DenizBank Economic Update

December 2018

- Economy
- Financial Markets
- Banking Sector

DenizBank Economic Research and Strategy

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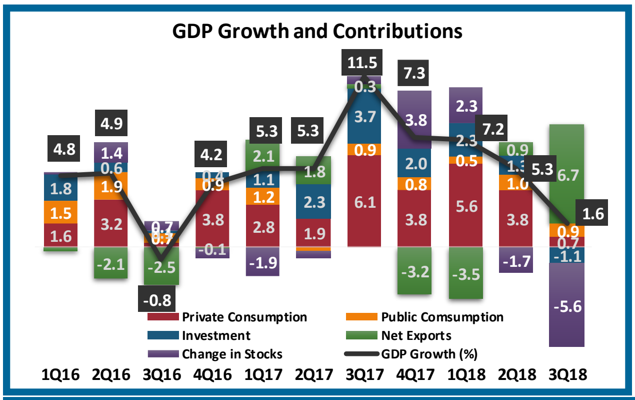
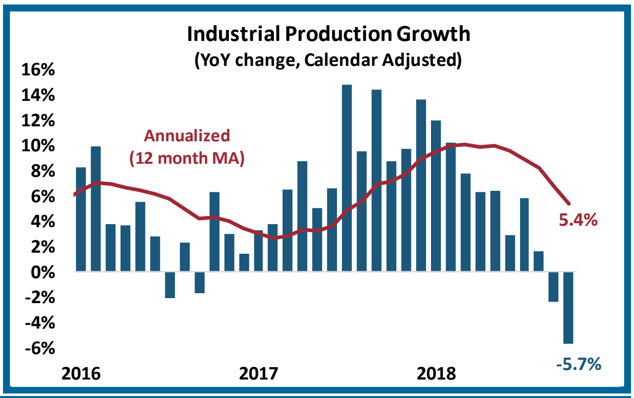
December 2018

DenizBank Economic Update

Economy (I)

Growth





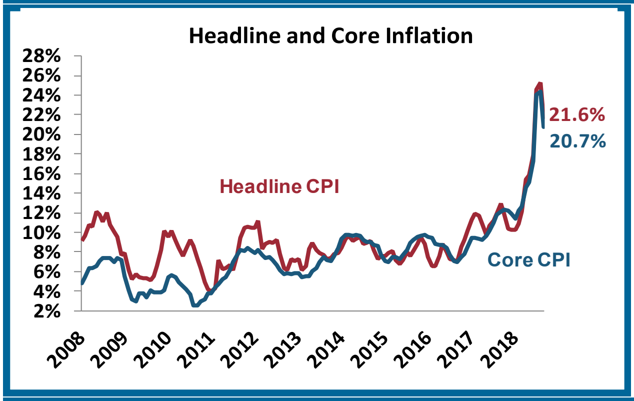
Slowdown in economic activity deepens in 4Q18…

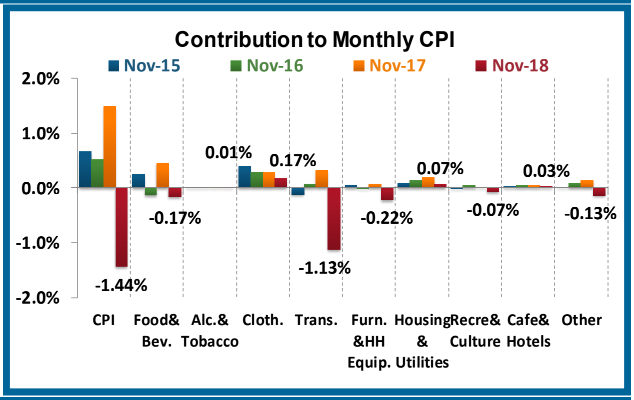
●Economic growth decelerated to 1.6% YoY in 3Q18 compared to 6.2% YoY in 1H18, as economy entered a phase of subdued growth starting from 3Q18. Seasonally adjusted QoQ growth turned to negative (-1.1%) for the first time since 3Q16. Thanks to strong increase in exports (+13.6% YoY) along with sharp decadence in imports (-16.7% YoY), net exports were the main driver of growth in 3Q18. Growth in private consumption slowed significantly (1.1% compared to 7.7% in 1H18) in addition to the 3.8% drop in investments.

