growth rate in the range of 4-4.5% with the support of robust domestic demand.

● Survey-based indicators suggest a more visible downturn in economic activity going into 3Q18 Manufacturing PMI, which was at its highest level (55.7) in seven years in the 1Q18, has been below the 50 threshold in July for the fourth consecutive month. In August, real sector and economic confidence indices plunged to lowest in levels since 2009. The manufacturing industry capacity utilization rate was at 77.3% in July-August period, compared to 78.9% in 1Q18 and 78% in 2Q18. Hard data signals a weakening domestic demand in the beginning of 2H18 as well. Imports contracted by 6.7% YoY in July while auto sales dropped by 33%.

● Looking forward, with weaker domestic demand resulting from recent volatility in financial markets, considerably slower credit growth and tighter fiscal policy, we expect contraction in the economic activity in the last quarter of the year. Hence, we revise our whole year growth forecast for 2018 down to 1%-1.5%.

External Sector





External deficit starts a downward trend in June...

● Current account deficit (CAD) decreased for the first time in ten months in June ($3bn in 2018 vs $3.8bn in 2017) due to the slowdown in imports, marking the beginning of an adjustment period external balances. 12 month trailing CAD narrowed modestly to $57.4bn (6.6% of GDP) from $58.2bn in May.

● Surge in gold imports and higher energy prices had been the main reasons behind deterioration in CAD since mid-2016. While upward trend in energy deficit continued due to higher oil prices (up YoY by 34% to $36.5bn), gold imports decreased thanks to high base effect ($13.4bn). CAD exc. energy and gold which has been rising since mid-2017 declined to $7.5bn, attesting to weakening domestic demand conditions.

● On the financing side, loans provided from abroad by banks and corporates (20.3bn annually) together with reserve assets (13.1bn) has been the main source of CAD financing. Portfolio investments continued to decrease significantly (7.1bn annually) and FDI (7.7bn) has been weak.

● Foreign trade data indicates that improvement in CAD becomes more visible in July. With TL depreciation and weaker domestic demand compressing imports, price competitiveness supporting exports and higher tourism revenues in 2H18, we expect CAD (% of GDP) to contract significantly in 2H18.

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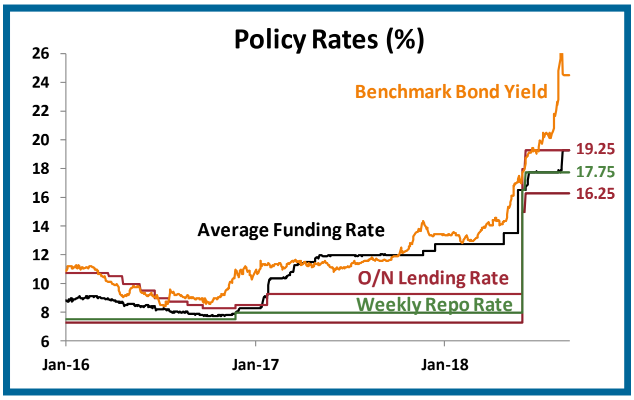
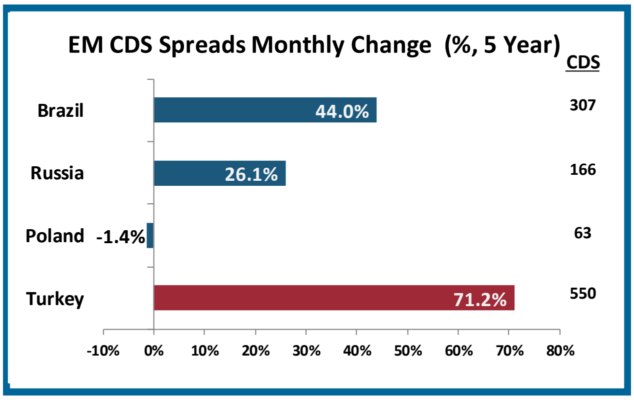
Financial Markets

