DenizBank Economic Update

August 2019

- Economy
- Financial Markets
- Banking Sector

DenizBank Economic Research and Strategy

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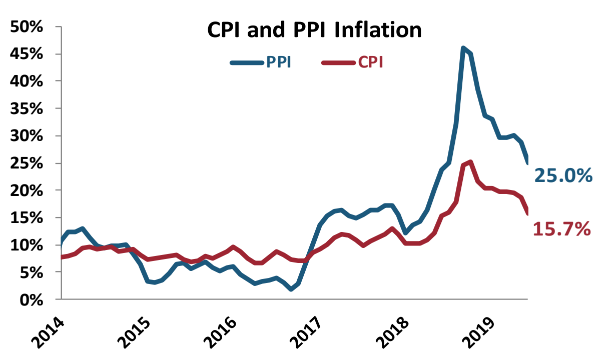
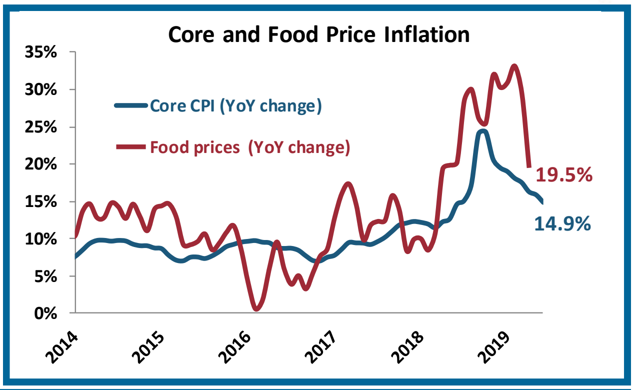
DenizBank Economic Update

Economy (I)

Inflation



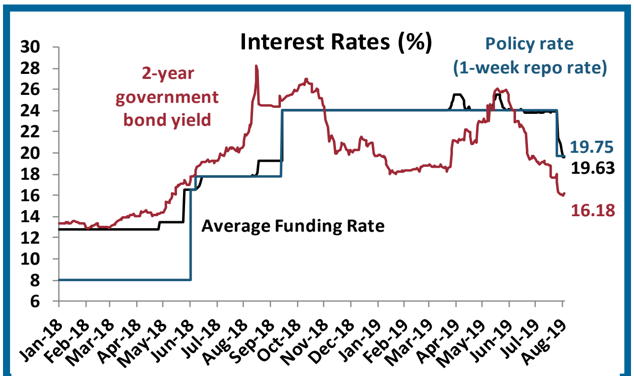


Inflation retreats to 12-months low in June on the back of favourable base effect

● Monthly inflation surprised to downside for the third consecutive month in June (0.03%), bringing annual inflation down to 15.7% from 18.7% a month ago, lowest in 12-months. Besides favourable base effect, muted domestic demand, normalization in food prices, decline in commodity prices and subdued volatility in TL were instrumental in the disinflation process. Core inflation moderated further to 14.9%, as supply-side pressures on core goods prices were mitigated by weak domestic demand. Services inflation on the other hand, remained high.

● Termination of tax cuts in white goods, furniture and automotive, rise in administrative prices such as gas and electricity, and increase in tobacco prices will push inflation up by 2-2.5% in July and August. However, as base effect becomes more significant in August, we expect inflation to fall temporarily to single digits in September-October, before finishing the year at 13%. Elevated cost-push pressures with PPI inflation at 25%, high levels of inflation expectations, backward-indexation behaviour in prices and administrative/tax hikes create upside risks on inflation. With gradual recovery in economic activity, disinflationary contribution of demand conditions may decline in the second half of the year.

Monetary Policy



Central Bank started monetary easing with a higher than expected 425 bps cut

● In 1H19, Central Bank (CBRT) kept the one-week repo rate unchanged at 24% against the risks to price stability. In the July meeting, assessing the significant decline in inflation, weak domestic demand, supportive global environment, stabilization in TL and decline in country risk Premium, CBRT delivered a deeper than expected 425bp cut, bringing the policy down to 19.75%. Improvement in inflation expectations, with 12-month ahead inflation expectation down to 13.9% from 15.5% in two months, supported the decision.