●Moreover, preliminary indicators signal contraction in economic activity in the last quarter of 2018. Industrial production fell by 5.7% YoY in October, sharpest decline since September 2009. Capacity utilization rate decreased to 73.9% in last two months of the year from 75% in October and PMI manufacturing was weak at 44.7 in November, both indicating negative IP growth in the rest of 4Q18. In addition, sharp decrease continued in house (-27%), auto (-42%) and white good (-21%) sales in November, demonstrating muted domestic demand despite the temporary tax cuts in specific sectors.

● As growth turns to negative in the last quarter of the year, we expect 2018 full-year growth rate to decrease to 2-2.5%.We expect growth to remain in negative territory in first two quarters of 2019 before it turns positive in 3Q19 with the help of lower interest rates and favorable base effect.

Inflation





Annual inflation fell more than expected in November…

● Consumer prices decreased by 1.44% MoM in November, significantly below the market expectations of -0.3%. Decreases in transportation, household equipment and furniture prices due to the tax cuts (effective in November and December) were the main driver of monthly disinflation. Stabilization in TL, lower food and oil prices also supported the deceleration in inflation in November.

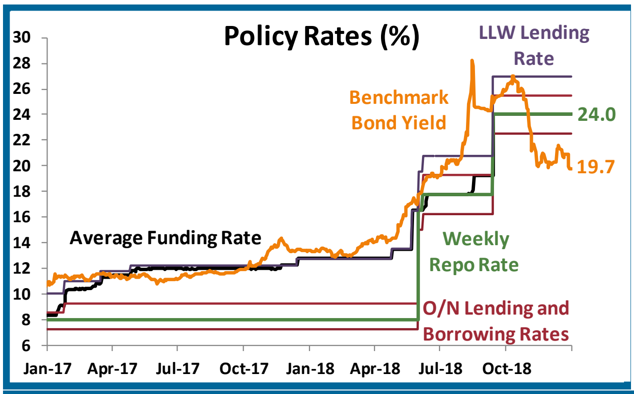
● November imprint pulled annual inflation to 21.6% from 25.2% a month ago, marking the first decrease in annual inflation in seven successive months. Core CPI regressed to 20.7% from 24.3%. However, with producers' price inflation elevated at 38.5% annually, cost-push pressures persist. As transitory impact of tax cuts and anti-inflationary campaign cease, we expect inflation to accelerate in 1Q19. Recently announced 26% hike in official minimum wage in 2019 will put further supply side pressures on inflation. On the other hand, 10% administrative cut in natural gas and electricity prices (effective in 2019) will have a direct downward effect on headline inflation.

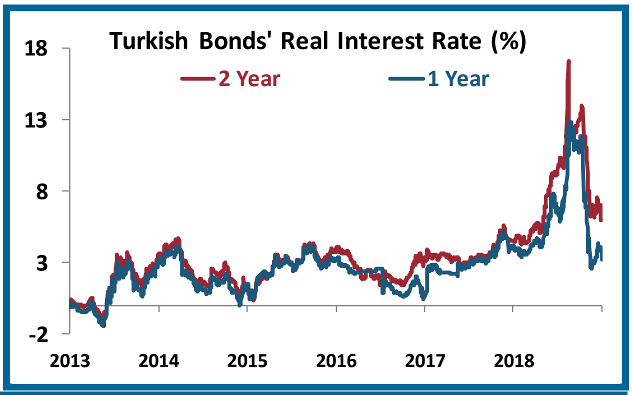
● In light of November print, our 2018YE inflation forecast is 20.5%. However we expect inflation to accelerate towards 24% in 1Q19 and remain above 20% in 1H19, before starting a sustained downward trend in 2H19.