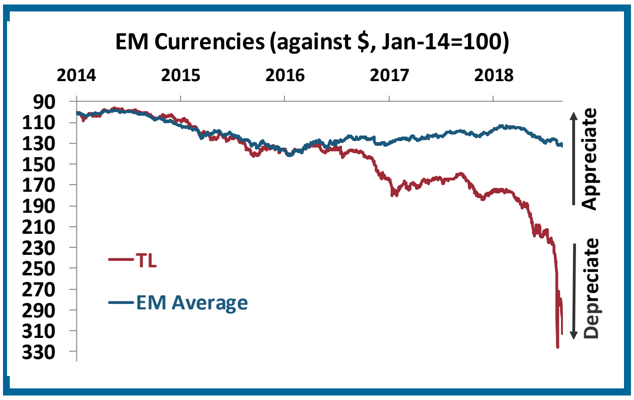
Debt Market

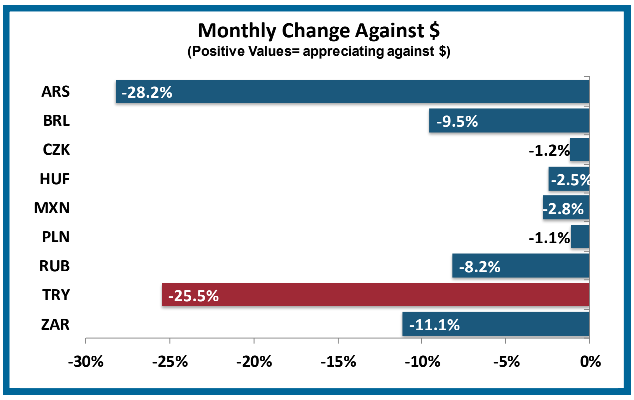




Turkey's CDS rose to 550 in August, its highest level since 2008. Correspondingly, Turkey's 2-year benchmark bond yield increased to 24.5% as the end of August.

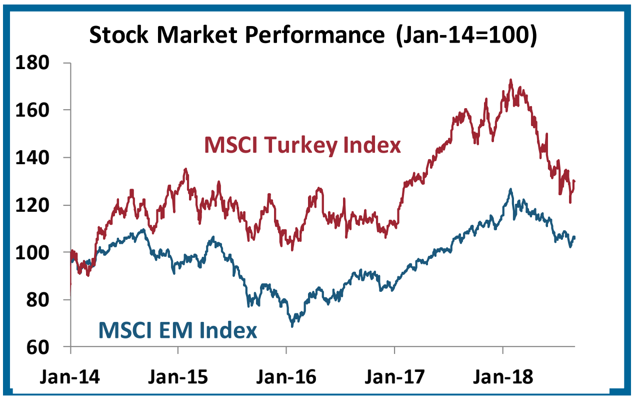
Currency Market

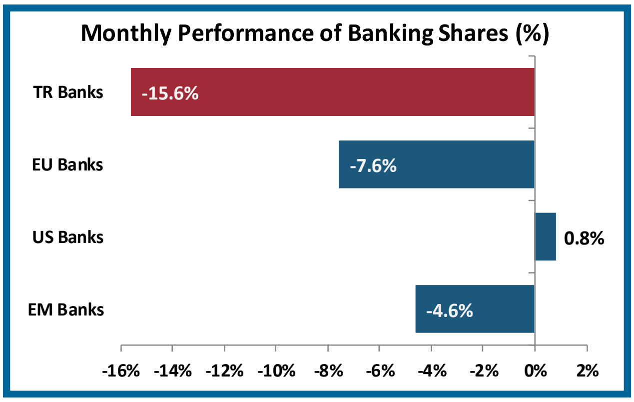




Amplified with political concerns, TL depreciated MoM by 26% against the USD in August. With a YtD depreciation of more than 40% (compared to 11% depreciation in EM currencies on average), TL became the weakest performing currency after Argentine Peso.