● Tone of the announcement note was dovish, citing the faster-than-expected improvement in inflation outlook and accommodative policy stance of the core central banks. Yet, CBRT still emphasized that keeping the disinflation process in track with the targeted path requires the continuation of a cautious monetary stance, and the extent of tightness will be determined to ensure the continuation of the disinflation process.

● In the much-awaited quarterly inflation report, CBRT revised its 2019 inflation forecast to 13.9% from 14.6%, mainly due to lower-than-expected inflation in 2Q19. In the press conference, Governor Uysal expressed that CBRT will keep a 'neutral real rate' which will take into account global environment, peer countries' real rates, risk premia, dollarization and loan growth, while ensuring continued decrease in inflation and managing external balances. In our view, statements of CB suggest that following the front-loaded 425 bps cut which takes advantage of the current environment, cautious cuts with a total of 250-300 bps will follow in rest of the year, as long as political risks are avoided and global conditions continue to be supportive.

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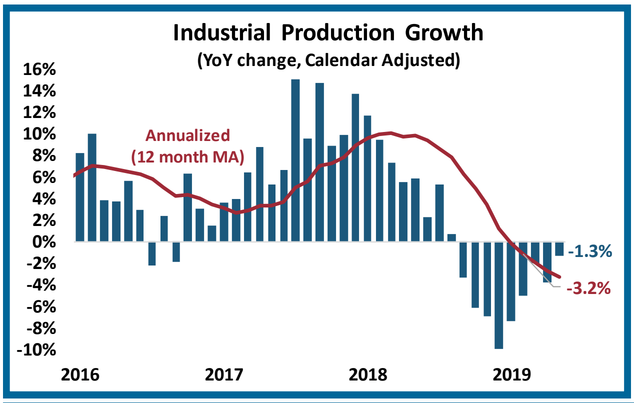
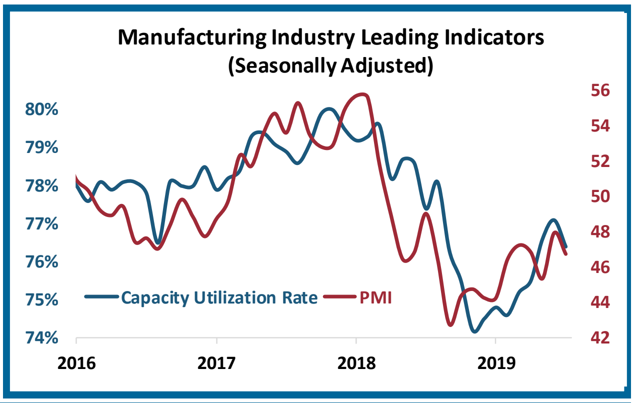
Economy (II)