DenizBank Economic Update

Economy (II)

Monetary Policy



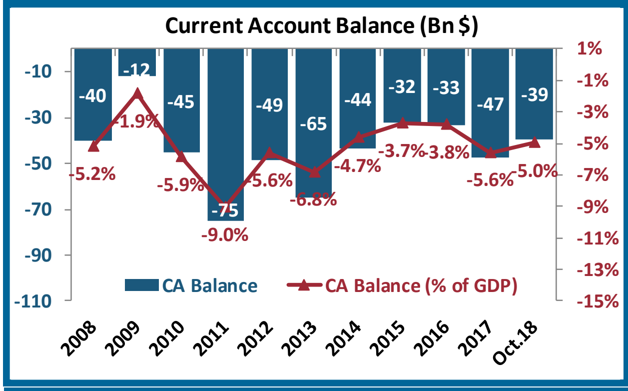


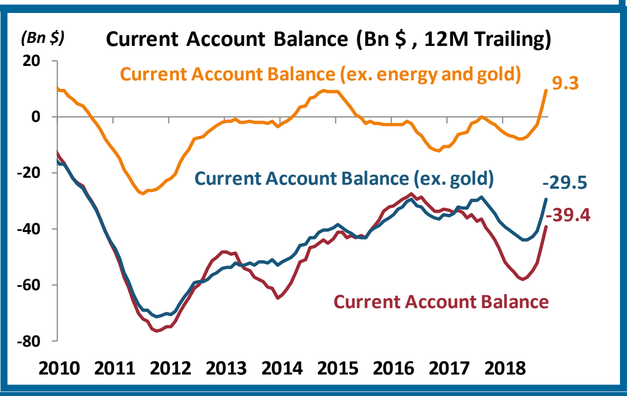
Central bank remains on hold in line with market expectations...

● Central Bank (CB) kept the policy rate unchanged at 24% in December meeting in line with the market expectations. In the decision note, CB cited some improvement in the inflation outlook on the back of November imprint, yet still emphasized the risks on price stability. Overall, CB kept the policy guidance unchanged, reiterating that the tight monetary stance will be maintained until inflation outlook displays significant improvement, and preserved the tightening bias.

● We consider the decline in inflation in last two months of 2018 to be temporary, and expect inflation to accelerate towards 24% in 1Q19. While rapid stabilization in TL since the 625 bps hike in September and ongoing contraction in economic activity provides case against further rate hikes, we think CB would wait to see a sustained improvement in the inflation and avoid a premature rate cut. Given the elevated levels of inflation expectations in 1H19, we expect CB to keep on hold until the end of 1H19.

External Sector





Improvement in external balances gains momentum...

● Slowdown in economic activity led to a rapid improvement in external balances as of 3Q18. In August-October period, current account recorded all-time high monthly surpluses (Aug:$1.9 bn, Sep:$1.8 bn, Oct: $2.8 bn), and 12-month trailing current account deficit (CAD) decreased further to 3Q17 levels of $39 bn (5.0 % of GDP) from a peak of $58.3 bn in May.

● The $19 bn decrease in CAD compared to its peak in May, is mainly driven by $17 bn improvement in core CAD (exc. energy and gold). Due to sharp slowdown in domestic demand and strong performance in exports, core CAD (exc. energy and gold) gave a $9.3 bn annual surplus in October, highest since February 2009. Normalization in gold imports continued as well; annual net gold imports decreased $9.9 bn compared to $ 14 bn in May. Lastly, energy deficit continued to worsen ($10.4 bn annually) due to higher energy prices (Brent oil $75/bbl in Oct 18 vs. 61$/bbl in Oct 17), though at a much slower pace. As oil prices retreated sharply to $59/bbl in November (Nov 17: 64$) and $53/bbl in December (Dec 17: 67 $) prolonged deterioration in energy deficit should have also come to an end in the last two months of 2018.

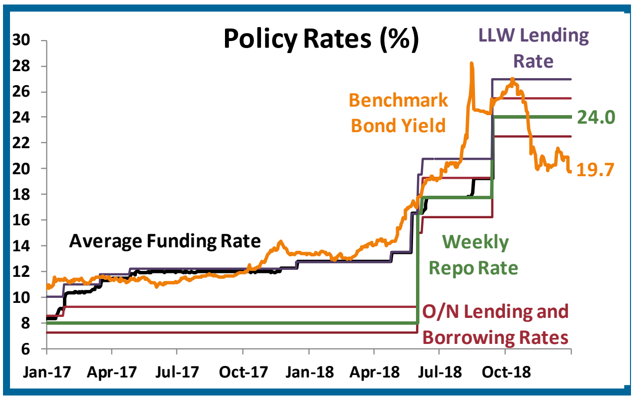
● On the financing front, capital outflows continued. Reserve drawdowns ($28 bn annually) together with net errors and omissions ($19 bn) have been the main source of CAD financing