Stock Market





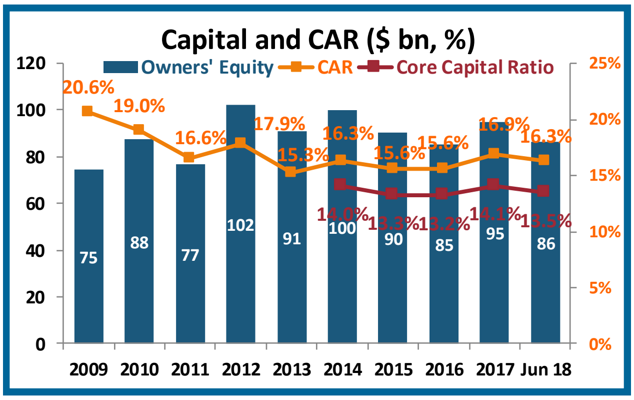
MSCI Turkey index was down MoM by 3.5% and YtD by 21% in August, also underperforming EM peers (MSCI EM down YtD by 9%).

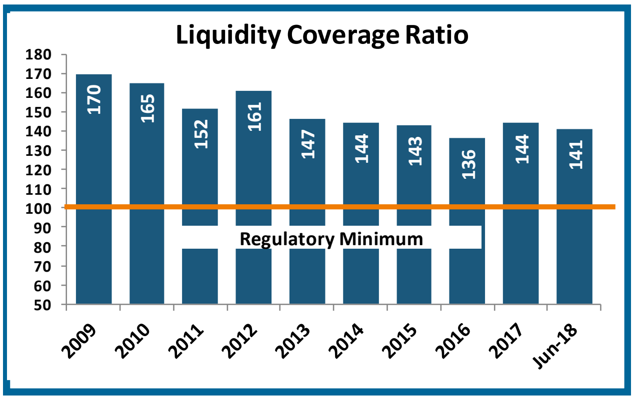
Data retrieved from Bloomberg as of 16:00 (GMT + 3), 31.08.2018

DenizBank Economic Update

Banking Sector (I)

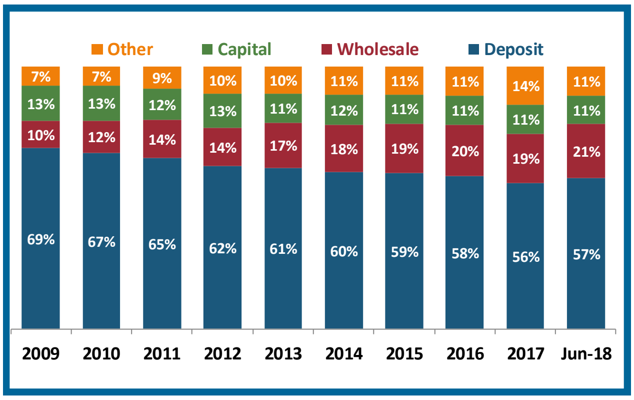
Capital

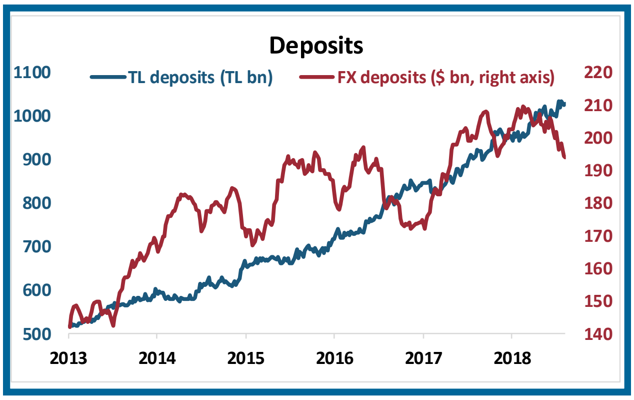




Turkish banking sector has strong capital base. Capital Adequacy Ratio is at 16.3% as of end 1H 2018.