Growth



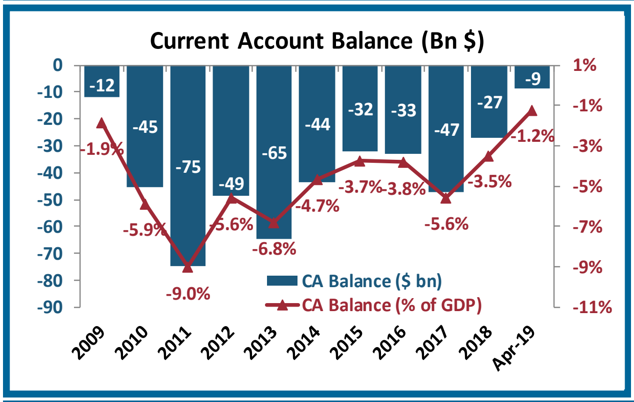


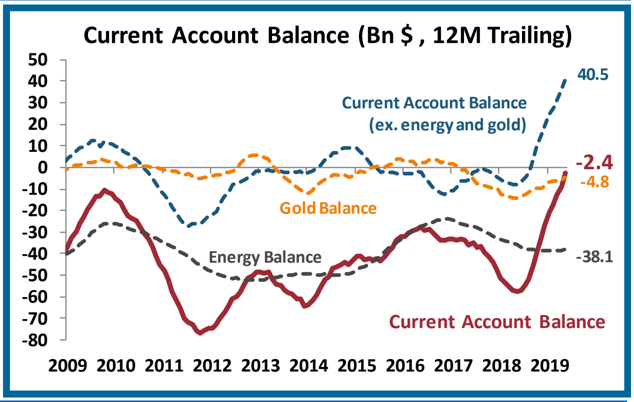
Economic activity is recovering at a moderate pace

●In 1Q19, Turkish economy contracted by 2.6% year-on-year (YoY) but expanded by 1.3% quarter-on-quarter (QoQ) in seasonally-adjusted terms, meaning the economy got out of recession. Leading indicators suggest that moderate recovery in economic activity continued in 2Q19. Industrial production was down 1.1% YoY in April-May compared to -5.6% in 1Q19, while capacity utilization rate (76.6%) and PMI manufacturing (47.9) reached 10-months high in June, indicating that the contraction in the economy is milder in 2Q19 and QoQ growth continues. In 2Q19, heightened financial volatility and tight financial conditions temporarily weighed on consumption and investment, while exports continued to support economic activity.

●In the remainder of 2019, looser financial conditions will accelerate recovery in economic activity and net export outlook is expected to remain favorable. On the other hand, public sector may provide less contribution to growth than in 1H19. We expect annual growth to turn positive in 2H19 on the back of low base effect and full-year growth rate to be 1%, significantly below its potential. As economy remains stagnant, weak labor market conditions should prevail.

External Balance





Current account balance will record annual surplus for the first time since 2002

● Rapid improvement in Turkey's external balances continue with sharp decline in imports and steady increase in exports. Goods imports are down by 20% to $197 bn annually in July 2019 from $247 bn a year ago while goods exports are up by 5% to $171 bn from $163 bn. Rising tourism revenues ($31 bn annually) with all-time high foreign visitors and transportation income balance out remaining external trade deficit. As a result, annual current account deficit (CAD) came down to almost zero ($2 bn, 0.3% of GDP) in May from $58 bn (6.5% of GDP) a year ago, its lowest level since 2003. Excluding energy and gold, current account yielded a record-high surplus of $41 bn (%5.6 of GDP).

● On the financing side; FDI inflows ($10 bn), reserve drawdowns ($9 bn) and net errors/omissions ($9 bn) compensated for banks' debt repayments ($19 bn) and deposit outflows ($17 bn). Annual portfolio inflows came down to zero despite the Eurobond issuances in the first quarter, compared to $ 16 bn inflow in the same period the previous year.

●In June-July period, annual trade deficit decreased further by $5bn, suggesting annual current account balance have turned to a surplus for the first time since 2002. As economic activity picks up gradually in 2H19, we expect CAD/GDP to finish the year at 1%.

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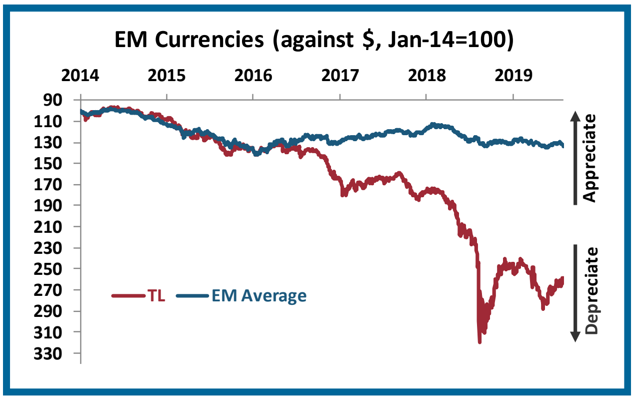
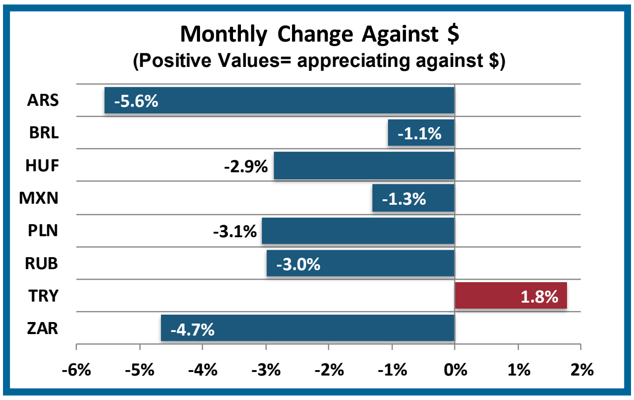
Financial Markets