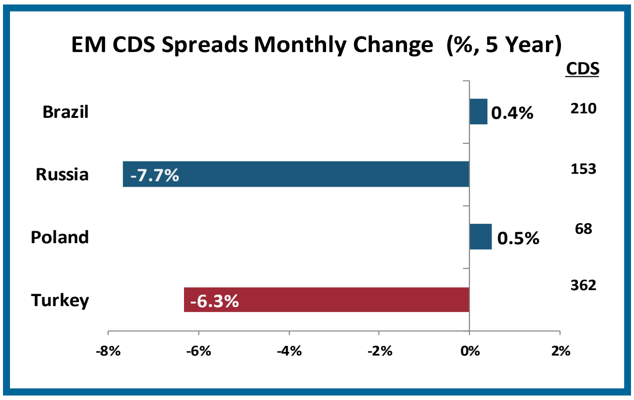
● Significant decrease in trade deficit (imports down by 21%) points to another current account surplus in November. As contraction in domestic demand continues, we expect CAD to GDP to decrease below 4% in 2018 YE and improve further in 2019.

DenizBank Economic Update

Financial Markets

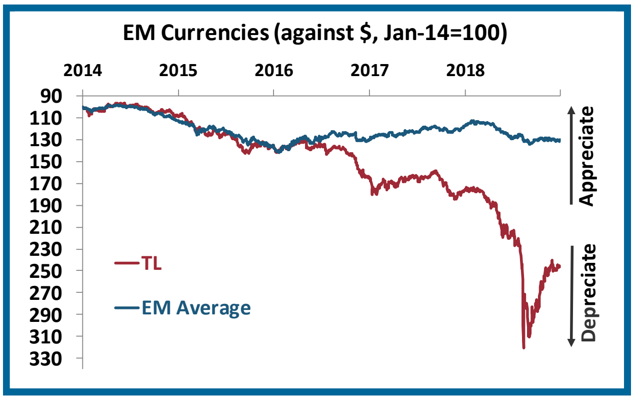
Debt Market

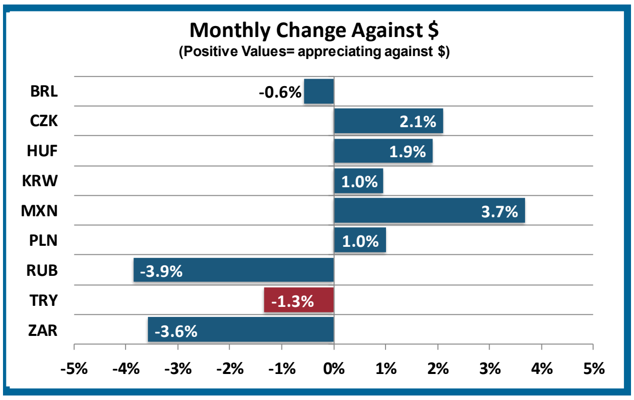




Turkey's 2-year benchmark bond yield decreased below 20% by the end of 2018 from a peak of 28% in August (2017: 13.4%)