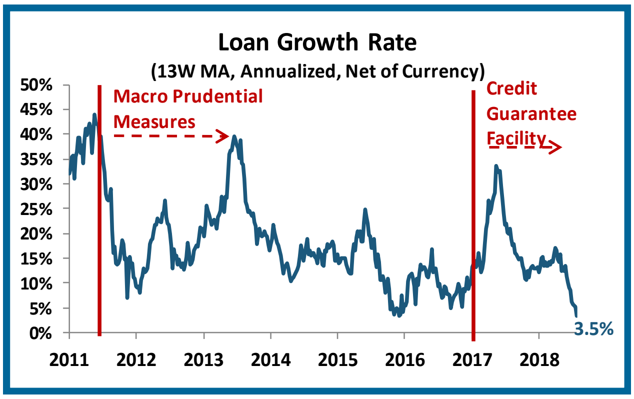
Funding

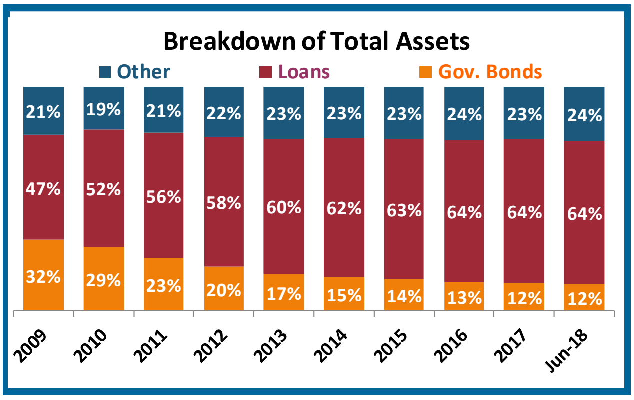




Deposits went up YoY by 35% (3.7% net-of-currency) to TL 2.2 trillion as of August 10th. Share of deposits in funding is stable at 57%.

Lending





Annualized 13w average net-of-currency loan growth decelerated to 3.5% as of August 10th.

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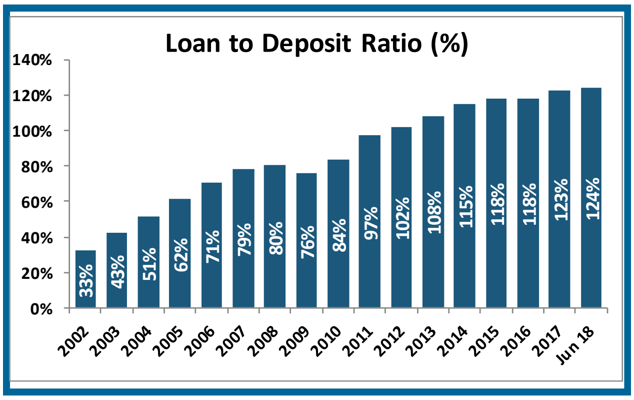
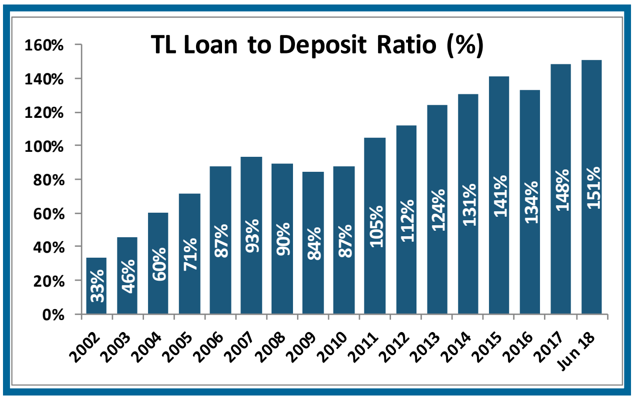
Banking Sector (II)