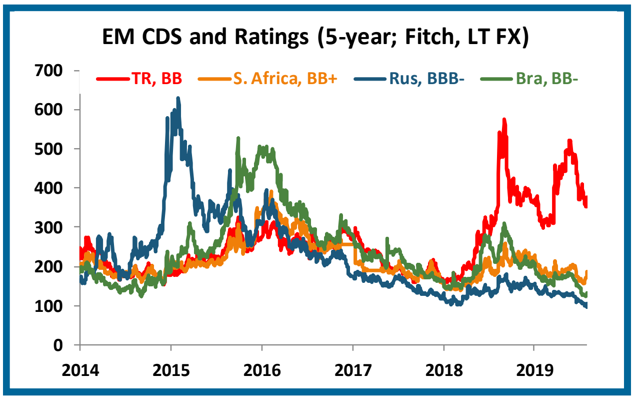
Currency Market

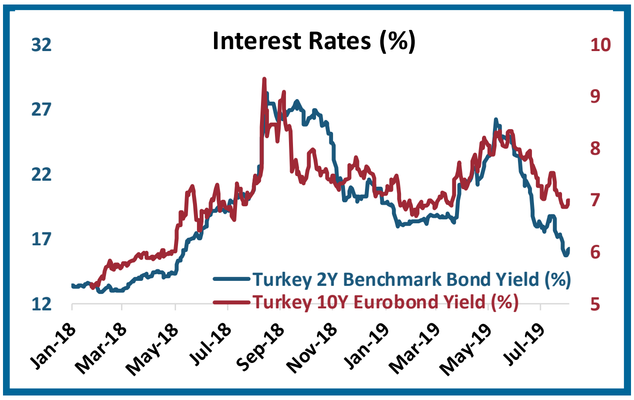




Supported by accommodative stance of core central banks and decreased political risks, Turkish Lira appreciated by 10% since the end of May, dragging year-to-date losses to 5%.

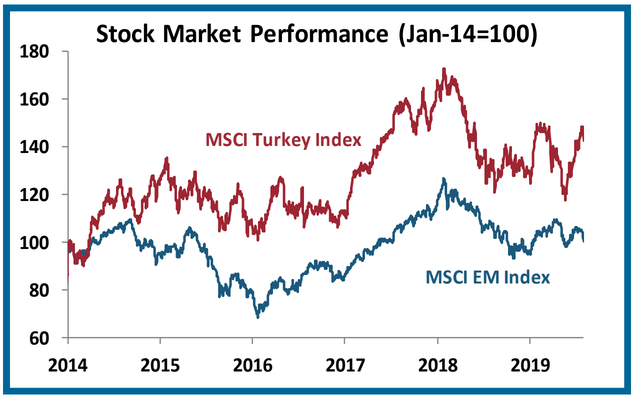
Debt Market

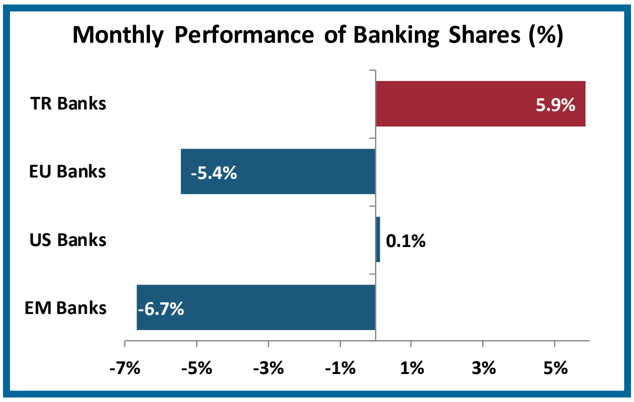




Turkey's risk premium and funding costs decreased significantly compared to the recent peak in May. Turkey's CDS spread fell to 375 bps, and 2-year TL benchmark bond yield decreased by 870 bps down to 16.2%, lowest since May 2018.