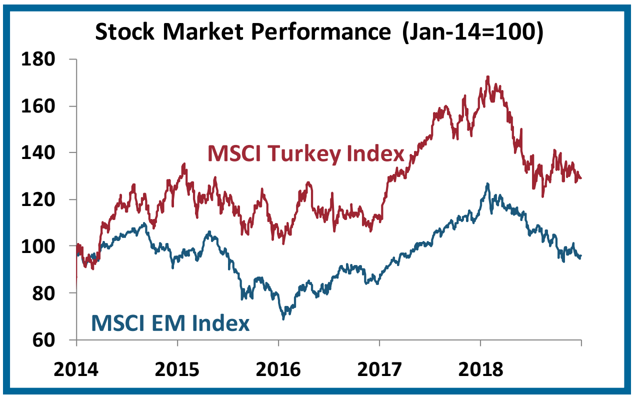
Currency Market

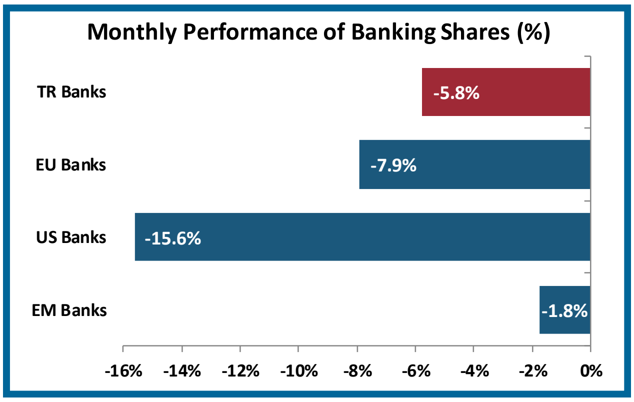




TL appreciated by 24% since September, recovering most of its losses of the sharp depreciation in August. Yet depreciation in TL in 2018 is still high at 28%, while EM peers on average depreciated by 11%.

Stock Market





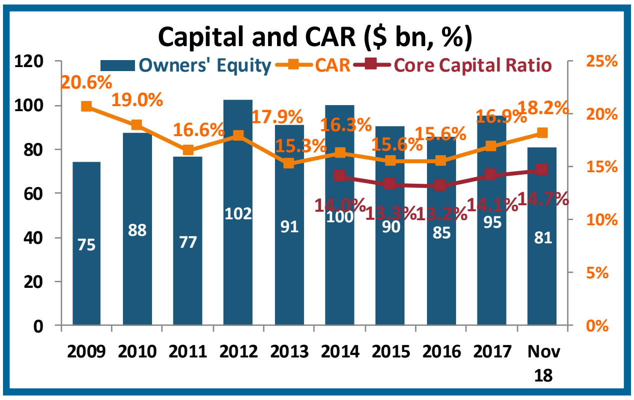
MSCI Turkey index was down by 22% (in TL terms) in 2018, underperformed its EM peers.

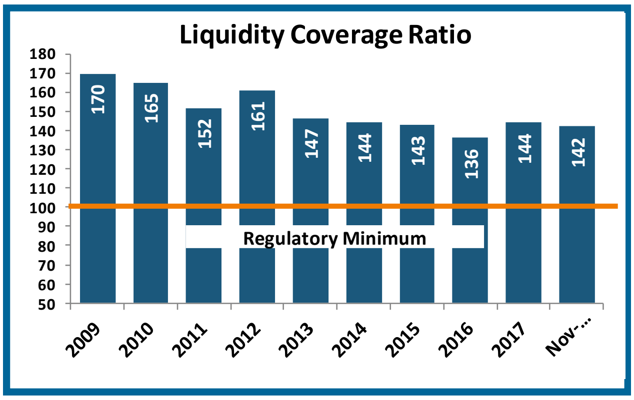
Data retrieved from Bloomberg as of 14:00 (GMT + 3), 31.12.2018

DenizBank Economic Update

Banking Sector (I)