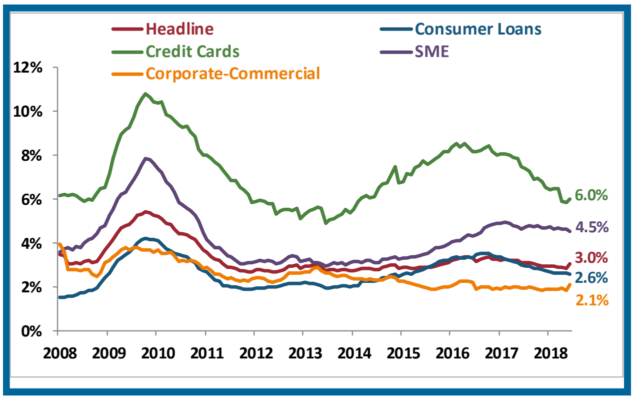
Loan to Deposit Ratios

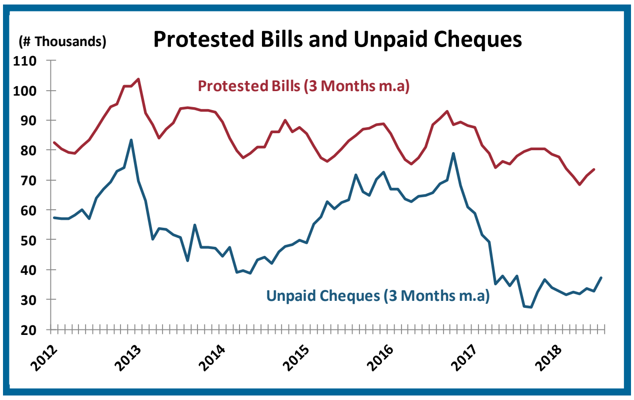




Loan to deposit ratio (LDR) and TL LDR has risen to 124% and 151%, respectively.

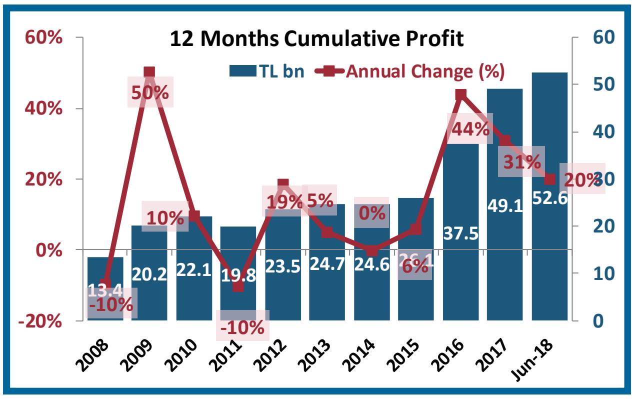
Loan Quality

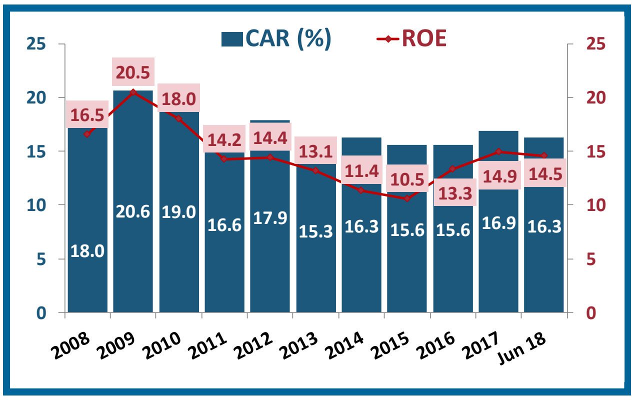




Headline NPL ratio for the banking sector is stable at 3.0%.

P & L





As of end 1H 2018, 12 months cumulative profit increased YoY by 20% to TL 52.6 bn. ROE of the sector remains high at 14.5%.