Stock Market





MSCI Turkey index was up 18% (in TL terms) since the end of May led by banking shares, over-performing EM peers (MSCI EM index was up 4%) and bringing year-to-date gains to 10%.

Data retrieved from Bloomberg as of 13:00 (GMT + 3), 03.08.2019

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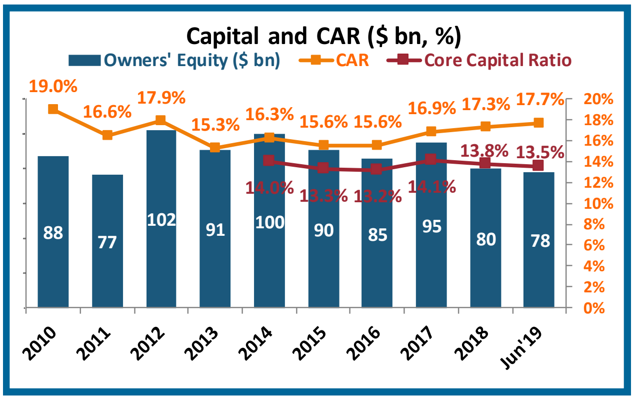
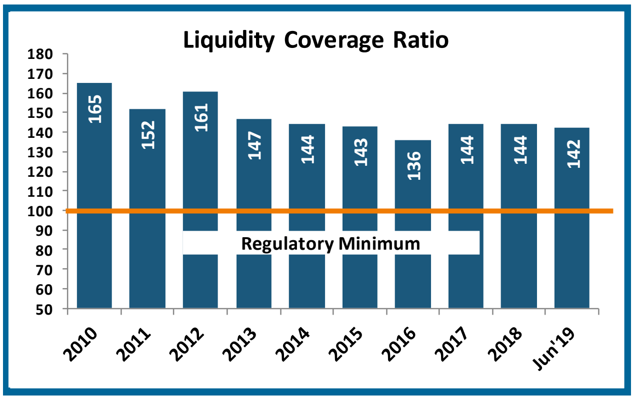
Banking Sector (I)

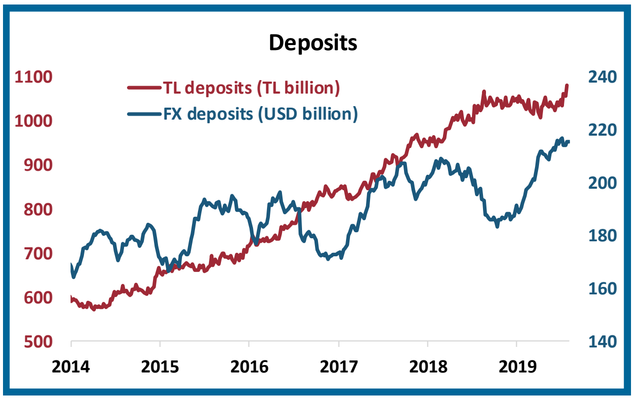
Capital

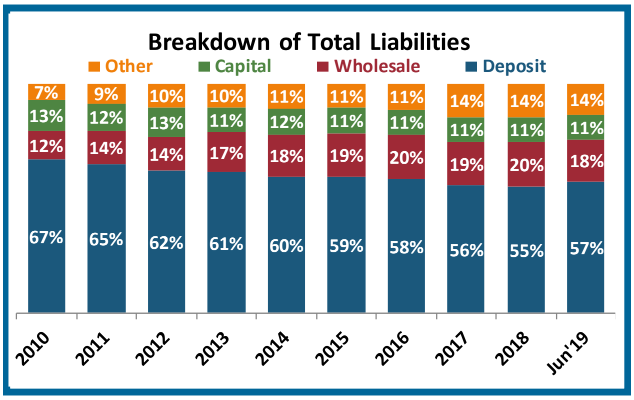




Turkish banking sector has a strong capital base. Capital adequacy ratio is at 17.7% as of June 2019.