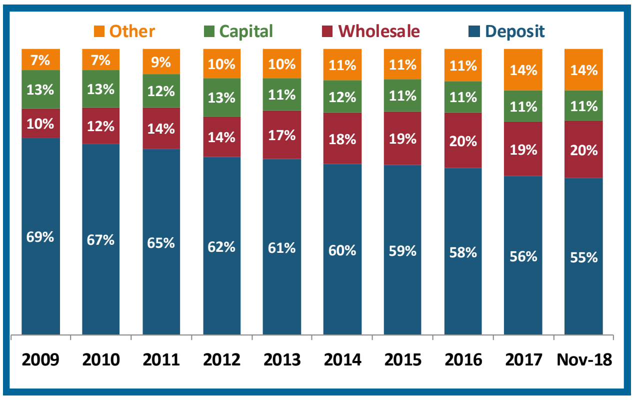
Capital

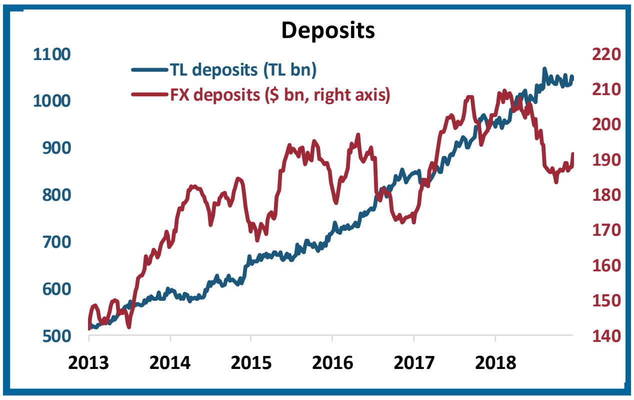




Turkish banking sector has a strong capital base. Capital Adequacy Ratio is at 18.2% as of November 2018.

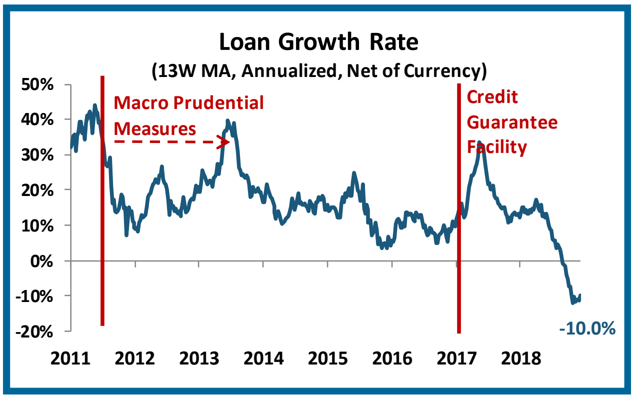
Funding

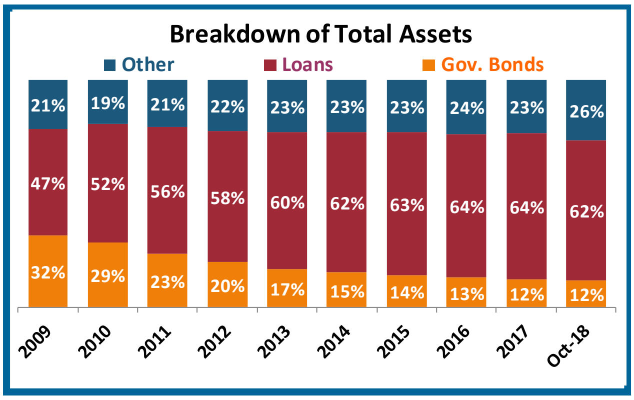




Deposits went up by 19% YoY (2.8% net-of-currency) to TL 2.1 trillion as of December 21st. The share of deposits in funding is stable at 55%.

Lending



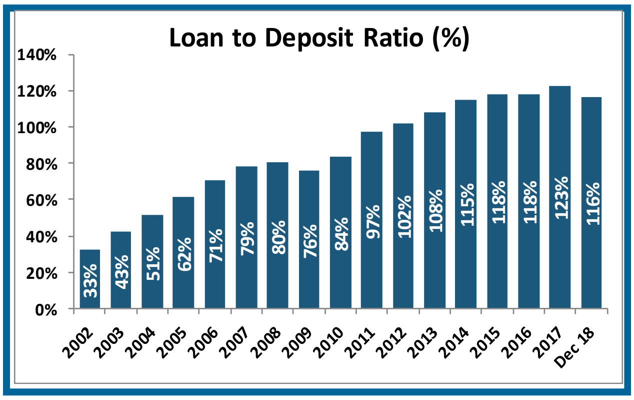


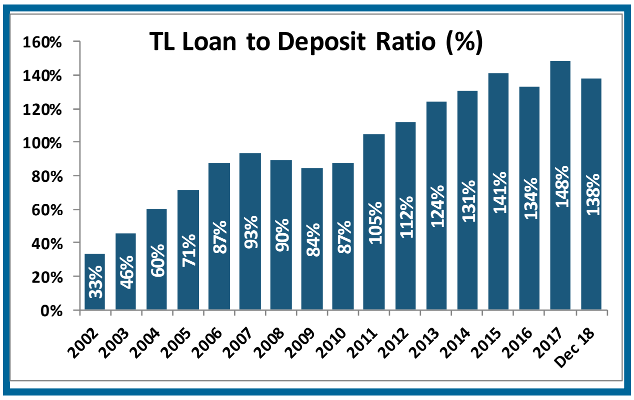
Contraction in loans (13 week average net-of-currency) accelerated to an annualized rate of 10%.