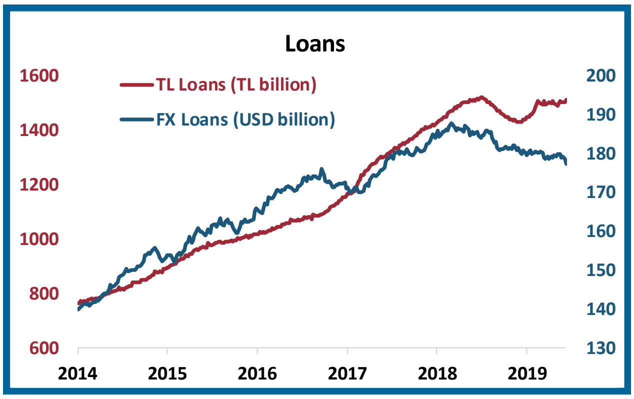
Funding

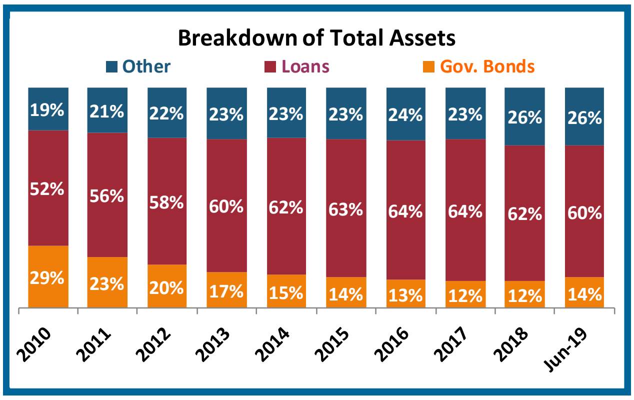




FX deposits went up by 14% since the beginning of 2019 while TL deposits increased mildly by 4%.

Lending





Year-to-date loan growth has been weak at 5% (2.2% net-of-currency effect).

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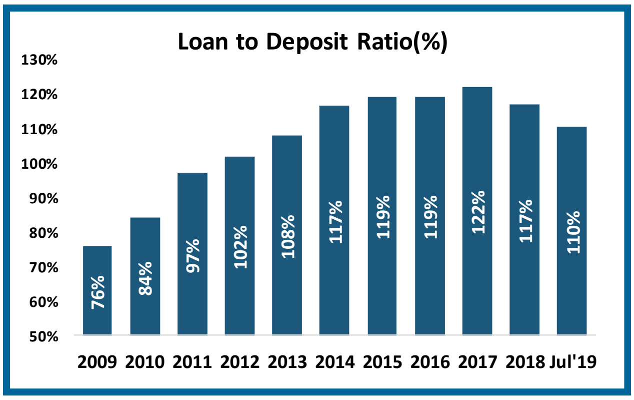
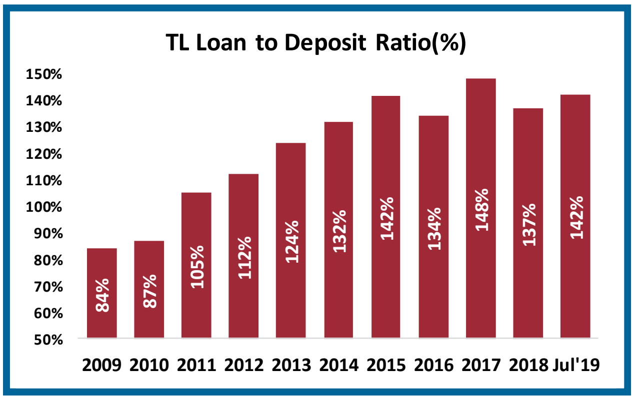
Banking Sector (II)

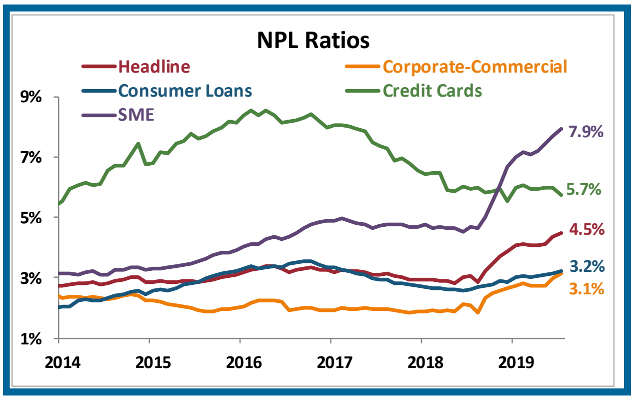
Loan to Deposit Ratios

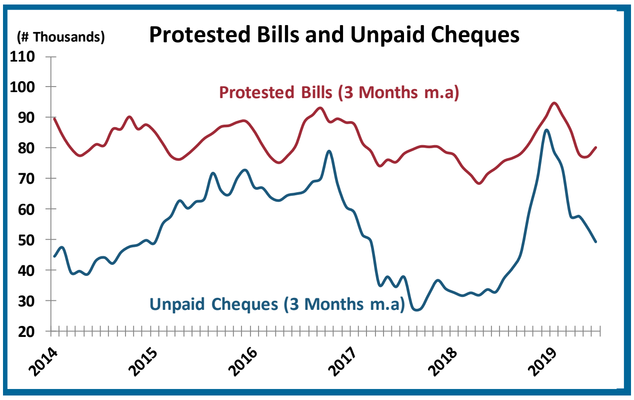




Total loan to deposit ratio (LDR) decreased to 110% while TL LDR remains high.

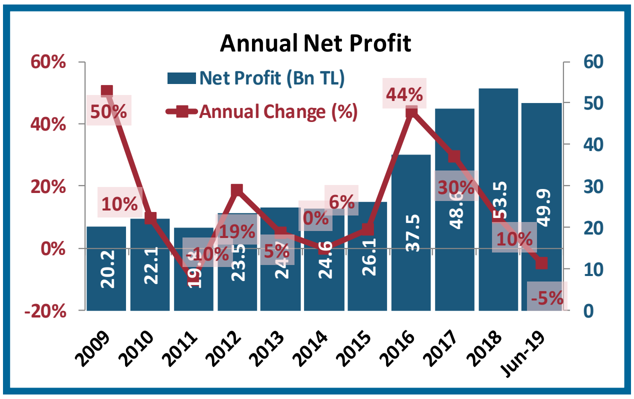
Loan Quality

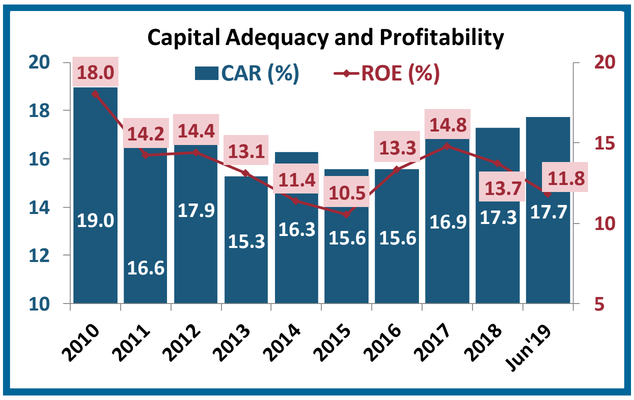




Headline NPL ratio for the banking sector rose to 4.5% by July 2019.

P & L





Banking sector's annual net profit decreased by 5% YoY to TL50 bn in 1H19. RoE of the sector decreased to 11.8%.