DenizBank Economic Update

Banking Sector (II)

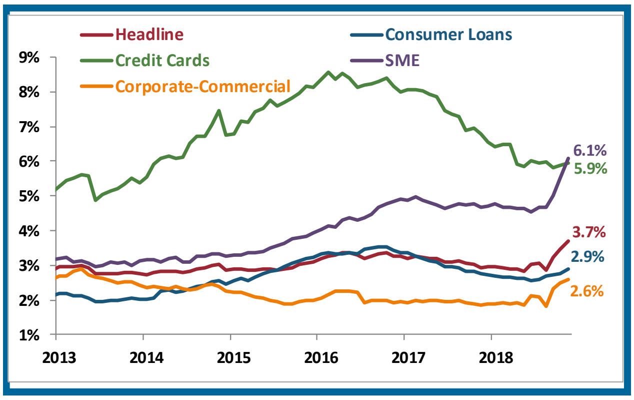
Loan to Deposit Ratios

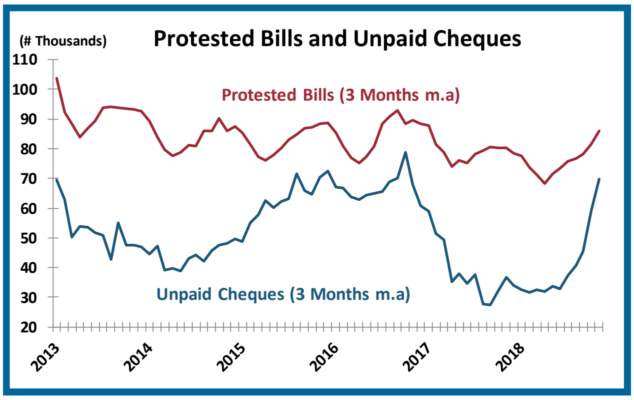




Loan to deposit ratio (LDR) and TL LDR decreased to 116% and 138%, respectively.

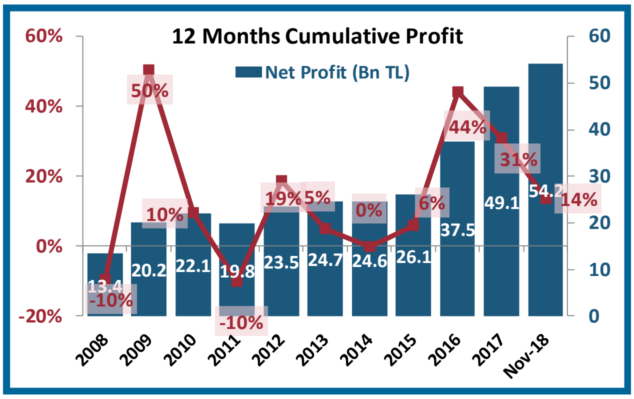
Loan Quality

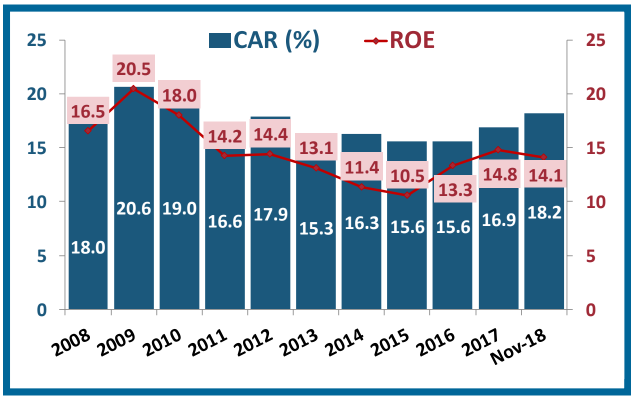




Headline NPL ratio for the banking sector rose moderately to 3.7% from 3% in 2017YE.

P & L





As of November 2018, 12 months cumulative profit increased YoY by 14% to TL 54 bn. RoE of the sector decreased slightly to 14.1%.